THE ROLES AND RESPONSIBILITIES OF THE BRANCH OFFICE MANAGER

INTRODUCTION:

The NYSE Rule 342, (b) paragraphs (1) and (2) calls upon the general partners or directors to provide "supervision and control" by delegating to qualified principals authority and responsibility for supervision of each office, along with procedures of supervision and control. It also requires a separate follow-up system and review to determine if the delegated authority and responsibility is properly exercised.
The NASD Rule 3010 states the same but with specific reference to supervision of the registered representatives. It states the need to have qualified supervisory personnel by virtue of training and experience.

BACKGROUND:

The Branch Office Manager of a securities firm has four essential drivers. These are: sales and marketing, operations/administration, personnel and compliance. The people who are customarily chosen to be Branch Office Managers (BOM) are usually from the sales side of the business with a proven track record of revenue enhancement and a "clean book of business." The reasons they choose to become managers differ, but all have one fundamental theme: leverage their own business by participating in the profits of the office. This is true of managers who keep their book of business and those who are full time managers.
Since compliance is viewed as a "boring" area, most managers try to delegate as much as they can in order to focus on driving the business or revenues for the profit center of the branch. They do not get a bonus for compliance. They may get disciplined or fired for failure to supervise but generally they spend only the minimum time required on compliance matters. As a result, ninety percent or more of the daily activity is spent away from compliance matters. Add this to the general lack of any formal compliance training and it is often the case that the BOM finds the job is not only unfulfilling but also dangerous to his career in the securities industry.
The NYSE Rule342 Supplementary 13, regarding the acceptability of supervisors, states that a candidate should have a creditable record as a registered representative or equivalent experience and should pass the BOM exam.
The NASD states that reasonable efforts should be made to determine if the candidate is qualified by experience or training to carry out the responsibilities of a BOM. (NASD Rule 3010 (a) paragraph 6).
The background of the requirements of experience, proven sales record, passing an exam and some training are essential requirements of a BOM.
The realities of the qualifications place the BOM squarely in the role of a sales/marketing manager who is presumed to be the compliance manager while supervision operations, administration and personnel matters.

CRITICAL FEW OR CRITICAL MANY:

There are nearly 50 items for which the BOM is responsible for in his supervisory role. They vary in importance and in intervals. Signing the new account form is a daily responsibility and the annual compliance audit takes place in that interval. In the interim, the responsibility ranges from the simple: approving or not approving a mutual fund switch from one fund to another; to the complex: reviewing the daily trade blotter to check for excessive trading in an account, suitability, size of transactions, account number changes, trading the same stock, option trades and ensuring the broker is licensed in the state where the client resides.

The usual “red flag” areas for the BOM are: option accounts, which have to be monitored in line with the objectives and the resources of the client; customer complaints about a broker using unauthorized discretion as to time, price and sale of a security; the “exception report” which shows that a client has generated high commissions in a short period (usually three to five thousand dollars); and a significant loss in a clients account due to a concentrated position or excessive trading. A decline of $10,000.00 year to date or a continuous monthly decline of ten per cent will usually cause the account to come up for review by the broker, manager and client. Two more items would be the sudden change of trading not in line with the client objectives stated the new account form and the need for extensions to make payment for a transaction or repeated margin calls in an account.

It is usually a “red flag” when confirmations of trades are mailed to PO boxes. In one instance, the broker would pick up the confirms in collusion with a client who was a foreign national and meet with him once per year to give him the confirms and statements. The client then died and the broker kept trading, waiting for the client to come on his annual visit to collect the documents. Then the account lost significant value in this time period. The widow and her children discovered the account in the deceased man’s papers and sued the firm for discretion in Federal Court and won.

Several years ago a client handcuffed himself to the door of the branch office after calling the national evening news for a nationwide appearance, complaining that his order was not executed and the gaming stock he wanted ran up without his order being filled. The BOM called the proper authorities, negotiated a settlement with the client and invited him to take his business elsewhere. The broker was correct in entering the limit order but the client felt entitled to his limit order, which it was determined to be wrong, as there was stock ahead.

All correspondence from the office must to be approved before it is mailed to the client to ensure that fair dealing and correct representations are made to the public. This is especially true with regard to prospectus items or an IPO, which must stand-alone without comment by the broker.

