NEWS

SECURITIES AND
EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 272-2650

Remarks to the
Fifteenth Annual Rocky Mountain
State-Federal-Provincial Cooperative Securities Conference
Denver, Colorado
October 29, 1982

THE DUTY TO SUPERVISE: SELF-DISCIPLINE WITHIN THE SECURITIES FIRM

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The Duty to Supervise:
Self-Discipline within the Securities Firm

The federal scheme for regulating the securities markets relies on self-discipline at two levels. There are the self-regulatory organizations -- ten exchanges and the NASD -- through which industry professionals join together to establish and enforce standards of conduct. Self-discipline in the securities industry really begins, however, at the firm level, and that is where I should like to focus today.

While effective internal controls are important to the success of any profit making organization, they are critical in the securities industry, where participants are so remarkably interdependent. A lack of sound supervisory controls may cause large losses to a single firm. Moreover, given the volume of interfirm dealings, those losses may have a ripple effect, damaging other firms and undermining public confidence in the securities markets. The 1980 silver crisis demonstrates this point. For six days, it appeared to government officials, Wall Street and the public at large that a default by a single family, the Hunts, on its obligations in the plummeting silver market might seriously disrupt the U.S. financial system. The potential failure of even one of the various broker-dealers carrying Hunt accounts threatened a financial chain reaction that would have jeopardized commodity clearing houses and their members, other broker-dealers and their customers, as well as banks, public companies and their stockholders. Although financial castastrophe was ultimately averted, the silver crisis starkly revealed the fragility and interdependence of the financial community. So too did the recent failures of Drysdale Government Securities, Inc., Comark, and Lombard-Wall, Inc.

While none would argue against effective supervision in the securities industry or, for that matter, any other industry, not everyone agrees on how best to promote that goal. Some might argue that the marketplace provides sufficient discipline for ensuring quality control; that there is rarely a need for regulatory intervention. After all, companies that fail to maintain adequate control of their business inevitably lose out to those who do, making enlightened self-interest an adequate stimulant to assure the development of sound internal controls.

The views expressed in this speech are my own and do not necessarily represent those of the Commission, my fellow Commissioners or the staff.

For many industries, marketplace discipline may assure adequate protections to the customer. But this is not true in the securities industry. The securities business functions through customers' reliance on firm integrity in many matters beyond their ability to verify. Customers cannot judge the products of a securities firm in the same way that they can gauge the performance of a car before buying it. There are no "test drives" for customers of securities firms. Customers often lack the sophistication necessary to assess the appropriateness of investment advice. Nor can they realistically be expected to examine a firm's books and records to make sure their funds and securities will be safeguarded. While the marketplace, no doubt, serves as a discipline of last resort for the firm, a firm's demise is small consolation to its customers, and to other securities firms and their customers, who are hurt in the process.

The depth, liquidity and efficiency of the nation's capital markets, so vital to the economy, depend on public confidence in the integrity and stability of financial intermediaries. It was for that reason, and in recognition of the difficulties investors face in protecting themselves, that our securities laws were enacted. Firm self-discipline, through vigorously implemented supervisory procedures and internal controls, is a critical element in the regulatory scheme. Self-discipline is achieved through a combination of firm self-interest, SRO oversight and Commission action. Questions remain as to the interrelationship of these elements, and perhaps they always will. I want to talk about these three elements and their interrelationship in promoting adequate supervision. To gain perspective, it may be helpful to recall the origin of the duty to supervise and its place in the securities laws.

Evolution of Duty to Supervise

Today, when an employee of a brokerage firm violates the securities laws, the Commission has a range of enforcement options, against both the firm and its employees, including injunctive actions for violations, administrative proceedings for violations and for failure to supervise, and reports of investigation. Its options were not always so clear. Before the 1964 Amendments to the Exchange Act, the responsibility of a firm and its associated persons to supervise employees was not explicitly a part of the statutory scheme. However, in early cases, the Commission did examine the firm's supervisory procedures to determine whether, if the procedures were deficient, it would serve the public interest to impose sanctions on the broker-dealer.

