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DESIGNING AN EFFECTIVE RETAIL SURVEILLANCE PROGRAM

Effective surveillance systems are now risk-based and exception-driven, allowing compliance issues to be identified across every aspect of a broker-dealer's business. The authors describe five essential steps in the design and implementation of such systems and provide a checklist of exception reports that are accepted in the industry.

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One of the fundamental elements of a broker-dealer's system of supervision and compliance required by Financial Industry Regulatory Authority ("FINRA") Rules is a surveillance program reasonably designed to monitor and provide exception information regarding the firm's business. An important concept under the rules is the distinction between a supervisory system and written supervisory procedures. FINRA Rule 3010 (and NYSE Rule 342) establishes the broker-dealer's obligations to establish both a supervisory system and written supervisory procedures. The written supervisory procedures document the established system, and although not expressly required by the Rule, the system necessarily will include elements such as automated exception reports and surveillance programs that monitor for unusual activity tailored specifically to the broker-dealer's business.¹ FINRA Rule 3012 requires that broker-dealers have a system to test and verify that its supervisory procedures are:

Reasonably designed with respect to the activities of the member and its registered representatives and associated persons to achieve compliance with applicable

securities laws and regulations, and with applicable NASD rules, and to amend those supervisory procedures when the testing and verification demonstrate a need to do so. Rule 3012 also requires that a member's supervisory control policies and procedures include, among other things, procedures that are reasonably designed to review and supervise the customer account activity conducted by a member's producing managers.²

¹ FINRA Notice to Members 99-45, "NASD Provides Guidance On Supervisory Responsibilities" (June 1999) (hereafter "NtM 99-45"), p. 294. See also "FINRA Compliance Tools: Improving Examination Results" (May 2006), available at www.finra.org.

² Rel. No. 34-52799 (2005), "Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change and Amendment Nos. 1 and 2 Thereto Relating to Amendments to the Rule regarding Supervisory Control Systems, Rule 3012, To Require Notification of Reliance on 'Limited Size and Resources' Exception." The amendments to NASD Rule 3012 became effective January 31, 2005. Rule 3012 was subsequently further amended on February 14, 2006, to reflect an exception for member firms of "limited size and resources." See also NtM 06-04, "SEC Approves Amendments to NASD Rule 3012 to Require Members Relying on Rule 3012's 'Limited Size and Resources' Exception to Notify NASD of their Reliance; Effective Date: February 14, 2006" (January 2006).

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IN THIS ISSUE

• **DESIGNING AN EFFECTIVE RETAIL SURVEILLANCE PROGRAM**

Thus, for firms conducting business with retail customers, a retail surveillance program must provide compliance officials and supervisors with the tools necessary to meet the regulatory requirement that firms establish, maintain, test, verify, and enforce a supervisory control system.

Designing an effective retail surveillance program is an important process that requires adequate planning, analysis, and implementation, with a focus on firm-specific factors. As the SEC Staff has explained in a related context:

Each firm's programs should take into account firm-specific factors, for example – its organizational structure, operating units, size and geographic dispersion, types of business activities and product lines, and its customer base. Other relevant factors are: operations and technology, reporting systems, legal and regulatory issues, experience and disciplinary records of personnel, and market conditions.³

While the ultimate responsibility for the proper system of supervision cannot be delegated to those outside the firm, as FINRA has noted, this responsibility does not preclude a broker-dealer from implementing a system designed by an outside vendor, or even another broker-dealer. This could include, for example, acquisition of computer software programs to conduct surveillance of various retail brokerage activities as long as the firm was satisfied that the technology was current and fit the needs of the firm.⁴

Designing a program should be treated like any important project undertaking: Design a project plan; state the goals of the project; identify those responsible for the various elements of the plan; describe what you expect the outcome to be; and establish a schedule for delivering the final plan. The same care must be used in assessing gaps in the program and in maintaining the currency of the program. As the Securities Industry Association (now the

Securities Industry and Financial Markets Association) explained in its “White Paper on The Role of Compliance”:

Effective compliance programs require continuous review and updating, particularly in light of new risks.... As new rules and regulations are proposed, the Compliance Department must evaluate those proposals and their impact on the firm and its compliance program. An important facet of program assessment is the identification and remediation of gaps in supervisory and compliance systems, and the testing and verification of control systems. New regulations have placed [additional] responsibility on senior management to certify that processes are in place and are reasonably designed to ensure compliance with applicable laws and regulations”.⁵

Additionally, FINRA's Sanction Guidelines specifically identify, as a principal consideration in determining sanctions, “whether, at the time of the violation, the respondent member firm had developed reasonable supervisory, operational, and/or technical procedures or controls that were properly implemented.”⁶

Design of the program

Appropriate personnel, resources, and time must be devoted to the planning and execution of the project. Traditionally, surveillance systems were reports-driven, providing a tactical, reactive approach that lacked sufficient detail. Now, effective surveillance systems are risk-based and exception-driven, allowing compliance issues to be identified through consideration of the relationships between every aspect of the retail business (*e.g.*, trades, accounts, brokers, branches). This provides a strategic, proactive approach with increased supervisory efficiencies.