In one case, a broker stapled a sales solicitation to a copy of the front page of a prospectus of a Bank Floating Rate Note: “Interested in getting 10% from a Bank? Call this number…”
He placed it under the windshield wipers of cars at a mall parking lot. The BOM discovered it and promptly reported it to his superiors who notified the SEC. The NYSE banned the broker from the industry for life, the firm was banned from the offering the security and the BOM was able to keep his job with out disciplinary action.

An area that has become a focus for the BOM has been the use of brokerage firms as a vehicle for money laundering. No cash is taken in at the window and any funds wired in from foreign entities must be monitored carefully under NYSE Rule 405 the “know your customer” rule. Any transaction over $10,000 is usually reviewed by the operations manager and reviewed with the broker as to the identity of the client and source of funds. A brokerage firm recently accepted a series of third party checks from a corporation to meet margin calls in an individual’s option account. It was discovered the client was signing the checks in his corporate capacity for his personal use. The manager was a producing manager who told the margin department that it was the client’s company. The manager is no longer in the securities business and the client pleaded guilty to a felony offense and took up residence at a Federal penitentiary to serve out his sentence. The firm sued the brokerage firm in Federal Court, as it was a foreign corporation.

ALL THINGS TO ALL PEOPLE:

Beginning in the 1970’s brokerage firms shifted from a transaction business to a marketing business offering a whole series of investment products. Options began in the commodity pits in Chicago and became a hot new product. This required registration with the CBOE for the brokers and a Registered Options Principal exam for the BOM. Since, then options have been a major source of customer complaints because they are basically futures trading with stocks/bonds/currencies as the derivative vehicle. They have been a compliance challenge for the BOM basically in the area of suitability. Since the commission payouts are higher and the amount of money required to invest in options can be small, the brokers find ways to get clients involved in trading options. Entering trading options in margin accounts causes the risk exposure increases at a double the rate of risk in a cash account.
The basic mistakes made by brokers and BOM’s is that they allow allocation of liquid assets to be too high (15% is the usual amount recommended), and allow clients to get into spreads and combinations that the client does not understand.

In one case a client had huge profits in naked puts but would not close his positions because he wanted a certain profit gain. He then let the options expire and become worthless. The BOM called, asked to meet with the client, showed him his losses and counseled him to lower his risk. The client refused. The BOM instructed both the broker and the client that there would be no new positions allowed and that the margin debit must be paid off. The client opted to go elsewhere. The BOM prevented the client from committing financial suicide while under his supervision.

In another case, an executive used the stock option-financing program of a major firm to pledge his restricted stock to borrow millions of dollars with a customized collar. He gave the broker Power of Attorney (POA) to trade options. In a two-year period the client paid $2 million in commissions and lost $7million. The BOM “left no finger prints” during this process. He never met the client or his wife, it was a JT/WROS. The POA was not appropriate because it was simply a way to avoid a discretionary account, which requires duplicate statement to a principal of the firm and heightened supervision and approval of every trade. The operations manager was initialing the order tickets. The broker traded on the same ticket with the client instead of following the FIFO practice when it comes to trading securities the same a client’s. Aside from a few “feel good” letters, after three years of losses the BOM was not supervising the broker or the account. The firm’s margin department and option department did nothing to supervise the account.

The BOM did not monitor the type, size, amount, frequency, profit/loss or suitability of the trading in the account. The BOM never spoke to the client or the wife, who was owner of the account with the husband. The BOM never updated the option documents. In the same case the broker lost over one and one half million dollars selling bullish straddles in an up market for three years. The strategy was flawed and yet the broker continued to tell the “gambling” client to keep doing it using a POA for discretionary trading. An NASD panel found that the broker has no business catering to and enabling the blindly bullish and flawed options strategy.

Failure to supervise by the manager was testimony given by the home office compliance director who said the BOM had the duty: a. to call a. to call the client; b. to have the trades ratified: c. assure that the client was comfortable with the strategy: d. that the strategy made sense. In short the home office placed the responsibility on the BOM. See: “The Failure to Recommend Hedge Strategies as a Basis for Stockbroker Liability.” PIABA Bar Journal. Vol.9. No.1. (Spring 2002).

