

NASD Notice to Members 98-38

NASD Reminds Members Of Supervisory And Inspection Obligations

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Executive Summary

National Association of Securities Dealers, Inc., (NASD[®]) rules require that members supervise each of their associated persons, regardless of their location, compensation arrangement, or registration status. This *Notice* addresses firm obligations to supervise associated persons located in Offices of Supervisory Jurisdiction (OSJs), branch offices, and all other offices (referred to in this *Notice* as “unregistered offices”) and to inspect these offices. This *Notice* supersedes the guidance on inspections set forth in *Notice to Members 86-65*.

Due to the significance of the issues discussed in this *Notice*, the NASD strongly urges each member to duplicate this *Notice* and distribute it individually to all associated persons working in unregistered offices and to all persons with supervisory responsibility for unregistered offices, no matter where such persons may be located. In addition, the NASD recommends that members that have unregistered offices include this *Notice* in their compliance manual and discuss the *Notice* at their annual compliance meetings with registered representatives under NASD Rule 3010(a)(7).

Questions concerning this *Notice* may be directed to the following individuals in NASD Regulation, Inc. (NASD RegulationSM): Daniel M. Sibears, Department of Member Regulation, at (202) 728-6911; Lawrence N. Kosciulek, Department of Advertising/Regulation, at (202) 278-8329; or Mary Dunbar, Office of General Counsel, at (202) 728-8252.

Background And Discussion

Some NASD members employ associated persons at offices that are not designated OSJs or registered as branch offices.¹ For purposes of this *Notice*, such offices are referred to

as “unregistered offices,” and include any location at which a member is conducting a securities business that does not fall within the definition of OSJ or branch office.² Some associated persons working in these unregistered offices are involved in other business enterprises, such as insurance, real estate sales, accounting, tax planning, or investment advisory services, and consequently may be classified for compensation purposes as part-time employees or independent contractors.³ Some unregistered offices also operate as separate business entities under names other than those of the members. While the NASD does not encourage or discourage such arrangements, a large number of geographically diverse offices presents the potential that sales practice problems will not be as quickly identified as would be the case for larger, centralized branch offices. Such potential needs to be taken into account in drafting supervisory procedures.

The purpose of this *Notice* is to remind members of their supervisory and inspection obligations for all of their associated persons and offices. Member firms must supervise all of their associated persons—regardless of location, compensation or employment arrangement, or registration status—in accordance with the NASD By-Laws and Rules.⁴ The fact that an associated person conducts business at an unregistered office or is compensated as an independent contractor does not alter the obligations of the individual and the firm to comply fully with all applicable securities regulatory requirements.

NASD Rule 3010(a) sets forth the basic duty of a member firm to establish and maintain a system to supervise properly the activities of each registered representative and associated person.⁵ Although the rule does not prescribe specific supervisory

procedures to be followed by all firms, it sets forth minimum requirements for a supervisory system and mandates that the supervisory system adopted enable a firm to supervise properly the activities of each associated person to assure compliance with applicable securities laws, rules, regulations, and statements of policy and with NASD rules. Thus, the adequacy of a firm's supervisory system is evaluated based on its structure and activities.

Firms employing associated persons in unregistered offices are responsible for establishing and carrying out procedures that will subject persons working at these locations to effective supervision. To be effective, the supervision must be designed to monitor securities-related activities and to detect and prevent regulatory and compliance problems of associated persons working at unregistered offices. A member's supervisory responsibility includes:

1. maintaining a record of the locations of all unregistered offices, which must be made available to regulators upon request;
2. educating associated persons working from an unregistered office as to their obligations to the firm and to the public, including prohibited sales practices;
3. maintaining regular and frequent professional contact with such individuals; and
4. implementing appropriate supervisory practices, such as records inspections and compliance audits at the associated persons' places of employment, to ensure that their methods of business and day-to-day operations comply with applicable rules and requirements.

To fulfill these obligations, a firm should consider whether the number

and location of its registered principals provides the capability to supervise its unregistered office personnel effectively.⁶

Rule 3010(c) imposes upon a member the obligation to review the activities of each office, which includes the periodic examination of customer accounts to detect and prevent irregularities and abuses. The rule requires an inspection at least annually of each OSJ and cycle examinations of branch offices. Although the rule does not specify the frequency of inspections for unregistered offices, in order to fulfill the general obligation to supervise, such inspections should be conducted according to a regular schedule. The frequency and scope of inspections should be determined based on factors such as the nature and volume of business conducted at the office and the nature and extent of contact with customers, for example. Any member that currently does not have a regular schedule for inspecting unregistered offices should adopt one no later than September 1, 1998.

As noted above, under Rule 3010(g)(1), an office that is responsible for supervising one or more branch offices must be designated as an OSJ, and each OSJ is subject to an annual inspection under Rule 3010(c). The rule does not address the frequency of inspections of a non-OSJ office that supervises one or more unregistered offices. A non-OSJ office that supervises one or more unregistered offices also should be inspected at least annually.

