

Heightened Supervision

Guidance on Implementing Effective Heightened Supervisory Procedures for Associated Persons With a History of Past Misconduct

Summary

FINRA is publishing this *Notice* to reiterate the supervisory obligations of member firms regarding associated persons with a history of past misconduct that may pose a risk to investors. FINRA Rule 3110 (Supervision) requires member firms to establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and FINRA rules. An effective supervisory system plays an essential role in the prevention of sales abuses, and thus, enhances investor protection and market integrity. As such, FINRA has long emphasized that member firms have a fundamental obligation to implement a supervisory system that is tailored specifically to the member firm's business and addresses the activities of all its associated persons. This *Notice* highlights particular instances where heightened supervision of an associated person may be appropriate. Firms are encouraged to adopt the practices that are outlined in this *Notice* to strengthen their own supervisory procedures, as appropriate to their business.

This *Notice* is one of several FINRA initiatives focused on associated persons with a history of past misconduct that pose a risk to investors and the firms that employ them. These initiatives are designed to strengthen oversight of such associated persons and firms through a combination of guidance, rule changes, and FINRA examination and surveillance programs. FINRA also is simultaneously issuing *Regulatory Notice 18-16* seeking comment on proposed rule amendments to further efforts to protect investors.¹

Questions concerning this *Notice* should be directed to Kosha Dalal, Associate Vice President and Associate General Counsel, Office of General Counsel (OGC), at (202) 728-6903 or kosha.dalal@finra.org.

April 30, 2018

Notice Type

- ▶ Guidance

Suggested Routing

- ▶ Compliance
- ▶ Legal
- ▶ Operations
- ▶ Registered Representatives
- ▶ Senior Management

Key Topics

- ▶ Heightened Supervision
- ▶ Supervision

Referenced Rules & Notices

- ▶ FINRA Rule 3110
- ▶ Notice to Members 97-19
- ▶ Notice to Members 98-38
- ▶ Regulatory Notice 18-16

Background & Discussion

FINRA administers comprehensive regulatory programs designed to help our members maintain trust in the financial markets. These programs serve multiple purposes in advancing FINRA's mission of protecting investors and market integrity—including promoting compliance with applicable rules, creating a level playing field, and enhancing transparency and access to information. One of their most important purposes is to protect investors from bad actors: those who seek to evade regulatory requirements and harm investors for their own personal gain. FINRA continues to evaluate and augment its regulatory programs to better identify and supervise potential bad actors.

Member firms also have a key role to play in protecting investors from bad actors. While FINRA believes that the vast majority of registered representatives seek to serve their clients in accordance with all applicable regulatory requirements, ongoing vigilance by member firms is critical. Member firms should be reviewing and updating their supervisory systems and procedures for hiring practices, monitoring brokers and investigating red flags suggestive of misconduct. FINRA requires member firms to establish and maintain supervisory systems for each of their associated persons and to test and verify annually that they have established reasonable procedures, including procedures for heightened supervision of associated persons, where necessary. FINRA and the SEC have emphasized the need for heightened supervision when a member firm associates with persons who have a history of industry or regulatory-related incidents.² These heightened supervisory procedures are a critical element in a member firm's supervisory system. As such, it is essential that firms monitor the histories of their associated persons and establish heightened measures to supervise the activities of those associated persons with greater potential of creating customer harm.

FINRA previously issued guidance regarding the application of heightened supervisory plans for associated persons with a history of industry or regulatory-related incidents.³ For example, a firm that hires an associated person with a recent history of customer complaints, disciplinary actions involving sales practice abuse or other customer harm, or adverse arbitration decisions should determine whether it needs special supervisory procedures for that associated person, or whether its existing supervisory procedures are sufficient to address the circumstances.⁴ Firms also should make this determination where an associated person, during his or her employment with the firm, develops a history of problems.

Member firms often serve as the first line of defense against customer harm through establishing and maintaining effective supervisory systems, particularly with regard to associated persons who may pose higher risks of causing customer harm. In order to provide additional guidance to firms, FINRA has identified certain circumstances under which firms are encouraged to consider implementing heightened supervisory procedures for an associated person.⁵ Implementation of the suggested recommendations may

help to reduce future customer harm by brokers; however, the recommendations below are not intended to be an exhaustive list of circumstances firms should consider when determining whether to implement heightened supervisory procedures. Moreover, a firm's implementation of the recommendations in and of themselves would not necessarily satisfy its obligations under Rule 3110(a) to establish and maintain a supervisory system reasonably designed to achieve compliance with applicable securities laws and applicable FINRA rules or other obligations that may arise under FINRA rules.

