

General Supervision

INTRODUCTION

The foundation of a firm's supervisory system is its written supervisory manual, also known as the firm's policy and procedures manual. All members are required to have a policy and procedures manual that outlines the supervisory structure of the firm and that designates a principal to be responsible for each business area of supervision. The policy and procedures manual must include the title, location, and registration status of all supervisors, and a copy of the manual must be kept in each office of the firm where supervised activities are conducted. The purpose of the written policy and procedures manual is to ensure compliance with the firm's rules, as well as the rules of the industry. The manual must be updated to reflect the adoption of new policies, a change in personnel, or new industry regulations. The manual must also clearly outline the way the periodic compliance examinations are conducted and documented. Both the SEC and FINRA can take action against a firm or principal for failing to supervise its operations and agents.

THE ROLE OF THE PRINCIPAL

Prior to any firm being admitted as a member of FINRA, it must have at least two principals to supervise the activities of the firm. At a minimum, one must be a principal to supervise employees and the other must be a financial

operations principal, or FINOP, to supervise the financial and operational activities of the firm. It is the principal's responsibility to ensure that all rules in the policy and procedures manual are followed by the firm's employees. It is also the responsibility of the principal to review and approve all of the following:

- New accounts.
- Retail communications.
- Transactions.

The principal reviews and approves the above listed items in writing by signing or initialing the item. In the case of transactions, a principal may initial each ticket or initial a daily trade run. This supervisor's initials will evidence the fact that the trades have been reviewed and approved. There is no requirement that a principal approve a trade prior to its execution, but the trade must be reviewed and approved promptly. Each registered representative must be assigned to a specific supervisor. A principal of a member firm who fails to supervise the actions of the agents under his or her control may be subject to action by both FINRA and the SEC. A principal will not be subject to action if there are written procedures in place that are designed to detect and prevent violations. These procedures must have been enacted, and the supervisor must not have reason to believe the system is not operating properly. Additionally, the principal will not be found to have failed to supervise if an agent has employed extreme measures to conceal his or her actions. Each member firm must designate a principal to review the firm's supervisory system. This person is responsible for recommending changes in the system to the firm's senior management, and this person must be identified to FINRA as the principal in charge of reviewing the firm's compliance systems.

SUPERVISOR QUALIFICATIONS AND PREREQUISITES

People who supervise or train agents generally must register as a principal with FINRA and qualify by training or experience. Prior to taking a principal exam, the individual must have successfully completed the appropriate registered representative examination. A principal of a FINRA member firm conducting business in mutual funds and variable contracts will usually take the Investment Company and Variable Contracts Limited Principal exam, known as the Series 26. Series 26 principals may manage or supervise the

firm's business in investment company products and variable contracts. A Series 26 does not qualify an individual as a:

- General securities principal.
- General securities sales supervisor for options or municipal securities.
- Municipal securities principal.
- Financial and operations principal.
- Introducing broker dealer financial and operations principal.

All portions of FINRA-administered exams are proprietary and to be held in the strictest of confidence. FINRA considers it a violation of its rules for any individual to:

- Disclose exam questions or content to anyone.
- Reproduce exam questions.
- Receive exam questions or content from anyone.
- Compromise the content of any exam.
- Remove any portion of an exam from the exam location.

CONTINUING EDUCATION

Most registered agents and principals are required to participate in industry-mandated continuing education programs. The continuing education program consists of a firm element, which is administered by the broker dealer, and a regulatory element, which is administered by the regulators.

FIRM ELEMENT

Every FINRA member firm must identify the training needs of its covered employees and develop a written training plan based on its employees' needs at least annually. A covered employee is a registered person who engages in sales of securities to customers, trading, and investment banking and the employee's immediate supervisors. The firm, at a minimum, should institute a plan that increases the covered employees' securities knowledge and should focus on the products offered by the firm. The plan should also highlight the risks and suitability requirements associated with the firm's investment products and strategies. The firm is not required to file its continuing education plan with FINRA unless it is specifically requested to do so.

However, firms that fail to adequately document their continuing education program, including their covered agents' compliance with the program, may be subject to disciplinary action.