As early as the mid-1940's, the Commission concluded that, through the doctrine of respondeat superior, willful violations of the securities laws by a firm's employees, committed in the course of their employment, constituted willful violations by the firm. As stated in the case of Bond & Goodwin, Inc., the Commission took this step in order to prevent brokerage firms from escaping liability "with 'wide-eyed disavowals' of fraud committed by a subordinate that can all too readily lead to a firm's enjoying the fruits of wrongful conduct while avoiding the statutory consequences."

However, the Commission lacked authority to bring administrative proceedings directly against a firm's employees, including supervisory personnel. In order to impose sanctions on employees who violated the law, the Commission was required to name the firm itself and either suspend or expel it from membership in the NASD or an exchange. If the firm was suspended or expelled, the Commission could then make a finding that particular employees, by reason of their conduct, were "causes" of the suspension or expulsion, and could bar them from the NASD or the exchange while the order against the firm was in effect.

The respondeat superior doctrine worked fairly well in holding firms accountable for violations of the federal securities laws by individual employees, but was of limited use in reaching individual supervisors who, while not engaging in primary violations of law, had failed to supervise an employee who did. In Reynolds & Co., the Commission held in 1960 that where the failure of a securities firm and its responsible personnel to maintain and enforce adequate supervisory procedures resulted in the perpetration of fraud upon customers, or in other misconduct, the failure to supervise constituted "participation in" the misconduct of the employees. Stated another way, supervisors were held to have "aided and abetted" the misconduct. While that approach reached the desired result, there was some doubt whether the Commission would prevail in a contested case, given the uncertain scope of the "aiding and abetting" doctrine at the time.

The Reynolds case established a benchmark in the supervision area. The Commission affirmed that broker-dealers have a duty to supervise the actions of their employees and that added diligence was needed under the conditions that existed at that time -- active markets, increased interest in securities by inexperienced customers, the rapid growth and broadened operations of large securities firms and growing competitive pressures -- conditions, incidentally, that characterize today's markets at least as well and perhaps to an even greater degree.

By the early 1960's, supervisory standards were a source of major concern. The Special Study of Securities Markets chronicled abuses, concluding that inadequate supervision was a serious problem, particularly in firms with numerous branch offices where home office controls were often lacking. It recommended that firm supervision of the selling activities of its personnel be strengthened. It concluded that sanctions available to the Commission in cases of fraudulent selling practices -- revocation of the firm's registration or expulsion from or suspension of membership in an exchange or the NASD -- could be unsuitable where the disciplinary action was focused only on a few salesmen, supervisors and branch offices. Accordingly, the Special Study recommended that the Commission be given flexibility to proceed directly against individuals associated with a broker-dealer, without naming the broker-dealer, and to impose sanctions better tailored to remedy misconduct.

Forward looking leaders of the securities industry agreed that sales practice supervision should be strengthened. Donald Regan, then Vice President and Secretary of Merrill Lynch, addressed the need for stronger supervisory controls in a 1962 speech to securities industry executives. He put it this way:

> In other words, gentlemen, the doctrine of "Caveat Emptor" was superseded by the "shingle" theory. That is, if you put your shingle out as a notice that you are prepared to do business with the public, then you are assuming a responsibility to that public to protect them from wrongful acts of your employees, or your firm.

The Congress agreed. The 1964 Amendments codified the duty to supervise that the Commission had evolved through its enforcement proceedings. Congress provided the Commission with express authority in Section 15(b) of the Exchange Act to sanction both the firms and their supervisory personnel for failure to supervise. Specifically, the Commission can sanction a broker-dealer or associated person if it finds that the firm or such person has failed reasonably to supervise, with a view toward preventing violations of the securities laws, another person who commits such a violation, and if the sanction is in the public interest. The Commission was given a broad array of possible sanctions ranging from a censure to the revocation of a firm's registration or a bar against a person's being associated with a broker-dealer.