Heightened Supervisory Procedures

A firm should routinely evaluate its supervisory procedures to ensure they are appropriately tailored for each associated person and take into consideration, among other things, the person's activities and history of industry and regulatory-related incidents. When an associated person of the firm has a history of industry or regulatory-related incidents, the firm must make a reasonable determination as to whether its standard supervisory and educational programs are adequate to address the issues such person's history raises or whether the firm should develop tailored heightened supervisory procedures to address such issues. The failure to assess the adequacy of its supervisory procedures in light of an associated person's history of industry or regulatory-related incidents would be closely evaluated in determining whether the firm itself should be subject to disciplinary action for a failure to supervise should that person be the subject of a future industry or regulatory-related incident.

A. Identifying Individuals for Heightened Supervision

In identifying which associated persons to place on heightened supervision, firms should consider, among other things, customer-related regulatory actions; criminal matters; the firm's pre-registration investigation; internal investigations; firm-imposed discipline; disciplinary actions; final, pending and settled arbitrations; past, open or settled customer complaints; terminations for cause; and other items disclosed on the person's uniform registration forms.⁶ While final adverse adjudicated matters such as disciplinary actions, criminal matters and arbitrations clearly indicate a disciplinary problem, a pattern of unadjudicated matters, such as unadjudicated customer complaints, also may be indicative of a history that should be carefully reviewed.

In addition, FINRA believes that the following two circumstances raise significant investor protection concerns, and firms should evaluate the facts and circumstances to make a determination of whether heightened supervision would be appropriate.⁷

▶ *Heightened Supervision of Statutorily Disqualified Persons During Eligibility Review Process*

Currently, if an associated person who has an industry or regulatory-related event that qualifies as a statutory disqualification (SD) under the Securities Exchange Act of 1934 (Exchange Act) wants to continue associating with a member firm, he or she must undergo a FINRA eligibility proceeding.⁸ Under FINRA's current rules, a person who becomes statutorily disqualified while associated with a member firm is allowed to remain associated with that member firm during FINRA's review process, so long as the member firm promptly files a Form MC-400 application (SD Application). In reviewing an SD Application, FINRA can seek to prevent the statutorily disqualified person from associating with a member firm or can permit the statutorily disqualified person to associate with a member firm if it is consistent with the public interest and protection of investors. Generally, where FINRA permits the statutorily disqualified person to associate or continue association with a member firm, FINRA will condition the association on the establishment of certain safeguards, including the adoption and implementation of a heightened supervisory plan by the member firm of the person's business activities. To further promote investor protection, member firms should consider adopting and implementing an interim plan of heightened supervision for any statutorily disqualified person associated with the firm once the SD Application is filed with FINRA and to keep such heightened supervisory plan in place while the review is pending. FINRA believes heightened supervision may be appropriate for such persons because they have already been statutorily disqualified, and, in nearly every case, the continued association of a statutorily disqualified person approved through a FINRA eligibility proceeding is conditioned on the individual being subject to a robust heightened supervision plan.

▶ *Heightened Supervision of Persons While Disciplinary Case Is On Appeal*

Currently, when an associated person or member firm in a litigated disciplinary case appeals a Hearing Panel decision to the National Adjudicatory Council (NAC), sanctions are generally stayed pending an appeal.⁹ In cases where the Hearing Panel has rendered a decision making a finding of violation against the associated person and where an appeal is filed, to further promote investor protection, firms should consider adopting and implementing an interim plan of heightened supervision for such associated person and keep such heightened supervisory plan in place while the appeal is pending. FINRA believes heightened supervision may be appropriate for such persons because they have already been found to have violated a rule.

B. Developing and Implementing a Heightened Supervision Plan

Once a firm determines that heightened supervision is necessary, the firm should develop written, tailored heightened supervisory procedures designed to address the nature of the particular concerns the associated person's incident history raises and the nature of such person's ongoing activities. When developing a heightened supervision plan, the firm should determine the parameters of the plan on a case-by-case basis for each associated person that the firm has identified as requiring heightened supervision.

In making this determination, a firm should consider whether the nature of the concerns the associated person's incident history raises involved a particular product, customer type or activity. In any of these instances, the firm should examine the product, customer type or activity to identify the level and type of risk it presents. The firm should then determine what type of supervision might best control and limit this type of risk. The plan should reflect a firm's reasonable consideration of how to effectively supervise the individual through tailored provisions designed to prevent and deter future incidents.

FINRA has provided a number of factors that firms should consider including in a heightened supervision plan. Firms are cautioned that these factors are neither exhaustive nor will they constitute a safe harbor for FINRA rules. Based on staff experience, FINRA believes effective heightened supervision plans should include, at a minimum:

- ▶ designating a principal with the appropriate training and experience to implement and enforce the plan;
- ▶ requiring appropriate additional training for the associated person subject to the plan to address the nature of incidents resulting in the plan;
- ▶ requiring the written acknowledgment of the heightened supervisory plan by the associated person subject to the plan and the designated supervisory principal; and
- ▶ periodically reviewing the heightened supervision plan to assess its effectiveness.

