Risk Management For Broker-Dealers

By Alan M. Wolper

> With the increased volume of transactions, new financial products, global marketplaces and expanding use of the internet, the nature of securities business is constantly changing and becoming more complex. As a result, a dynamic risk management function must play an essential role in assuring investor protection and the integrity of a firm's financial condition.
>
> — *FINRA Notice to Members 99-92*

I. Overview

The concept of "risk" for broker-dealers is broader today than perhaps at any point in history. Not surprisingly, risk is also potentially more expensive and difficult to deal with than ever before. The aim of this article is to provide a broad overview of certain common risks pertinent to broker-dealers, and describe the manner in which those risks can be managed, or, at least, mitigated.

II. Risk, Generally

Broker-dealers, like all businesses, live in a world of risk – operational risk, legal risk, reputation risk, managerial risk, credit risk, among others. Of course, the overarching concern – regulatory risk – is something unique to regulated entities. In many respects, management of any type of risk comes down to the same calculus faced by a broker-dealer's customers, that is, the ability to balance risk against the potential rewards. Both in theory, and typically in practice, investors make investments hoping the potential reward – profits – outweighs the risks attendant to their particular investments. Even the most naïve of investors, for example, will reluctantly concede on cross-examination at least a rudimentary understanding of the notion that stocks sometimes go up, and sometimes go down, and that there is no guarantee of a given return. Accordingly, managing that risk is central to the customer's decision in choosing his or her investments, and to the broker-dealers which recommend and monitor those investments.

Broker-dealers employ a similar analysis of risk/rewards from the moment they describe to FINRA in their new member applications the types of business they intend to conduct, through their everyday supervision of the trades effected in their customers' accounts.

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What business model will yield the greatest returns while presenting the least risk of failure? How can a compliance department, which generates zero revenues, be designed to achieve strict adherence to the rules without causing the expenses associated with that effort to mushroom out of control? While there is always a legitimate risk of a financial loss, especially in today's volatile market, the real risk broker-dealers face is the receipt of a customer complaint, or, worse, a regulatory inquiry. While these risks cannot be eliminated, they can be managed – and regulators increasingly expect broker-dealers to do so.

Aside from identifying the particular members of the firm who are responsible for managing risk and describing precisely how that function is to be carried out and documented, the most important aspect of risk management is identifying the highest risk areas for a particular firm. This depends, in large part, on factors such as the size, structure and culture of the firm, and the business lines in which the firm works.[1] Making the assessment of risk even more challenging is the fact that risk is a constantly moving target. Given the changeable nature of risk, the most effective risk management program involves regular review and reconsideration of a firm's needs.[2]

III. Risks Specific To Broker-Dealers

General risk management principles can be applied to a variety of specific issues that broker-dealers must face. As mentioned above, risks will be different for different firms, but this section explores risks common in the broker-dealer context.

A. Hiring Practices

Proper hiring practices are essential to managing and minimizing risk. But how much due diligence is necessary in investigating an employee's background? Consider that Conduct Rule 3010(e) mandates a "duty" to "investigate," but, strictly speaking, only requires that an applicant's most recent Form U-5 be reviewed. And while a principal's signature on Form U-4 serves to confirm that an applicant's prior employers for the past three years have been contacted, it is common knowledge that such communications yield relatively little beyond the dates of employment, out of fear of being accusing of defamation. Despite these seemingly modest investigative requirements, business sense suggests that more intense scrutiny at the front-end of an employment relationship may prevent many problems.

Obviously, firms should carefully investigate potential employees' prior interactions with regulators. Regulators have long memories. They may pay lip service to the notion that sanctions are designed to be remedial, but, by and large, it is questionable whether any regulator truly feels an individual with a disciplinary history can be reformed, no matter how old that history is or how unrelated it may be to some present perceived misconduct. Indeed, even absent disclosed U-4 or U-5 issues, a prospective employee's "pedigree" alone can attract undue attention from the regulators if their prior employers are notorious enough, or if there are simply too many changes in employers. And remember – just because an individual has experience does not necessarily mean they have been trained adequately, or at all. Just as registered representatives should select their customers with care (and irrespective of the size of their accounts), firms should be selective when considering who to hire (and not fall victim to the common but faulty belief that a troubled broker's ability to be "rehabilitated" is somehow directly related to the size of his book of business).