³ Mary Ann Gadziala, Associate Director, Office of Compliance Inspections and Examinations, Remarks on: The Vital Role of Effective Comprehensive Compliance Controls at Broker-Dealers (February 4, 2004).

⁴ NtM 99-45 at p. 295.

⁵ Securities Industry Association, Compliance and Legal Division, “White Paper on the Role of Compliance”, p. 14, (July 2005).

⁶ “Principal Considerations in Determining Sanctions,” *available at* www.finra.org.

The five essential steps to include as part of the project plan include: assessment, evaluation, creation, implementation, and maintenance.

1. *Assessment* has several aspects. First, there must be an assessment of the business, products, and services offered by the firm in order to determine the risks faced by the firm and its clients. For example, does the firm offer traditional securities products: equities, taxable fixed-income, municipal securities, mutual funds, and insurance/annuity products? Does the firm offer customers structured products, advisory services, or non-discretionary advisory accounts? Does the firm's business or clientele have special client concerns – seniors, for example?

Second, there must be an assessment of the current tools and reports, including paper-based reports, web-based reports, tools provided by the clearing firm, and any FINRA reports used by the firm, such as the TRACE Quality of Markets Report Card.⁷ Some of the more useful exception report types are listed in the Appendix.

Third, there must be an assessment of the resources available for each aspect of the surveillance plan. For example, the firm must explore building the program in-house vs. buying the solution from a vendor. Each option has costs. Does the firm have – and will it commit – IT resources as necessary to build the system or evaluate vendors, or must that task also be outsourced?

2. *Evaluation* requires a thoughtful and careful review of the identified risks in light of the firm's experience and industry trends. Has the firm previously been the subject of regulatory action or faced examination deficiencies? What patterns and trends can be identified among the firm's industry peers that warrant consideration?

The second step in a searching evaluation is to perform a "gap analysis" to make sure the firm's planned retail surveillance program conforms to the firm's written supervisory procedures, applicable legal requirements, and industry practice. This generally requires a mapping of the applicable rules, practices, and policies as they relate to the firm's business against the firm's written procedures. Next, any gaps or deficiencies between the planned surveillance program and the firm's written procedures must be analyzed so that they may be addressed in the retail surveillance program. For example, NASD Rule 2821

requires firms to document that customers have been informed of various features unique to deferred variable annuities (including such features as the surrender period and surrender charge, potential tax penalties, mortality and expense fees, potential charges for and features of riders, and the insurance and investment components of deferred variable annuities) prior to investing in variable products. While a particular firm's written supervisory procedures may require specialized review of variable annuity transactions, the firm's surveillance program may not provide for specific review of those transactions separate from another account transaction, because variable annuities do not comprise a primary line of business for the firm. Once this gap between the firm's written procedures and its surveillance program has been identified, the firm's surveillance procedures should be revised to require the collection of information sufficient to accomplish the specialized review of variable annuity transactions, separate from other transactions, to assure compliance with the disclosure requirements set forth in the Rule.

3. The *Creation* step requires development of a well-defined concept and an end-state vision. For the concept, the main objective is to identify and prompt an ongoing dialog with the key stakeholders. They must recognize the need for a flexible program that can adjust to changing technology and should formalize this concept, including recognition of the need to continually update and improve the program, as a key priority for the organization. The concept must be communicated to staff and executive management.

Next, focus on creating a statement of the object of the program, which could be viewed as its vision statement. The goal is to develop a clear, concise vision around the future of surveillance and supervision. It is from this vision statement that the actual design of the surveillance system will flow. This design is the key deliverable in this phase of the project. To do this, key compliance, risk, and business colleagues must be fully involved in the process. In addition, IT must participate in developing the vision for the surveillance system and the system itself. An important goal is to avoid complexity.

As noted above, when designing a surveillance program, the firm's written procedures must be considered and any deficiencies addressed. The surveillance project must include development of an escalation plan with timely and effective corrective actions based upon identification of the issue, escalation of the issue to the appropriate level in the firm, and resolution of the issue with corrective action.

The identification phase is normally the product of surveillance and focuses on the exceptions. The plan must have a designation of items requiring consideration and provide for monitoring for designated items. The key to success of this phase is training of appropriate staff to

⁷ The Trade Reporting and Compliance Engine ("TRACE") is the FINRA-developed vehicle that facilitates the mandatory reporting of over-the-counter secondary market transactions in eligible fixed-income securities. See www.finra.org/RegulatorySystems/TRACE/index.htm. It is designed to bring transparency to the corporate, and other bond markets, thereby enhancing the integrity of those markets.

identify issues with emphasis on communication “up the line.”

