Protecting Reputations: Hiring and Management Best Practices in the Financial Institution Channel

by Mike Burns, Chief Compliance Officer
Cetera Financial Institutions

Introduction

Investor-fraud sweeps by scornful-looking regulators—and the reputation-crushing headlines that follow—are sobering threats for financial institution senior managers. The headaches are merely beginning as investor-bilking registered representatives are marched away, often with an irreversible wake of damage trailing them out the financial institution door. And the sad reality is that these types of disasters are even more likely in these challenging economic times.

No doubt, senior managers who have faced this grim scenario wish they could simply turn back the clock and be just a bit more diligent in their oversight. While it's impossible to guarantee that a job candidate will be completely ethical, greater scrutiny prior to hiring and best-practice program design can significantly reduce the likelihood of misconduct. This article outlines several ways that you can protect your own reputation and that of your financial institution from the damages caused by unscrupulous registered representatives.

Focus Area 1

Selection of Candidates

Below are several suggested control points for selecting candidates. Bear in mind that attention to these areas of concern extends beyond the initial selection process.

Check Their Credit

The extreme highs and lows sometimes apparent in registered representatives' production can lead to risky lifestyle choices. Tales of lavish purchase decisions—like the registered representative who buys a luxury automobile for self-motivation—are not uncommon. Those kinds of decisions can lead a seemingly ethical person astray when the spring of wealth (and credit) runs dry. Even additional debt that appeared manageable when incurred can lead to increased financial pressure in a challenging marketplace. There are many pitfalls that can snare someone in a precarious credit position, none of which are likely to make a registered representative serve clients in an ethical manner. As a manager, you have the opportunity to incorporate credit-history checks into your screening process, subject to disclosure and permission requirements of the Fair Credit Reporting Act. This simple step can help you discover red flags before they become pending disasters. It's a small price to pay for greater peace of mind.

Beware of Job-Hoppers

While 30 years at a single firm might be a thing of the past, a little stability isn't too much to ask when screening potential registered representatives who will have access to the best clients of your financial institution. Be sure to review your candidate's job history closely. Several brief tenures at various firms can be an indicator of registered representatives who chase sign-on commissions. Or they could have a reputation of grabbing guarantees but then failing to produce. Or they could be a supervisory problem. There's no shortage of reasons that recent or frequent employment changes should serve as a red flag of warning during the screening process. Be extra diligent in your review of candidates displaying these characteristics and scrutinize questionable reasons for changing jobs.

Regulatory or Legal Matters

Cetera Financial Institutions conducts background checks on potential registered representatives and continuously monitors disclosure events as a matter of course, but you can take steps on your own to ensure an extra level of confidence when screening applicants. Special concern should be given to applicants' business history. It might be awkward, but proactively questioning applicants about their U-4 disclosure history, future disclosure potential, outstanding complaints and total number of complaints is a wise practice when your reputation is at stake.

Focus Area 2

Segregation of Duties

Fostering a harmonious environment in your financial institution is a good thing. In relationships, harmony benefits both staff and client. However, harmonious functions can be anything but beneficial. In fact, too much concentration of responsibilities with one party can be dangerous. Basics like separating the deposit-taking areas from non-deposit sales function areas in the financial institution are a must. But physical segregation is only a start. Dual control on movement of customer funds is a proven means of risk mitigation.

Best practices demand a clear separation between financial institution employee responsibilities and investment personnel responsibilities. In an ideal world, registered investment personnel would not have financial institution duties that could provide an unnecessary level or concentration of control. However, there often are programs where it is impractical to utilize a full-time investment program employee, but that doesn't relieve us of the responsibility to maintain the highest degree of security and integrity.

Consider the cases of registered representatives who could easily harm customers in these dual roles because they had access to financial institution customer information or accounts. For example, registered representatives may have the ability to obtain cashier checks without reference information noted, move customer funds out of accounts without a financial institution customer's authorization, or use signature guarantees to sign-off on securities paperwork (as an aside, Cetera Financial Institutions does not permit use of signature guarantees by its registered personnel on items related to investment activity). Instances like these illustrate some of the potential dangers that can emerge from insufficient segregation of duties. Bottom line: if unscrupulous registered representatives have too much control on the banking side, it can lead to abusive practices. In scenarios where this lack of segregation is unavoidable, then it is imperative that senior managers have the necessary oversight and compensating controls in place to monitor those activities and mitigate risk.

Focus Area 3
Sales Practices

When financial institutions choose to enter into networking arrangements with firms such as Cetera Financial Institutions, the expectation is that we will establish and maintain a control environment that is reasonably designed to protect clients' interests and the financial institution's reputation. We establish practice parameters that control the activities of sales personnel in areas like solicitation of transactions, discretion in client accounts, custody and control of client funds and securities and, most of all, consistency and integrity in dealing with clients. Outlined below are some specific issues to be addressed in the financial institution channel.