B. New Products

New products can be inherently risky, but the desire to reap the potential reward of growing the business, as well as the need to keep up with competitors who are also coming out with new products, are frequently deemed sufficient to merit the gamble. Often, the risks presented by new products can be significantly mitigated with appropriate procedures and training.

Implementing the appropriate process to "vet" new products is essential.[3] A firm's supervisory policies and procedures must be reviewed and evaluated regularly to ensure they adequately address the needs and risks associated with the new products.[4] Also, firms must properly train employees to understand the new products so those products can be presented to clients in a manner that assures sales are driven by customer needs, rather than higher payouts. Finally, and perhaps most importantly, it is critical that firms conduct follow-up evaluations to make certain the new product is performing as expected.

C. Audit issues

There are basically three ways for a firm to find itself in hot water with a regulator for a supervisory problem: a failure to have adequate written supervisory procedures, failure to follow those procedures, and/or failure to document that the procedures have been followed. Ongoing audit issues implicate all three areas, and present a potentially treacherous terrain to navigate successfully. Discussed below are a few of the more common issues encountered during routine audits.

1. Surveillance and retention of electronic communications. Conduct Rule 3010(d) requires firms not only to review all incoming and outgoing correspondence, both written and electronic, but to retain it, as well.[5] Both aspects of the rule present ample opportunity for regulatory scrutiny. Indeed, it is now commonplace to receive a request for emails during routine FINRA and SEC exams. A firm's inability to produce requested emails may provide regulators with the dreaded "low-hanging fruit" they often seek as the basis for an enforcement action.

2. Outside business activities. Broker-dealers may not appreciate the risks involved with certain outside business activities, which are governed by Conduct Rule 3030, relying on the fact that there is no sale of a security (which is governed by Conduct Rule 3040[6]). Such an assumption can be dangerous, however. For example, many firms assume that Equity Indexed Annuities, or EIAs, are strictly insurance products, and, therefore, not covered by 3040. Unfortunately, whether an EIA is a security is a determination that cannot be made easily, and will depend on the nature of each particular product.[7] The consequences of incorrectly assessing whether a product sold away from the firm is a security can be serious, with potentially staggering regulatory implications. The lesson: know what products your registered persons are selling.

3. Suitability. Before every recommended trade, broker-dealers are required to undertake two suitability analyses: first, for general suitability, i.e., is the recommended product appropriate for any investor, and, second, customer-specific suitability, i.e., is the product appropriate for the particular customer to whom the recommendation was made.[8] Broker-dealers can help to ensure they reasonably discharge this obligation by starting with the basics: effective training programs, meaningful review of daily trading blotters, and, most important, ensuring that customer account information is up-to-date, complete and accurate. There is no easier way to hand the regulators or a complaining customer a suitability case on a silver platter than by failing to ensure that a customer's stated investment objectives align with the actual trading in the account.

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4. Special problems presented by branches. Branch offices present special audit problems. The *Raymond James* case provides a striking illustration. According to FINRA, between 2000 and 2004, Raymond James permitted more than 1,000 branch managers to operate virtually unchecked. One manager in particular was found to have approved 900 of her own accounts, many of which appeared to assign an unacceptably high level of risk to the investments of her elderly clients. In February 2007, Raymond James settled the matter with FINRA for $2.75 million, and the manager in question was barred.[9]

Unfortunately, issues like this are not new. The SEC has been routinely complaining about the inadequacy of branch office compliance programs for 20 years.[10] The challenges presented by geography cannot be completely overcome by technology, regardless of the bells and whistles. This is simply all the more reason for firms to institute strong oversight systems throughout the entire company.

