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Legal Risk Management Tip
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HOW COMPLIANCE FAILURES CAN LEAD TO ENFORCEMENT

Two recent SEC orders bring to light the importance of how internal compliance gaps can lead to enforcement. On September 10, 2012, the Securities and Exchange Commission ("SEC") accepted an Offer of Settlement and entered into an Order Instituting Administrative Proceedings with JP Turner & Company, LLC ("JP Turner") and its former president, William L. Mello ("Mello"), in connection with the SEC's findings that JP Turner and Mello failed to reasonably supervise three former brokers accused of "churning" customer accounts, causing approximately $2.7 million in investor losses.[1] That same day an Order Instituting Public Administrative Cease-and-Desist Proceedings was instituted against JP Turner's Executive Vice President and Head of Supervision, Michael Bresner, whereby it is alleged that he failed to supervise reasonably two of the three registered representatives accused of churning customer accounts.[2]

According to the SEC's Orders, three former JP Turner brokers – Ralph Calabro, Jason Konner and Dimitros Koutsoubos, collectively churned the accounts of seven (7) customers by engaging in excessive trading with disregard to the customers' conservative investment objectives and low or moderate risk tolerances.[3] Churning occurs when a broker engages in excessive buying and selling of securities in a customer's account chiefly to generate commissions that benefit the broker.[4] Churning is recognized as an intentional act of fraud under the securities laws and violates Section 17(a) of the Securities Act of 1933 ("Securities Act") and Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder.[5]

<u>The Importance of Supervisor Liability – Lessons Learned</u>

Section 15(b) of the Exchange Act provides for "the imposition of sanctions against a person associated with a broker or dealer who has failed to reasonably supervise, with a view to preventing and detecting violations of the securities laws, another person who commits such a violation, if such other person is subject to his supervision."[6]

In this matter, the SEC claims that Mello, as President of JP Turner, was ultimately responsible for establishing supervisory policies and procedures, and had failed to establish procedures and systems reasonably designed to prevent and detect the churning of customer accounts.[7] Had he done so, he would have seen annualized turnover rates of up to 56, which reflects the number of times that the customer's securities were replaced with new securities.

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[1] *See* Securities Exchange Act of 1934 Release No. 67808 (September 10, 2012) at http://www.**sec**.gov/litigation/admin/2012/34-67808.pdf.
[2] *See* Securities Exchange Act of 1934 Release No. 67810 (September 10, 2012) at http://www.sec.gov/litigation/admin/2012/33-9359.pdf.
[3] *See* Securities Exchange Act of 1934 Release No. 67808 (September 10, 2012) at http://www.**sec**.gov/litigation/admin/2012/34-67808.pdf.
[4] *Id.*
[5] http://www.sec.gov/litigation/admin/2012/33-9359.pdf.
[6] *Id.*
[7] http://www.sec.gov/litigation/admin/2012/34-67808.pdf.

Furthermore, while JP Turner had a monitoring system known as the Active Account Review System ("AARS"), to identify actively traded accounts, the system imposed few requirements on, and no meaningful guidance for supervisors in terms of reviewing these accounts and taking meaningful action to investigate the trading activity.[8] In fact, JP Turner's policies and procedures did not specify how to analyze or explain what would trigger an internal review of any account flagged in AARS, nor did the internal controls require follow-up with a customer when excessive trading was flagged repeatedly. While the firm utilized certain suitability supplements, questionnaires and cover letters to send to customers whose accounts were "flagged" as active trading accounts, such communications omitted important information regarding the commissions, margin interest and fees associated with active trading that could have affected the customer's approval of such activity. As William P. Hicks, the Associate Director of the SEC's Atlanta Regional Office stated: "broker-dealers' supervisory systems must provide customers with reasonable protection from churning and similar abuses. JP Turner's systems failed to do that."[9]

Michael Bresner is accused of failing to reasonably supervise two of the former brokers, who generated such high commissions from some of their churned customers that it triggered a requirement in the firm's procedures requiring that Bresner personally review the underlying trading activity.[10] However, Bresner failed to take appropriate action in response to the trading in these accounts despite several "red flags."

Mello and JP Turner have since settled for their respective failures to implement sufficient supervisory policies and procedures.[11] Mello was required to pay a $45,000 penalty and was suspended from association in a supervisory capacity with a broker, dealer or investment advisor for five months.[12] JP Turner agreed to pay $200,000 in disgorgement, a $200,000 penalty, $16,051 in prejudgment interest, and hire an independent consultant to review the firm's supervisory procedures. [13] Bresner meanwhile is currently facing suspensions and administrative proceedings by the SEC to be decided within the year.