Since the introduction of listed options in 1973, the securities industry has offered: tax shelters of all kinds from oil drilling to wind farms, retirement accounts, unit investment trusts, annuities and whole life insurance, mortgages, business loans, stock option financing with the use of customized collars, cash management accounts, professional money managers, who are registered investment advisors Series 65 licensed, and various forms of index and derivative based closed- end funds. Finally, most recently, firms have become “financial planners.”

The new era of fee based accounts from B share mutual funds, 12 B 1 fees, fee based trading accounts and “outside money managers” has added another layer of supervision. The fees are silent revenue streams for the firms and are aimed at asset allocation models for clients. The money managed accounts for instance charge a fixed fee 1.5% to3% regardless of performance. In some instances clients have complained that they were paying a fee when the account was 40% in cash! In other cases brokers have been asked why they have not traded in an account when the client was paying a fee in lieu of commissions. These issues are open have not been resolved by the industry.

To put this in perspective, the term “registered representative” has been translated into “account executive” and most recently, “ financial consultant,” “wealth manager,” or “specialists” in retirement plans and the other products mentioned above. The broker and managers have had to become insurance licensed, Series 65 licensed as money managers and in some cases, licensed in real estate.

The BOM is faced with having these products coming into his office by way of various marketing specialists. These specialists are compensated on marketing their particular product. Few of them have ever been brokers, managers or are licensed in the securities industry. The BOM then has the job of supervising the products sold in the office without the authority to supervise the specialists who report to their home office department heads. Few of the department heads have ever been in the branch or are licensed in the securities industry. This situation makes the reporting and monitoring of what is best for the client a steep challenge for the BOM.

A clear example of this is the current customer complaints about tax-deferred annuities, which have been sold in the billions to clients. The BOM often does not even see the contract that it is signed by the client and approved by the insurance specialist. Yet he is responsible for the sale in the office. On occasion, specialists will recommend a 1035 exchange from one annuity to the one offered by the firm they represent. The BOM must sign off on these though they are usually a high cost to the client with little real benefit or need.

Clients are attracted to the tax-deferred annuity by such terms as, “guaranteed principal,” “fixed rate for the first 3-5 years or market appreciation, whichever is higher,” “free of state and federal taxes” and other marketing buzz words. The cost of the contract, the mutual fund fees, and the high redemption fees in the first 3-6 years are lost in the presentation. The fact that the principal is “guaranteed” (you must die to collect) makes it attractive to put into IRA accounts for some clients. This opens up a series of compliance violations from the ”Fair Dealing with Clients and Suitability” rule.

Recently, a woman who was in a terrible auto accident survived a three month coma and took a partial settlement in cash from the insurance account. With no job and two teenaged children, an insurance specialist proceeded to have her invest $500,000 in a tax-deferred annuity. Inside the annuity were four speculative mutual funds. The client lost $250,000. A paraplegic who has a learning disability, she retained counsel.
The insurance company refused to talk settlement. They sent five attorneys to defend the broker before the Arbitration Panel. The BOM "left no finger prints" and was not at the hearing. The decisions was in favor of the claimant. The point is that the BOM could have intervened or the insurance company should never have offered the contract with speculative mutual funds, which the claimant did not understand.
Examples abound in the cases of retirees rolling over their pensions into tax-deferred annuities. One major firm fired six managers where the abuses of this product occurred. See: Variable Annuities: What You Should Know, US SECURITIES & EXCHANGE COMMSISSION. http://www.sec.org/investor/pubs/warranty.htm.
NASD Takes Disciplinary Actions for Variable Annuity Abuses and Investor Alert on Variable Products, 1991 NASD Lexis 57 1991. Notice to Members 40 (May 27,2003).