D. Risks created by compensation issues

Some of the problems firms encounter can be directly traced back to registered persons with a desire to sell products that provide higher payouts. Consider, as an example, the recent B-share sweep, and the resultant refunds ordered by the regulators. Largely, the B share purchases that came under scrutiny resulted not from an analysis of what was in the customers' best financial interest, but, rather, from the desire for higher commissions. Similarly, the regulators' rather vocal concern over variable

products is driven, at least in part, if not principally, by concern over the amount of commissions variables generate.

1. Sales Incentive Programs and Proprietary Products. Another obvious example of the seemingly inherent conflict between a customer's need for an appropriate investment and a financial advisor's desire to generate income arises in the context of sales incentive programs, in which payouts are increased for certain products during a particular time period. Last year, two individuals were permanently barred by FINRA and each fined about $200,000 in part for fraudulently failing to disclose to public customers potential sales incentives for selling a particular recommended stock.[11] And, in 2006, Merrill Lynch paid a $5 million fine to FINRA for, among other things, holding improper sales contests at its call center. During those contests, sales persons competed for tickets to concerts and sporting events and dinners based solely on their sale of Merrill Lynch proprietary products.[12]

By offering special incentives for sales, firms encourage those broker-dealers to act in their own self-interest, and risk objectivity in the customer suitability analysis. In July 2005, FINRA fined Horner, Townsend & Kent, Inc. $325,000 for conducting improper sales contests that encouraged brokers to focus on proprietary products. As Mary Schapiro observed following the case:

> By favoring the sale of some variable life and annuity products over others, these contests created conflicts of interest that could undermine the broker's obligation to recommend suitable investments based on the needs of the customer. . . . NASD rules are designed to prevent such conflicts between the broker's self-interest and the customer's.[13]

Firms would do well not to miss this lesson again. While most broker-dealers will undoubtedly make a good-faith effort to meet the needs of their clients, creating incentives to act in their own interests can create an unnecessary and undue risk of misbehavior and exposure to liability.

2. Fee-based accounts. Broker-dealers have a responsibility when considering fee-based programs, or programs that "charge a customer a fixed fee or percentage of assets under management in lieu of transaction-based commissions," to ensure that they have a reasonable basis for recommending such a program to a client.[14] In order to minimize the risk of putting customers into fee-based programs when they would be better off paying commissions on a transaction-by-transaction basis, FINRA recommends that firms "make reasonable efforts to obtain information about the customer's financial status, investment objectives, trading history, size of portfolio, nature of securities held, and account diversification."[15] Even then, however, it is critical to monitor fee-based accounts on an ongoing basis to ensure that the customers' circumstances have not changed.

3. Non-cash compensation. FINRA restricts non-cash compensation in an effort to protect the integrity of investment services. While such compensation is not altogether proscribed, FINRA is serious about enforcing the limits it sets. For example, in February 2007, three firms were fined for various violations of the rules governing non-cash compensation: Scudder Distributors, Inc. was fined $425,000, Putnam Retail Management Limited Partnership of Boston was fined $175,000, and AllianceBernstein Investments was fined $100,000.[16] Such fines are seemingly easily avoided: *know the rules*. Like most rules, if firms take the time to understand the structure of the rules and expectations of the rule-makers, the risks inherent in paying non-cash compensation can be virtually eliminated.

4. Gifts and gratuities. Conduct Rule 3060 essentially prohibits members from giving gifts or gratuities to individuals connected with the business of the recipient's employer, "in excess of one hundred dollars per individual per year."[17] In addition, the rule requires that members keep a record of any such gifts, of any amount in accordance with the SEC's guidelines. In 2006, FINRA discovered a pattern of violations, and issued a notice outlining common compliance issues including: the exclusion for personal gifts, such as a wedding gift; the exclusion for *de minimis*, promotional and commemorative items; permissible aggregation of gifts; methods for valuing gifts; and application of the rule to gifts incident to business entertainment.[18]

Remember that some gifts and gratuities are okay – they are part of doing business – but make sure to record your generosity. Conduct Rule 3060 requires *separate* record-keeping, and Rule 3010 requires supervision of all gifts.[19]