REGULATORY ELEMENT

All registered agents who were not registered on or before July 1, 1988, must participate in the regulatory element of the continuing education requirement. Agents subject to the requirement must complete the computer-based training at an approved facility on the second anniversary of their initial registration and every three years thereafter. The content of the exam is developed by the Securities Industry Regulatory Council on Continuing Education and is not the responsibility of the broker dealer. FINRA will notify agents 30 days prior to their anniversary date. This notification provides the agent with a 120-day window to complete the regulatory continuing education requirement. Agents who fail to complete the requirement within that period will have their registration become inactive. Agents whose registrations have become inactive may not engage in any securities business that requires a license and may not receive commissions until their registration is reactivated. Registered representatives are subject to Series 101 of the regulatory element, whereas registered principals are subject to Series 201 of the requirement. Agents who were exempt from the regulatory element as a result of having been registered for 10 years or more with a clean disciplinary history on July 1, 1998, who become the subject of a significant disciplinary action will now be required to participate in the regulatory element of the continuing education requirement. Additionally, if an agent who was exempt from the regulatory element subsequently becomes registered as a principal, that agent will become subject to the Series 201 requirement. The one-time exemption is only for the regulatory element; there is no exemption from the firm element of the continuing education program.

TAPE RECORDING EMPLOYEES

Certain firms may be subject to special supervision requirements if a significant number of their registered agents came from a firm or firms that have been disciplined by regulators. Firms that are subject to the taping rule must implement special written procedures and begin taping the conversation of its registered personnel and customers within 60 days of being notified by FINRA that the firm has become subject to the taping rule. The firm also

must implement written procedures to retain, review, and classify the recordings. Firms that fall into the following categories must tape their employees:

- Have more than five but less than 10 registered representatives and 40% or more have come from disciplinary firms within the last three years.
- Have at least 10 but less than 20 registered representatives and four or more have come from disciplinary firms within the last three years.
- Have 20 or more employees and at least 20% have come from disciplinary firms within the last three years.

A broker dealer that has been notified by FINRA that it is subject to the taping rule has a one-time option to reduce its number of registered representatives. If the firm elects to reduce a portion of the subject agents to eliminate the taping requirement, the firm may not rehire the subject agents who were eliminated for 180 days.

INFORMATION OBTAINED FROM AN ISSUER

If a broker dealer obtains information during the performance of duties to an issuer of securities, it may not use that information to solicit business. A broker dealer may obtain information from an issuer while acting as:

- An underwriter.
- A transfer agent.
- A paying agent.
- An investment banker.

CUSTOMER COMPLAINTS

All written complaints received from a customer or from an individual acting on behalf of the customer must be reported promptly to the principal of the firm. The firm is required to:

- Maintain a copy of the complaint at a supervising office of supervisory jurisdiction.
- Electronically report all complaints to FINRA within 15 days of the end of each calendar quarter. If no complaints were received, no report is due.

- Report complaints within 10 days to FINRA if the complaint alleges misappropriation of funds or securities or forgery.

The firm must maintain a separate customer complaint folder, even if it has not received any written customer complaints. If the firm's file contains complaints, the file must state what action was taken by the firm, if any, and it must disclose the location of the file containing any correspondence relating to the complaint.

 **TAKENOTE!**

A principal is required to review all written customer complaints, but there is no required time frame to respond or take action.

INVESTOR INFORMATION

All broker dealers that carry customer accounts must send their customers information detailing FINRA's public disclosure program at least once per calendar year. The information must contain the program's 800 number, FINRA's website address, and a statement that an investor brochure includes the same information and is available.

MEMBER OFFICES

As a member's business grows, it will often wish to open new offices. The classification of the additional offices depends on the type of activity that is conducted. A member may open three types of offices:

- An office of supervisory jurisdiction (OSJ).
- A branch office.
- A satellite office.

OFFICE OF SUPERVISORY JURISDICTION

A member firm must inform FINRA which offices it has identified as being an office of supervisory jurisdiction (OSJ). An OSJ is any office that conducts one or more of the following activities at that location:

- Has custody of customer funds or securities.
- Has final approval for retail communications.

- Has final approval of customer accounts.
- Reviews and approves customer orders.
- Executes orders or makes markets in securities.
- Forms or structures offerings.
- Supervises employees at other branch offices.