FEAR OF LOSING THE "BIG HITTER":

Securities firms recruit and cater to larger "producers." The BOM has the job of recruiting and supervising these brokers, as well as his own homegrown talent.
Often the big producer will resist compliance rules as he views these rules to be annoying and most of the time not applicable to him. The big producer will not review accounts requiring an activity review, will get involved with outside interests and not report them on the outside interest annual questionnaire or be allowed to do so without investigating a conflict of interest, and he will make demands for special treatment on IPO's, mortgage approvals and building positions in highly speculative stocks on margin. A recent quarterly report by a major firm showed a loss of $40 million in bad loans to key clients. The reason stated for approving the risky loans was the pressure from big producers. . Thus the BOM fears losing the large producer or is afraid of the big producer calling the company president in order to get the BOM off his back or get loans or trades approved. The BOM is then called on the carpet for not being broker- friendly and in some cases removed as manager. In other words, firms may not back up their BOM, so he maintains a low compliance profile with big producers, which eventually results in a customer complaint and a failure to supervise on the part of the BOM.

WE ARE WITH YOU WIN OR TIE!

The home office compliance departments usually have the first objective to defend the firm. A BOM is resembles a professional coach who is expendable in the heat of a financial battle. As was mentioned in the case above in “All Things to All People,” the home office legal and compliance department will back the manager when he follows protocol, but is hard pressed to give any support to the BOM other than to put forth an argument that in effect says he has no responsibility to supervise.

In a recent NYSE case a major firm stated:

> “When a non-discretionary securities account is involved, the broker’s duty Is limited to executing the order properly.”
>
> “Moreover, a broker does not have any responsibility to his customer after The transaction is complete.”
>
> “A broker has no continuing duty to keep abreast of financial information that may affect his customers’ portfolio, or to inform his customers of developments that could influence their investments.”

The panel found this argument to be wrong and awarded a six-figure sum, damages and legal expenses to the claimant.
The net result is that the CRD of the BOM shows the finding on his permanent record. This “de minimis” approach did not give the BOM a chance to defend himself.

It should be noted that “Feel Good Letters” or form letters to active accounts are letters from the home office and signed by the BOM. Rarely does the client call the BOM but relays any issues the broker, who advises his client to ignore the letter as a public relations matter. The letters are generic but recently have required the BOM to put in the letter the total commission dollars and a profit and loss picture year to date. Brokers usually see this as trying to “start trouble” with a good client. In those cases, the BOM will often invite the broker to be on the call with the client to ease his concerns. This puts the client in the difficult position of complaining to the manager in front of his broker. The procedure does have merit, however, as it gives the BOM some proof that he did contact the client and take the necessary action such as a personal meeting or reviewing the risk profile of the client. Again, this is not an area that the BOM finds comfortable and will try to speak with the broker alone as a substitute to personal client contact. Again, the burden of supervising rests on the shoulders of the BOM.

RECRUIT OR DIE:

In the late 1970's and early 1980's the "gentlemen's club" of Wall Street took a bounce when Mr. George Ball left E.F.Hutton to become the head of Prudential Securities. He revolutionized the industry with his huge up-from bonus checks to attract brokers from the competition. The rationale was that the cost of training was higher and the attrition rates in the industry demanded a new approach: an upfront bonus based on a percentage of the brokers trailing twelve-month gross production. The bonus took the form of an upfront, annual forgivable loan over a three-year period. For a million dollar producer the deal is structured as 75% cash of the trailing twelve-month's production, 10% in deferred compensation five to ten years out and a 15% "look back" bonus over a twelve to fifteen month period at the new firm. The broker pays back one third of his cash bonus each year and gets a check (less taxes) in return as a bonus. The bonus also may have a higher percentage payout in the first few months and a back end bonus for assets and production targets. The point is that the recruiting process can become a distraction from watching the compliance posture of his office. He also must recruit and beware of the possibility of losing his best brokers to the competition.
The results have been an unmitigated disaster for Wall Street with brokers hopping from deal to deal and leaving a trail of unsecured debts and compliance complaints. The NEW YORK TIMES featured such a debacle in its issue of Sunday, January 16,2005.
In the late 1990's the SEC under Arthur Levitt established the Tully Commission to stop the job-hopping by brokers with a list of complaints and to stop the extravagant payouts to brokers. This has met with limited success. Examples are that customers and recruiting firms now can view the brokers CRD on the NASD Website and firms must now promptly report customer settlements and complaints or face substantial fines.