<u>How to Establish Effective Supervisory Procedures</u>

As seen described above, failure to supervise violations are broad in application and apply to firms and those individuals responsible for overseeing the compliance and supervisory systems for those firms. Consequently, it is important to formulate supervisory procedures that are reasonably designed to ensure compliance with federal securities laws.[14]

Generally, regulators focus on the individual conduct causing alleged violation(s) first, and thereafter determine whether the firm's supervisory structure was reasonably designed to detect the violation(s).[15] While no formulaic supervisory structure exists that will fit every firm, there are certain risk management areas that should be considered.

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[8] *Id*
[9] See Securities Exchange Act Release No. 2012-186 (September 10, 2012) at http://www.sec.gov/news/press/2012/2012-186.htm
[10] http://www.sec.gov/litigation/admin/2012/33-9359.pdf
[11] Id.
[12] http://www.fa-mag.com/fa-news/12222-jp-turner-brokers-accused-of-churning-client-accounts.html
[13] *Id.*
[14] Anthony Pirraglia, Note, *A Tangled Web: Compliance Director Liability Under the Securities Laws*, 8 Fordham J. Corp. & Fin. L. 245, 255 (2003).
[15] *Id*. at 267.

1. Structure: Establish a compliance infrastructure with a department head and clear line of responsibility and duties for compliance support staff. Multiple layers of employees and supervisors will be required for those firms operating satellite or regional branches. Note that a compliance director in name only does not prevent liability from attaching to other executives of the firm.[16]
2. Customization of Internal Controls: Implement customized written policies and procedures tailored to your business. Resist the urge to use another company's policies, or to rely too heavily on any given "template" being used as a guide as these will not fully capture what it is your firm does and the risks it's exposed to. Developing practical, not theoretical, methods to address regulatory exposure is paramount.
3. Education: Education programs should also be implemented as they show the dedication of a compliance director, and the firm as a whole, to comply with the securities laws.[17] To be effective, the programs should be administered regularly and inform employees of the written internal policies and the relevant securities laws and regulations
4. Testing: At least annually, review the firm's policies, procedures and internal controls to ensure their effectiveness in helping to prevent and detect potential and actual violations. This review should focus on whether the policy is clearly defined, whether the procedure is currently followed and if the procedure articulates roles and responsibilities for personnel to perform.[18]
5. Suitability: Effective standards and criteria for determining suitability must be established. State regulations and FINRA Rules 2090 and 2111 require registered persons to "know your customer" and receive training sufficient to demonstrate knowledge of products pre-sale.[19]
6. Customer Complaints: Upon receipt of a complaint, firms must acknowledge the receipt, conduct and document a thorough review of the customer's allegations. In situations where the firm discovers wrongdoing, the firm should redress customer harm.[20]
7. Be Responsive: Ensure that when a violation is detected, prompt action is taken to mitigate the violation, a record is maintained and processes are in place to help ensure the same violation does not happen again. A supervisor must adequately investigate "red flags" or allegations of irregularity and cannot satisfy their duty to supervise by merely relying on the statements of employees.[21]
8. Branch/Remote Office Supervision: Develop a branch audit program that includes a meaningful risk-based audit plan, include unannounced visits, and develop a means to effectively convey audit results, with follow-up on areas requiring corrective action.[22] (*Tip: Review the "Joint Office Exam" form when developing such a program - http://www.sec.gov/about/offices/ocie/riskalert-bdbranchinspections.pdf.*)
9. Performance: Develop policies to review low-performing accounts in order to determine if the returns are being diminished by activities such as excessive fees. Conversely, high performing accounts should also be monitored to ensure that their success is a product of legal means.

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[16] *Id*. at 268.
[17] *Id*. at 267.
[18] *Id*.
[19] NASAA Report: Coordinated Examinations Identify Top BD Compliance Violations; State Securities Regulators Offer Recommended Best Practices, September 10, 2012, available at (http://www.nasaa.org/15306/coordinated-examinations-identify-top-bd-compliance-violations/)
[20] *Id*.
[21] Pirraglia, *supra* at 269.
[22] *Id*.

10. Develop Effective Means to Evaluate Conflicts of Interest: Finally, consider what conflicts exist between the firm, its employees and its customers. Once those conflicts are identified, it is important to address through mitigation, elimination and effective disclosures.

Please keep in mind that the above list is not inclusive and may vary depending on the firm's business model. For more information about this topic and other legal services, please contact us at (619) 298-2880, info@jackolg.com or visit www.jackolg.com. Thank you.

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