The duty to supervise does not make a firm or its supervisors a guarantor of employee conduct. There is a "due diligence" defense based upon:

-- the existence of established procedures and a system for applying them that could reasonably be expected to prevent and detect violations;

-- the reasonable discharge by the firm or supervisor of the duties arising from those procedures; and

-- the absence of "red flags" -- that is, the absence of reasonable cause to believe that the procedures were not being followed by others.

These amendments to Section 15 were not intended as a Congressional signal to the Commission that the firms, themselves, need no longer be named in failure to supervise cases. In fact, precisely this concern was expressed by Congress during the hearings on the 1964 Amendments. The concern was answered by then Chairman William L. Cary, who testified to the Commission's continuing resolve to include the firms in failure to supervise cases.

> In nearly all cases, action will be taken against both firms and individuals. Only in the relatively unusual case when it is clear that no administrative sanction against the firm is warranted will action be taken solely against individuals . . . .

The resolve identified by Chairman Cary has in fact proved true over the years, and continues to be true today.

Role of the Self-Regulatory Organizations in Promoting Adequate Supervision

The Commission relies heavily on the exchanges and the NASD to establish rules governing the conduct of their members and to inspect for compliance. A key element of SRO oversight is assuring that member firms have adequate supervisory controls. SRO rules require member firms to establish and implement written supervisory procedures, to designate supervisors and to establish a system of follow-up and review to determine that any responsibility to supervise delegated to the compliance officer or qualified principals is being diligently exercised.

The SROs do not prescribe a particular system of supervision. They have recognized, and so too has the Commission, that effective supervisory procedures will vary among firms depending on such factors as structure and business mix. They recognize, however, that supervision is needed in such areas as the opening of new accounts, the review of account activity, and the procedures for handling the flow of customer securities and cash.

Both the exchanges and the NASD have examination programs designed to ensure compliance. These programs should be supported by better market surveillance. An effort should be made swiftly to initiate and complete investigations into market problems detected through surveillance and to impose stricter penalties on violators.

The SROs also play an important educational function in the supervision process. These functions will need to be augmented for the future. As problems develop that are not limited to one or two firms, the SROs should assist in developing sound solutions and then should give widespread currency to those solutions, perhaps through circulars sent to the membership. They need to become a clearinghouse for better ideas, a library to house guild standards, as they evolve.

Role of the Commission in Promoting Adequate Supervision

Supervision continues to be an important facet of Commission oversight. Neither the Commission nor the self-regulatory organizations have the resources to oversee more than a fraction of the business of our approximately 7,000 broker-dealers. Where we do detect violations, our regulatory purposes are not well-served if we fail to examine the surrounding circumstances to determine whether adequate supervisory procedures existed or were followed. To the extent possible, each case we bring should send a useful message to the community of firms we regulate. Efficiency demands that our enforcement efforts achieve a ripple effect in deterring wrongdoing and achieving compliance among those not named. By ensuring sound supervision, we can best stretch our thin resources to protect investors.

Securities firms today generally have recognized the pivotal role that sound supervision plays in the successful operation of their businesses. They have fashioned appropriate procedures. But few in the industry would argue against the Commission's duty to act in appropriate cases when there has been a break in the supervisory chain.

While the Commission has authority to discipline firms directly for the actions of their employees, it does not generally name a firm where it is not involved in the wrongdoing and has not failed to supervise. In such a case the firm may be a "victim" and, as a matter of fundamental fairness, should not be prosecuted, even though Congress has preserved the Commission's authority to do so.