E. Anti-Money Laundering And Customer Identification Issues

The Anti-Money Laundering Rule, Rule 3011, imposes minimum requirements for compliance, including the need to establish policies and procedures to detect money laundering; internal controls to assure compliance with the Bank Secrecy Act; annual compliance testing; providing contact information for compliance-responsible individual; and ongoing training programs.[20] Unfortunately, it is increasingly evident that the key word in that sentence is "minimum," for doing the minimum may not be enough to avoid scrutiny. Firms must remember that regulators are renowned "Monday Morning Quarterbacks," and with the advantage of hindsight, will look not only at what you did, but what else you could have done (arguably, regardless of whether such additional actions were mandated by the touchstone of "reasonableness"). As such, firms must be extremely sensitive to any possible red flags, even if they do not merit the filing of a Suspicious Activity Report (SAR).

Accordingly, regardless of whether it seems required or necessary, in anticipation of the questions they are bound to receive from regulators, firms cannot be afraid to ask customers the hard questions, like "where did you get this money that you are depositing with us," or "what are you planning on doing with the proceeds of this sale," or even to ask customers to produce copies of documents that support the answers that they provide to the questions posed. And, once again, it is extremely important to record and document that the questions have been asked and the answers (and documents) have been received.

IV. Lessons Learned

A. Lesson One: Risk Management Is No Longer Optional—If It Ever Was

Nearly ten years ago, the SEC, FINRA, and the NYSE issued a joint statement to emphasize the importance of risk management, making it very clear to all firms that regulators expected to see comprehensive risk management systems in place.[21] Over and over again since then, leaders in the broker-dealer world have reiterated this message. Mary Schapiro, in her opening remarks at the 2000 Spring Securities Conference, stated: "I can't overstate the importance of financial surveillance, internal controls, and risk management."[22] And in October 2002, NASD emphasized: "Member firms should have established *risk management procedures* addressing all aspects of their businesses, prudent financial controls, and well thought-out business continuity plans. In order to avoid breakdowns in the future, examination efforts will be focused on ensuring that firms have addressed these issues."[23] Since these remarks, the examinations conducted by these securities regulators have made it abundantly clear that having a robust risk management plan is no longer optional; the inability to demonstrate a proactive approach to managing business risks is an invitation to regulatory scrutiny, or worse.

B. Lesson Two: Risk Management Must Run Through An Organization From Top To Bottom

No one would question the proposition that senior managers must take responsibility for risk management. It is clear, however, that this is not enough. In order to avoid risk, or at least minimize it, individuals at all levels of an organization must be invested in the effort. That starts before a representative is hired, and continues through initial and on-going training and educational efforts.

C. Lesson Three: Adequate Staffing And Budget Are Necessary

Risk management is not the place to cut corners. An investment in a firm's risk management system protects the firm and its assets, and in that way, is essentially an investment in each individual product and client the firm has. In short, risk management is well worth the time and money associated with the effort.

D. Lesson Four: Documentation, Documentation, Documentation

Document *everything*, and keep the records. It does not matter how good your risk management program is if you cannot prove it to a regulator – the regulator will not simply take your word for it. They will insist on seeing documentation.

E. Lesson Five: Red Flags— Or Maybe "Pink" Is More Accurate?

What constitutes a red flag is, of course, a subjective determination. Because reasonable people will inevitably disagree about this, and because regulators invariably adopt a much broader view of what is a red flag, when identifying potentially suspicious behavior, *do not* wait for red flag to be scarlet; rather, it is preferable to react when the flag may only be pink. It is

much more tedious, and potentially more expensive, to take an expansive approach to red flags, but, when it comes to this subject, it is clearly better to err on the side of reacting, as opposed to ignoring.

V. Conclusion

Proper risk management is neither cheap nor easy, yet no one could reasonably argue that it is something that can be sacrificed in deference to some other component of a firm's business. The supervisory rules have always required firms to take reasonable steps to detect and prevent rule violations. Risk management is simply a new-fangled way of stating this same requirement. A firm that ignores this requirement does so at considerable risk to its own pocketbook, if not its continuing viability.