The BOM now spends considerable time using the services of recruiters who get five to six per cent on the bonus paid and doing his own recruiting efforts.
In some cases a competitor raided entire offices including the BOM. The NASD ruled that taking the majority of the office revenues by another firm or firms as illegal and subject to substantial fines.

The BOM has had to deal with the downdraft in the market since 3/10/2000. With new brokers in his office his firms has had to extend the terms of the "loans" to five years. The intention was to give the broker time to build his business in a difficult market condition and ensure that he will not jump and leave the firm with the unsecured loan.

Recently, two high level managers at a major firm were fined six figures by the president for allowing a team of brokers to violate late trading rules in mutual funds. The BOM was praised for recruiting such a high-powered team without realizing that a large percentage of their business was in violation of mutual fund trading rules.

The job of recruiting often leads the BOM to compromise in the area of compliance. The broker may have questionable hedge- fund clients, he may do speculative business, he may be concentrated on a very narrow account base, and he may have a very short term trading mentality and comes to a large firm simply to get new issues for his clients.
In other words, the BOM is placed in the position of having to recruit or sit and watch his office be attacked. He may have to compromise compliance for his own big producers in order to keep them at the firm.

The recruiting game has heated up with the recovery in the market, but many firms are now trying to collect training fees from young brokers who jump and from larger produces that simply walk out the door to another firm. The panels of the NASD and NYSE have generally rule in favor of the firms in these contract disputes.

It is safe to say that the new era of recruiting has lined the pockets of brokers and recruiters. The clients have not benefited to any great extent and the brokerage firms are in a continual battle to buy business from other firms. The BOM is caught in the middle. He must spend time away from his normal duties of sales, compliance and administration to recruit and hand hold the big producers. He is also at risk to the profit and loss of the his office bottom line when a big producer leaves and a new bonus broker is slow to get his business growing to pay off the loan, or in some cases never do enough to cover the cost of the upfront loan.

THE TOUGHEST JOB ON WALL STREET.

The BOM job is not an easy one. It has been called the “toughest job on Wall Street.” There are BOMs who have established an office culture of compliance that is acceptable to the brokers and the firm. When asked what it is that these BOMs do there are key components of their supervision.

1. Hires only employees with a solid ethical background as new hires or recruits from the competition. Solid background checks.
2. Delegates but does not abdicate responsibility on: new account forms and risk profiles, option new account forms, account activity reviews, margin agreements, outgoing correspondence, customer complaint log, daily trade activity review, client contact with accounts generating large commissions, updated license/registration files and communication of compliance updates to the office staff especially regarding money laundering and requests for verification of accounts on firm letterhead. Reviews mutual fund swapping to enhance commissions by the broker.
3. Makes preparations for operations and compliance audits.
4. Finally, when the BOM develops such a culture he gets support from the firm.

There are other factors that the BOM of professional offices use to stay compliance friendly. In the main, to fail to execute any of the above duties is an invitation to violation of NYSE and NASD rules and regulations and exposure to complaints and arbitration.

CONCLUSION:

In October of 2004 the NASD sent out guidance on supervisory controls to take effect on January 31, 2005.

The topics cover the following:

1. Account Name/Designation Changes.
2. CEO Certification and establishment of policies and procedures for compliance.
3. IM –3110 Holding Customer Mail.
4. Rule 2510 Customer Account Information.
5. Rule 3010 Customer Discretionary Accounts.
6. Rule 3010 Supervision.
7. Rule 3012 Supervisory Control Systems
8. Rule 3013 Annual Certification of Compliance and Supervisory Procedures.
9. Rule 3110 Books and Records.
10. Supervision.
11. Supervisory Control Procedures.
12. Time and Price Discretion.

The SEC on June 17, 2004 approved the amendments to the above rules and on September 30, 2004 granted accelerated approval to the proposed rule changes to conform to the NYSE's internal control amendments.

Particular attention is given to small offices with a producing manager. The need for heightened supervision for these "satellite" offices becomes very clear from the new supervisory controls.

The effect on the BOM is heightened supervision of his office by the home office and gives him the added responsibility to carry out the changes and to supervise any producing managers under his jurisdiction.

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ARBITRATION AND SECURITIES TESTIMONY

Securities Arbitration 2005 "Telling Your Story." Volume One page 367.