In addition to these minimum provisions, FINRA has seen, among other things, effective heightened supervision plans that provide for:

- ▶ heightened supervision of the associated person's business activities, including customer-related activities, employee personal trading accounts, outside business activities and private securities transactions;
- ▶ proximity of the supervisor to the associated person;
- ▶ more frequent contact between the supervisor and the associated person;
- ▶ more frequent review of the associated person's communications, particularly with customers;
- ▶ more frequent monitoring or inspection of the associated person's office(s); and
- ▶ expediting the handling of customer complaints related to the associated person.

A member firm's supervisory system is critical to protecting investors and market integrity, particularly where persons associated with the firm have a history of industry or regulatory-related incidents. It is essential that firms monitor the regulatory histories of their associated persons and establish additional measures to supervise the activities of those individuals with greater potential of creating customer harm. The implementation of heightened supervision does not diminish the importance of a member firm's overall supervisory obligations. Member firms must continue to have supervisory systems reasonably designed to ensure compliance with applicable securities laws and FINRA rules for each type of business conducted by the firm and its associated persons.

Endnotes

1. See *Regulatory Notice 18-16* (FINRA Requests Comment on FINRA Rule Amendments Relating to High-Risk Brokers and the Firms that Employ Them) (April 2018). In connection with our on-going efforts to address high-risk brokers, FINRA also will be publishing revised Sanction Guidelines shortly.
2. See, e.g., *Dep't of Enforcement v. J. Alexander Sec., Inc.*, No. CAF010021, 2004 NASD Discip. LEXIS 16, at *51 (NAC Aug. 16, 2004), *aff'd sub nom. Robert J. Prager*, Exchange Act Rel. No. 51974, 2005 SEC LEXIS 1558 (July 6, 2005); *Signal Sec., Inc.*, Exchange Act Rel. No. 43350, 2000 SEC LEXIS 2030, at *17 (Sept. 26, 2000); *James Harvey Thornton*, 53 S.E.C. 1210, 1216 (1999); *Consolidated Inv. Serv., Inc.*, 52 S.E.C. 582, 588-89 (1996); *Notice to Members 97-19* (April 1997); *Notice to Members 98-39* (May 1998).
3. See *Notice to Members 97-19* (stating that a member firm with a registered representative who develops a history of customer complaints, final disciplinary actions involving sales practice abuse or other customer harm, or adverse arbitration decisions should consider developing special supervisory procedures for that registered representative); and *Notice to Members 98-39* (indicating that unexpected supervisory visits to offices with personnel who have disciplinary records may be appropriate). See also, Robert W. Cook, President and CEO, FINRA, Address at the McDonough School of Business, Georgetown University: Protecting Investors From Bad Actors (June 12, 2017), available at www.finra.org/newsroom/speeches/061217-protecting-investors-bad-actors; and FINRA 2018 Regulatory and Examination Priorities Letter (January 8, 2018), available at www.finra.org/industry/2018-regulatory-and-examination-priorities-letter.

4. See FINRA Rule 3110(e), which requires a firm to ascertain by investigation the good character, business reputation, qualifications and experience of an applicant before it registers that applicant with FINRA. Firms are advised to consider all available information gathered in the pre-registration process for this purpose, including Form U4 and U5 responses, searches of the CRD system, fingerprint results, private background checks and communications with previous employers. In addition, FINRA strengthened the background check obligations of firms by requiring firms to adopt written procedures reasonably designed to verify the accuracy of completeness of the information contained in the applicant's Form U4. See also *Notice to Members 97-19*.
5. FINRA also requires heightened supervision in some cases when a firm hires numerous individuals from a disciplined firm. In such cases, a firm can become a "taping firm," and be required to tape record all of its registered persons' phone calls with investors. See FINRA Rule 3170 (Tape Recording of Registered Person by Certain Firms).
6. See the Uniform Application for Securities Industry Registration or Transfer (Form U4), the Uniform Termination Notice for Securities Industry Registration (Form U5) and the Uniform Disciplinary Action Reporting Form (Form U6).
7. See *Regulatory Notice 18-16* (April 2018), in which FINRA is seeking, among other things, comment on proposals to require mandatory heightened supervision in the two instances described.
8. Events triggering statutory disqualification include, for example, certain enumerated misdemeanor and all felony criminal convictions for a period of ten years from the date of conviction; temporary and permanent injunctions (regardless of their age) involving a broad range of unlawful investment activities; bars (and current suspensions) ordered by the SEC or a self-regulatory organization (SRO); and findings that a person willfully has made or caused to be made false statements of a material fact to an SRO. See Sections 3(a)(39) and 15(b)(4)(A) of the Exchange Act; FINRA By-Laws Article III, Section 4. Persons who are or become subject to a statutory disqualification may seek to enter, re-enter, or in the case of incumbents, continue in the securities industry.
9. See FINRA Rule 9311(b).