At least one resident principal must manage the OSJ. The resident principal must enforce the policies and procedures of the firm, review all customer activity, and inspect the branch offices within his or her jurisdiction.

 **TAKENOTE!**

A copy of the firm's policy and procedures manual as well as a copy of the FINRA manual must be kept in each OSJ. The FINRA manual must be made available to a customer upon request.

BRANCH OFFICES

A branch office is any location that is identified to the public as being a place where the member conducts business but does not engage in any of the activities that would require it to be considered an OSJ. Branch offices are inspected by an OSJ. A branch office may operate without a resident principal. A registered representative may act as the branch manager. The supervisory responsibility is with the OSJ.

SATELLITE OFFICES

A satellite office is usually a smaller office that does not meet the definition of a branch. A satellite office may not have any signs or advertising. The home office of a registered representative who works out of his or her house would be considered a satellite office.

ANNUAL COMPLIANCE REVIEW

At least once per year the member must conduct a compliance review of each OSJ and each registered representative. Branch offices are not required to be directly reviewed. When the member reviews the OSJ, the member is automatically inspecting the activities of the branch offices under the jurisdiction of the OSJ.

BUSINESS CONTINUITY PLAN

One of the regulations developed as a result of the attack on 9/11 is the requirement for FINRA member firms to develop and maintain plans and backup facilities to ensure that the firm can meet its obligations to its customers and counterparties in the event that its main facilities are damaged, destroyed, or are inaccessible. The plan must provide for alternative means of communication as well as a data backup. The plan must be approved by a senior member of the firm's management team and provide plans to ensure that customers have access to their funds. The plan must be provided to FINRA upon request and must identify two members of senior management as emergency contacts, one of which must be a registered principal with the firm.

CURRENCY TRANSACTIONS

All member firms must guard against money laundering. Every member must report any currency receipt of \$10,000 or more from any one customer on a single day. The firm must fill out and submit a Currency Transaction Report (CTR), also known as Form 4789, to the Internal Revenue Service (IRS) within 15 days of the receipt of the currency. Multiple deposits that total \$10,000 or more will also require the firm to file a CTR. Additionally, the firm is required to maintain a record of all international wire transfers of \$3,000 or greater.

THE PATRIOT ACT

The Patriot Act requires broker dealers to have written policies and procedures designed to detect suspicious activity. The firm must designate a principal to ensure compliance with the firm's policies and to train firm personnel. The firm is required to file a Suspicious Activity Report (SAR) for any transaction of more than \$5,000 that appears questionable. Anti-money-laundering rules require that all firms implement a customer identification program to ensure that the firm knows the true identity of its customers. All customers who open an account with the firm, as well as individuals with trading authority, are subject to this rule. The firm must ensure that its customers do not appear on any list of known or suspected terrorists. A firm's anti-money-laundering program must be approved by senior management.

The money-laundering process begins with the placement of the funds. This is when the money is deposited in an account with the broker dealer. The second step of the laundering process is known as layering. The layering

process will consist of multiple deposits in amounts less than \$10,000. The funds will often be drawn from different financial institutions; this is known as structuring. The launderers will then purchase and sell securities in the account. The integration of the proceeds back into the banking system completes the process. At this point, the launderers may use the money, which appears to have come from legitimate sources, to purchase goods and services. Firms must also identify the customers who open the account and make sure that they are not conducting business with anyone on the OFAC list. This list is maintained by the Treasury Department's Office of Foreign Assets Control. The list consists of known and suspected terrorists, criminals, and members of pariah nations. Conducting business with anyone on this list is strictly prohibited. Registered representatives who aid the laundering of money are subject to prosecution and face up to 20 years in prison and a \$500,000 fine per transaction. The representative does not even have to be involved in the scheme or even know about it to be prosecuted.

U.S. ACCOUNTS

Every member must obtain the following from U.S. customers:

- A Social Security number/documentation number.
- Date of birth.
- Address.
- Place of business.

FOREIGN ACCOUNTS

All non-U.S. customers must provide at least one of the following:

- A passport number and country of issuance.
- An alien ID number.
- A U.S. tax ID number.
- A number from another form of government-issued ID and the name of the issuing country.