Financial Services Industry Issues

Making investment, advisory and insurance solutions available through your financial institution does impose some additional obligations.

The interagency guidelines and NCUA Letter No. 150 mandate of the 1990s still apply today as best practices. As a senior manager, you must ensure vigilant adherence to the regulatory standards that protect clients from confusion. Also, it is essential that someone is acting as a designated supervisor within the investment program, reviewing new business and exchanges to ensure ethical practices. Cross-selling pitfalls (e.g., churning) are another focal point for proactive senior managers. Monitor these activities closely to mitigate risk and potential for reputation damage.

Regulation R was adopted to provide definition of the permissible securities activities of banks, including when banks enter into a networking agreement with a broker-dealer. One significant focus of Regulation R is limitation regarding payment of referral fees and incentive compensation to unregistered bank employees. The identified compensation restrictions are intended to prevent undue promotional interest or "salesman's stake" in the brokerage services offered by the broker-dealer.

Sales to the Elderly

Federal and state regulatory agencies have significantly increased scrutiny on sales to seniors in recent years. The importance of suitability cannot be overstated, as regulators seek to ensure that investment professionals are matching their clients with appropriate investments. Every recommendation to a client should first pass two analyses: reasonable basis and customer-specific. The reasonable basis analysis includes an obligation for investment professionals to perform appropriate due diligence so that they understand the nature of the securities offered, including associated risks and rewards. The customer-specific analysis requires that they consider facts disclosed by the customer about their unique needs. This analysis for seniors requires us to address issues such as potential diminished mental capacity of clients, reduced earning potential, and the need for capital preservation and liquidity.

Focus Area 4

Red Flags

In many of the highly-publicized cases of investor fraud, small clues were scattered along the road to ruin. Taken at face value, they might not have seemed like much, but in retrospect, they were indicators of disaster. We know these as "red flags." Senior managers who maintain a vigilant watch for them often can avert major reputational damage. Some potential red flags include:

- Significant change in client base for a registered representative
- Complaints regarding service or product sales
- Significant increases or declines in production, particularly if the economic environment doesn't correspond with such a change
- Lifestyle changes among registered representatives
- Gambling addictions
- Substance abuse/addictions
- Registered representatives living beyond their presumed means
- Evidence of unreported outside business activities for registered representatives, e.g., acting as an accountant or tax advisor, real estate agent/investor, practicing law, acting as a trustee, or the most common source of problems: owning a business

Conclusion

While we all want to trust others, it is the role of a prudent senior manager to be ever-vigilant. You have ethical standards that must be met throughout the financial institution which should also apply to securities activities. There can be no compromise. Ensuring adherence to those standards is a team effort but, ultimately, the responsibility to protect your reputation is yours. Please allow this article to serve as an introductory guide in your efforts and know that the Cetera Financial Institutions Compliance Department is at your service, so please don't hesitate to contact us at 800.245.0467 for additional guidance.

For more information,
please contact:
Cetera Financial Institutions
400 First Street South, Suite 300
St. Cloud, MN 56301
800.245.0467
www.ceterafinancialinstitutions.com

About Cetera Financial Institutions

Cetera Financial Institutions delivers customized investment and insurance solutions to nearly 500 financial institutions. With its focus exclusively on banks and credit unions, Cetera Financial Institutions offers flexible program options that help deepen relationships with clients, grow fee income and fulfill financial institution goals. Cetera Financial Institutions is a member of Cetera Financial Group, Inc., which provides award-winning wealth management and advisory platforms and innovative technology for more than 6,500 independent financial professionals nationwide. For more information, see www.ceterafinancialinstitutions.com.

Cetera Financial Institutions is a marketing name of Cetera Investment Services LLC, a self-clearing, registered broker-dealer and registered investment adviser. Cetera Investment Services is a member of the Depository Trust and Clearing Corporation (DTCC), the Securities Investor Protection Corporation (SIPC), and the Financial Industry Regulatory Authority (FINRA). For more information, see www.ceterainvestmentservices.com.

About Cetera Financial Group

Cetera Financial Group, Inc. is one of the nation's largest privately held, independent broker-dealer and registered investment adviser families. It provides award-winning wealth management and advisory platforms, comprehensive broker-dealer and registered investment adviser services, and innovative technology for more than 6,500 independent financial professionals and more than 600 financial institutions nationwide. Through its four distinct broker-dealers, Cetera Advisors LLC, Cetera Advisor Networks LLC, Cetera Financial Specialists LLC, and Cetera Investment Services LLC, Cetera Financial Group offers the benefits of a large, established and well-capitalized firm, while serving advisors in a way that is customizable to their unique needs and aspirations.

Cetera Financial Group is committed to helping advisors grow their business and strengthen their relationships with clients. For more information, visit www.cetera.com.