Conversely, the firm should be named where it is involved in the wrongdoing, where its supervisory procedures were not adequate or where they were not carried out by branch managers or other supervisors designated by the firm to discharge for it the firm's duty to supervise. In other words, since the firm can only act through individuals, at some level in the organization the acts of individuals are the acts of the firm and should be so treated by the Commission, regardless of the degree of care, or lack of care, exercised by the firm in selecting them. For example, I do not believe the Commission should proceed against a firm for failure to supervise where the firm, following procedures reasonably designed to detect misconduct in its branch offices, discovers that a registered representative has engaged in fraudulent selling practices and takes prompt action to remedy the situation. If, however, the firm (acting through its branch manager or other designated supervisor) did not properly exercise its supervisory responsibility for the registered representative, or discovered the misconduct and failed to act effectively to stop it, the public interest is served by proceeding against the firm for failure to supervise.

It is important to understand the remedial nature of the Commission's enforcement program with respect to broker-dealers. The Commission's primary emphasis is not on righting particular wrongs against investors. Private suits, which the Commission has always viewed as a necessary supplement to its own enforcement program, are designed to do that. Rather, the Commission's role is to prevent the recurrence of violations, to foster integrity in the firm and to upgrade standards in the industry as a whole. There may be cases where investors recover for losses caused by firm employees, yet there is no basis for charging the firm with failure to supervise. In contrast, there may also be cases where there is no investor loss, yet a failure to supervise charge is appropriate to achieve compliance and deterrence.

It also is important to remember that there is no litmus test for identifying inadequate supervision. It is not possible or prudent to devise a single rule or compliance procedure defining adequate supervision for the securities industry. The adequacy of supervision is a matter of judgment. In determining whether a firm failed to supervise, the Commission is required to use a reasonableness standard.

One of the most difficult issues in failure to supervise cases is whether a firm should be sanctioned when its supervisory procedures were comparable to those prevailing in the industry. In applying the reasonableness test, reference to industry standards is useful but should not always be dispositive. The Commission has held that the fact that others may be deficient in providing adequate supervision in a particular area cannot excuse a firm for failing to supervise. This principle is not unique to the securities industry. Fifty years ago, in the celebrated T. J. Hooper decision, Judge Learned Hand spoke for the Second Circuit in concluding that the owners of a tug boat could be held liable for negligence in the loss of property in a storm due to their failure to install an adequate radio receiving set, notwithstanding the widespread practice of the industry not to carry receivers. In most cases, Judge Hand wrote, "reasonable prudence is in fact common prudence; but strictly it is never its measure . . . ."

Questions arise as to whether it is appropriate to sanction a firm that, upon discovery of a violation, reports it to the appropriate authorities, reimburses investor losses and voluntarily cures the defects in its supervisory procedures. Conduct of this sort should not insulate a firm from sanctions for failure to supervise, although it may be a mitigating factor in determining the severity of sanctions imposed. Corrective action after the fact is obviously better than no action at all, and it may be necessary to avoid private litigation. It should not, however, supplant the need for Commission action to foster the implementation of supervisory procedures that detect and prevent violations, both at the subject firm and, through the ripple effect, across the whole industry.

I believe this is a particularly important point in today's marketplace, where firms are rapidly entering new markets, establishing new product lines in securities and commodities and enlarging their operations generally. The number of registered broker-dealers is at a record high, as are the numbers of branch offices and registered representatives. Since 1980, firms have added over 1,500 branch offices to their operations. Fifteen percent of all registered representatives have less than one year's experience in the business. As firms expand their business, they should also be expanding their supervisory procedures to ensure regulatory compliance and sound internal controls in these new and expanded activities, particularly since an increasing number of those doing the selling will lack experience.

I am concerned that the incentive for firms to maintain sound procedures would be significantly decreased if they believed that so long as they clean up their supervisory procedures once a violation takes place, they will not be sanctioned. Perhaps enlightened self-interest, in theory, should ensure a firm's continued dedication to supervision. But self-interest will not suffice where every dollar spent on compliance could otherwise be invested toward direct profit. Nor is it sufficient when many abuses, such as market manipulation and insider trading, do not affect a firm's clients or financial stability, but instead affect the market as a whole. Moreover, hightening competitive pressures make it simply unrealistic to expect firms to rely on their own self-interest as a complete substitute for Commission action.