The escalation phase requires development of a formal documented methodology. The plan should establish incident levels for mandatory reporting of incidents at the indicated level to supervisors, senior management, legal, and the Board or a Committee of Board as the incident may warrant. Finally, the firm should establish guidelines for those incidents to be reported to an SRO or the SEC and specify who is responsible for making the report.

The resolution-phase design should assure closure of the incident. Steps include analyzing the incident and documenting the action to be taken and the reasons for such action. It must include specific identification of the person(s) responsible for carrying out the corrective action and a schedule for completion. Finally, the plan should provide for identification of the persons(s) responsible for oversight monitoring of the progress of the resolution and should provide a methodology to test the corrective action plan.

4. *Implementation* of the retail surveillance plan is best approached in a series of action items. First, consider submitting the final draft of policy and system processes for legal review by inside or outside counsel. The draft should also be presented to management for review and comments. Generally, an overview, but not the details, of the plan should be given to employees when they sign an annual acknowledgement stating that they have received and reviewed the firm’s policies and procedures. Knowledge that a surveillance system is in place will provide added discipline. It is a critical but often forgotten step to update delegation of duties in the plan when necessary because of organizational changes, promotions, and terminations. All compliance department personnel changes should trigger a plan review to assure that system processes are not left unattended. Finally, any new procedures must be carried into all other applicable manuals, for example, the Operations Manual or the Branch Manager Supervision Manual.

5. *Maintenance* then becomes an every day practice. This involves monitoring for change and assessing the implication of any changes upon the surveillance plan. FINRA IM 3013(1)(b) requires firms to update policies and procedures as business, regulatory, and legislative changes and events dictate. The firm must review regulatory and statutory amendments and interpretative changes, FINRA Notices to Members, and other regulatory pronouncements. Key questions are:

- What does the amendment specifically require?
- When does the amendment go into effect?
- Who will be affected by the amendment?
- Has there been “rule-making by enforcement”?
- Are there sweep exams underway as an indication of concern?

Those responsible for the surveillance plan must stay informed of business changes. Are there new products and new business lines? Have there been changes in processing, operation, or technical systems?

The firm must revise the surveillance plan and processes as necessary and appropriate to meet these changes. Revisions must address:

- Who will supervise the activity?
- What training is needed?
- What written supervisory procedures and internal control changes are required?

As part of its internal controls, the firm should consider instituting a formal change control process.

* * *

Finally, each step in the surveillance plan project should be documented to clearly establish the methodology utilized and analysis that was performed.

CONCLUSION

Establishing an effective retail surveillance program is a substantial but essential project. The goal for the firm must be to establish a system reasonably designed to test and verify that the firm’s supervisory and operational processes are functioning normally. The key word in all of this is “reasonably”; remember the truism attributed to Carl von Clausewitz in another context: “the greatest enemy of a good plan is the dream of a perfect plan.”⁸ ■

⁸ Carl von Clausewitz, *On War* (1832).

Appendix

TYPES OF EXCEPTION REPORTS

Below are selected samples of the various reports and areas that can be included in a firm's surveillance program. As with any such undertaking, the selection of the types of reports that can be used for surveillance purposes will vary from firm to firm and will be based on the business lines, securities offered and technology available. The type of exception reports available to a firm often depends on whether the firm is self-clearing or introducing. A recent trend has been to bring in third party vendors who will deploy a rules-based system that is web based.

As noted in the text, surveillance programs generally will be either account-based or transaction-based. Over the years, numerous compliance reports have been developed in order to measure a firm's compliance using the surveillance system. In creating a surveillance system, firms should consider utilizing some or all of the following reports, which are accepted in the industry:

Selecting Accounts:

- Number of Trades
- Commissions/Equity
- Commission/Net Worth
- Turnover
- Losses
- Losses/Network
- Low Priced Securities
- Complex Product Concentration
- Mutual Fund Large Position Report
- Trade Corrections/Errors
- Large Margin Debt
- Trades Incompatible with Investment Objectives
- Similar trading in all accounts of same RR
- Credit Violations
- Syndicate Trading
- Option Trading
- Employee Trading
- Fee Charged vs. Potential Commissions
- Security Concentration
- Patterns of Mutual Fund Switches
- Patterns of 1035 Exchanges
- Pattern of Annuities in Qualified Plans
- Missing Documents
- Sector Concentrations

Selecting Transactions:

- Mutual Fund Market Timing Report
- Mutual Fund Breakpoint Report
- Mutual Fund B, C, L, R Share Reports
- Daily Mutual Fund Switch Report
- Reg 60 Reports
- 1035 Exchange Report
- AML Reports
- Blue Sky Reports
- Marking the Close Report
- Large Transactions
- Front - Running
- Registration Violations

– Solicitation Report

– Restricted List/Watch List

– Missing Documents

– Large Receipts of Securities

– Option Exception Reports

– Cross Trades

– Late Trades

Other:

– Email Review

– Complaint Reports

– Financial Advisor Top 25 Account Report

– Broker Overview Report

– Commission Rates

– Yield Rejects