Inspections of unregistered offices should include, among other things, a review of any on-site customer account documentation and other books and records, meetings with individual registered representatives to discuss the products they are selling and their sales methods, and an examination of correspondence and

sales literature. Unannounced visits may be appropriate, particularly where there are indicators of misconduct or potential misconduct, or "red flags," such as receipt of significant customer complaints; personnel with disciplinary records; or excessive trade corrections, extensions, liquidations, or variable contract replacements.⁷ Each firm should determine which other red flags would trigger an unannounced inspection based on the type of business and personnel located at its unregistered offices. Members should note that, in the Securities and Exchange Commission's (SEC or Commission) decision *In re Royal Alliance Associates, Inc.*, Release No. 34-38174 (January 15, 1997), which is quoted more extensively below, the SEC stated that it harbored grave doubts that a practice of conducting a pre-announced compliance examination only once a year would necessarily discharge the supervisory obligations of any firm that incorporates a structure in which smaller offices are operated by only one or two representatives.

Royal Alliance emphasized the need for close attention to supervision of small, dispersed offices. In that decision, which members are encouraged to read in its entirety, the SEC stated that:

The securities industry should be on notice . . . that where a firm employs branch offices made up of only one or two registered representatives and those individuals engage in misconduct, the Commission will, as it does for all firms, closely examine the responsibility of individuals charged with the duty to design and implement an adequate system of supervision.

Many failure-to-supervise cases involve indicators of misconduct, or "red flags," that should immediately alert management to potential wrongdoing. In circumstances

where a firm's compliance and supervision system is inadequate to discover the indications of problematic conduct, the personal responsibility for supervision cannot be fulfilled by a supervisor who is simply unaware of the indicators.

As discussed above, Royal Alliance operates 1,500 offices with 2,700 registered representatives. Some 49 of these are one-person Offices. Here, Royal Alliance's failure to scrutinize adequately the securities-related businesses of its registered representatives, which were conducted beyond the direct aegis of the firm, was a certain recipe for trouble. Further, Royal Alliance's practice of conducting a pre-announced compliance examination only once a year was inadequate to satisfy its supervisory obligations. . . .

We do not here suggest that firms which employ offices consisting of one or two registered representatives cannot devise an adequate system of supervision, nor do we discourage such offices. We recognize that many smaller communities are well served by such arrangements and generally cannot support a large office. Nevertheless, such arrangements necessarily entail greater supervisory challenges and the Commission requires firms organized in such a fashion, and individual supervisors at those firms, to meet the same high standards of supervision as at more traditionally organized firms.

The reference to branch offices in the above quote is generic and is not limited to NASD-registered branch offices. Thus, the SEC's guidance is equally applicable to NASD branch offices and unregistered offices.

Endnotes

¹ The terms "OSJ" and "branch office" are defined in Rule 3010(g). Under Rule 3010(g)(1), "Office of Supervisory Jurisdiction" means any office of a member at which any one or more of the following functions take place: order execution or market making; structuring of public offerings or private placements; maintaining custody of customers' funds or securities; final acceptance (approval) of new accounts on behalf of the member; review and endorsement of customer orders pursuant to Rule 3010(d); final approval of advertising or sales literature for use by persons associated with the member pursuant to Rule 2210(b)(1); or responsibility for supervising the activities of persons associated with the member at one or more other branch offices of the member.

Under Rule 3010(g)(2), "branch office" means any location identified by any means to the public or customers as a location at which the member conducts an investment banking or securities business, excluding:

(A) any location identified in a telephone directory line listing or on a business card or letterhead, which listing, card, or letterhead also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch locations are directly supervised;

(B) any location referred to in a member advertisement, as this term is defined in Rule 2210, by its local telephone number and/or local post office box provided that such reference may not contain the address of the non-branch location and, further, that such reference also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch location are directly supervised;

(C) any location identified by address in a member's sales literature, as this term is defined in Rule 2210, provided that the sales literature also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s)

conducting business at the non-branch locations are directly supervised; or

(D) any location where a person conducts business on behalf of the member occasionally and exclusively by appointment for the convenience of customers, so long as each customer is provided with the address and telephone number of the branch office or OSJ of the firm from which the person conducting business at the non-branch location is directly supervised.

² The term "unregistered office" is not defined in the NASD By-Laws or Rules.

³ Independent contractors under the control of a broker or dealer are considered associated persons for purposes of the NASD By-Laws and Rules. See letter from Douglas Scarff, Director, Division of Market Regulation, Securities and Exchange Commission, to Gordon S. Macklin, President, National Association of Securities Dealers, June 18, 1992, forwarded to all NASD members on August 25, 1982.

⁴ This obligation derives from Section 15(b)(4)(E) of the Securities Exchange Act of 1934.

⁵ Article I of the NASD By-Laws defines the term "person associated with a member" or "associated person of a member" to mean: (1) a natural person registered under the Rules of the Association; or (2) a sole proprietor, partner, officer, director, or branch manager of a member, or a natural person occupying a similar status or performing similar functions, or a natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration with the NASD under the NASD By-Laws or the Rules of the Association.

⁶ If a member wishes to establish new or additional branch offices or unregistered offices, and the number of such offices is restricted under an agreement with the NASD, NASD staff will analyze the member's ability to effectively manage and super-

vise such offices under the standards contained in Rule 1014(a).

⁷ Firms also are reminded that certain red flags may trigger heightened supervisory obligations for registered representatives. *See Notice to Members 97-19.*

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