ENDNOTES

1 NASD Notice to Members 99-92, at 704 (noting that the "elements of a comprehensive risk management system are highly dependent on the nature of the broker-dealer business and its structure").

2 *Id.* (stating that effective risk management requires "recognition that risk management is a dynamic function that must be modified and improved as a firm's business changes and improved processes and procedures become available").

3 *See* NASD Notice to Members 05-26.

4 NASD Notice to Members 99-92, at 705 (noting, as a sound practice, maintaining a "risk profile of a product or venture" when allocating capital and measuring performance).

5 Conduct Rule 3110 and SEC Rule 17a-4(b)(4) also govern the maintenance and retention of correspondence.

6 In Regulatory Notice 08-24, FINRA proposed to eliminate Conduct Rule 3040 and replace it with a new "streamlined" rule that would be part of Conduct Rule 3110.

7 *See* NASD Notice to Members 05-40.

8 *See* NASD Notice to Members 03-07, at 50; NASD Notice to Members 03-71, at 767-68; Conduct Rule 2310 (requiring broker-dealers to consider customer-specific factors including the customer's financial status, tax status, and investment objectives).

9 *See generally* NASD News Release, NASD Fines Raymond James Financial Services, Inc. $2.75 Million for Lax Supervision of Producing Branch Managers, Wednesday, February 21, 2007, at http://www.finra.org/PressRoom/NewsReleases/2007NewsReleases/p018681

10 *See* NYLIFE Securities, Inc., Release No. 40459 (Sept. 23, 1998), at http://www.sec.gov/litigation/admin/3440459.txt; Royal Alliance Associates, Inc., Release No. 38174 (Jan. 15, 1997), at http://www.sec.gov/litigation/admin/3438174.txt.

11 *Department of Enforcement v. John M. Meyers and Brian C. Klein*, NASD Case No. C3A040023, Jan. 23, 2007

12 FINRA News Release, NASD Fines Merrill Lynch $5 Million for Call Center Supervisory Failures, Sales Contest Violations, http://www.finra.org/PressRoom/NewsReleases/2006NewsReleases/P016181

13 FINRA News Release, NASD Fines Horner, Townsend & Kent, Inc. $325,000 for Improper Sales Contests, Email and Supervision Violations, http://www.finra.org/PressRoom/NewsReleases/2005NewsReleases/P014658.

14 NASD Notice to Members 03-6 at 1; *see i.d.* at 3 (stating "[i]t generally is inconsistent with just and equitable principles of trade – and therefore a violation of Rule 2110 – to place a customer in an account with a fee structure that reasonably can be expected to result in a greater cost than an alternative account offered by the member that provides the same services and benefits to the customer").

15 *Id.*

16 FINRA New Release, NASD Fines Scudder Distributors, Putnam Retail Management, AllianceBernstein for Improper Training and Education Expenditures, http://www.finra.org/PressRoom/NewsReleases/2007NewsReleases/P018596

17 FINRA Conduct Rule 3060, *Influencing or Rewarding Employees of Others*, available at, http://finra.complinet.com/finra/display/display.html?rbid=1189&record_id=1159000594&element_id=1159000596&highlight=3060#r1159000594

18 *See generally* NASD Notice to Members 06-69.

19 *Id.*

20 FINRA Conduct Rule 3011, *Anti-Money Laundering Compliance Program*, at http://finra.complinet.com/finra/display/display.html?rbid=1189&record_id=1159006049&element_id=1159000591&highlight=3011#r1159006049.

21 NASD Notice to Members 99-92.

22 Opening Remarks by Mary L. Schapiro, President, NASD Regulation, Inc., Wednesday, April 26, 2000, 2000 Spring Securities Conference, J.W. Marriott Hotel, Washington, DC, at http://www.finra.org/PressRoom/SpeechesTestimony/MaryL.Schapiro/P011056.

23 "Improving Examination Results," October 2002, at http://www.finra.org/RulesRegulation/ComplianceTools/ImprovingExamResults/p009702

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