The securities industry has become far more complicated in recent years, making effective supervisory procedures at once more important and more difficult to design and implement. This fact is well-documented in the Commission's Special Study of the Options Markets. In the mid-1970's, supervisory difficulties proliferated in connection with customer transactions in options because firms did not ensure that knowledgeable supervisors would oversee the options business of the firm, whether in central or branch offices. Many branch managers made little or no effort to understand the complex options trading strategies employed by their registered representatives.

Nearly every significant case of fraud encountered by the Options Study involved a local breakdown of supervision. Invariably, the cause was traceable, at least in part, to the conflict of interest between a manager's own stake in commission production and his supervisory responsibilities. Local managers frequently favored the "big producers" in their offices and actively recruited new customers for them, even though they were aware that the salesmen were mishandling their acccounts. Managers whose own livelihood depended on revenues generated by the "producers" -- who were free to leave the firm at any time, and take their customers along too -- were not always inclined toward vigorous supervision. Here's how the chief compliance officer of a major brokerage firm described the problem posed by the large producer:

> I asked [the branch manager] if he reviewed the monthly statements that were sent to him and he said "Yes, I just sign them and pray".

Praying, however, did not prevent firms from having to pay out millions of dollars to settle customer lawsuits when complex frauds were discovered in the handling of customer accounts.

The kinds of new options products traded in the market are on the rise. Last Friday, trading began in options on several interest rate sensitive instruments, including U.S. Treasuries. The SROs already have adopted special supervisory procedures for these new products, analogous to those applicable to trading in equity options. New competitive pressures are certain to develop in this area. Compliance officers will face the task of understanding complex new trading strategies. The interest rate sensitive options, which are under the jurisdiction of the Commission, will directly compete with futures on the same instruments, and options on those futures, regulated by the Commodity Futures Trading Commission. In this regard, CFTC rules concerning futures, unlike those of the NASD, the stock exchanges and the Commission concerning options, require no customer suitability determination by firms. It follows, of course, that in this area, there is nothing to supervise in the marketing of interest rate futures. Since those products and SEC-approved options will compete head to head for the same customers, it would be too much, by far, to expect broker-dealers to achieve adequate self-discipline absent a vigorous Commission presence. Even if we are vigorous, this major regulatory disparity is bound to have damaging effects on some customers.

Conclusion

Regulatory experience tells us that achieving the goal of adequate supervision rests, not so much on combatting yesterday's internal control failures, but on addressing the new securities activities of today and tomorrow. Despite the lessons in supervision of stock sales practices mastered in the 1960's, we had to learn them all over again when standardized options took off in the 1970's. Indeed, we were forced to take the extreme step of a three-year moratorium on expansion of options. Today, stock options are probably the best sales supervised product in the industry.

Only a few years ago, stock loans, repos and letters of credit were relatively insignificant activities in the securities industry. Today there are approximately $8 billion in aggregate stock loans, and the current reported repo positions exceed $100 billion. I have already referred to the explosion of new financial instruments in both the commodities and securities markets. These complex products pose tremendous management and internal control challenges, both in terms of investor protection and risk management. I think that an increase in the sharing of views among firms concerning appropriate supervisory procedures may be of significant benefit in the effort to meet these challenges.

We know from experience that internal control advances tend to lag behind business changes, usually with harmful consequences to the public investor and increasingly with potentially disastrous consequences to the markets as a whole. The supervisory systems of the past simply were not constructed to deal with these changes, which are occurring with growing velocity. While the management of the securities industry is stronger than it has ever been, today's proliferation of securities activities and their attendant risks make the challenge of effective supervision more important than ever before. That challenge can be met not alone by the industry and its SROs; it requires the vigorous help of the Commission.