

SafeAlert



A loss control advisory from the ABA-sponsored insurance program underwritten by Progressive

Critical Controls for Brokerage Operations

Offering brokerage services exposes a bank to both liability and embezzlement risks that must be contemplated in internal audit reviews. Utilizing the expertise of a third-party broker-dealer or acquiring an existing brokerage subsidiary does not relieve bank management from the responsibility of oversight of the brokerage operation and implementation of controls.

Banks need to have appropriate policies and procedures and a rigorous internal audit, even if a third-party is charged with supervision of the employees. To protect your customers, your bank and your reputation, ensure that the following controls are in place and reviewed regularly:

- ☑ **Every investment should include appropriate file documentation as to the suitability of the investment.** The biggest source of brokerage-related lawsuits involves “improper investments” alleged by a customer. Self-directed investments should be documented as such. Files should be audited regularly to ensure that brokers are documenting appropriately. An “approved” product list should be followed, and all client contracts should include an arbitration clause.
- ☑ **Statements should be sent at least quarterly from a central location directly to the client.** Clients do not typically check their brokerage statements as frequently as their bank statements. The ability to withhold or alter statements allows a rogue broker to cover his tracks while tampering with a client's portfolio – even if his intention was to just “borrow” the funds and pay them back later. Centralized dissemination of statements provides an additional level of control and places a burden of responsibility on the client. Address changes should require a written, signed request from the customer and management approval.
- ☑ **All employees should be precluded from accessing client funds.** All securities and funds should be shipped directly to the client or deposited directly into the client’s account.

A community bank in New England purchased a successful brokerage firm to serve their clients, relying on the expertise and experience of the firm's management to oversee broker activities. One broker's client profited handsomely for years by instructing him to invest in high-risk investments. When the stock market dropped in 2000, some of these high-risk investments lost money. When the client brought a \$3MM arbitration demand alleging unsuitability of investments, the bank's defense was weakened because of a lack of documentation in the file. Had the files reflected the client's desire to invest in this fashion, the bank may have reduced or avoided a \$250,000 settlement.

- ☑ **Transactions greater than \$10,000 should be verified with the customer** via a callback procedure by someone other than the broker.
- ☑ **Always investigate “lifestyle changes,”** whereby a broker suddenly appears to be living beyond his/her means. Monitor employee accounts on a monthly basis for irregularities. Understand that many improprieties begin when a loyal employee is faced with a personal crisis, and intends to just “borrow” funds temporarily and pay them back later.
- ☑ **If you are using a third-party vendor, make sure that your contract outlines the vendor's responsibilities for supervision of dual employees and includes indemnification** for the bank and its employees in the event of vendor negligence. Ensure that the vendor has appropriate liability and bond coverage in place. Inquire as to whether the bank can be an additional named insured under the vendor's errors and omissions insurance policy or bond.
- ☑ **Employ a highly-qualified Series 24-licensed individual to oversee compliance** – or hire the services of such an individual from an independent firm.
- ☑ **Do not abdicate your responsibility for overseeing employees and ensuring that controls are in place** – ultimately, regardless of who is “responsible,” it is your reputation and bottom-line at stake.

For more information about controls for or losses regarding brokerage operations, contact Tom Hruby, Loss Control Manager, at 800-274-5222.

A bank opened a brokerage subsidiary using a third-party broker-dealer to handle operations, training and compliance. As a dual-employee, the manager ran the operation single-handedly, with all brokerage employees reporting to him. The manager had complete control over all brokerage transactions and reconciliations, creating an environment lacking any segregation of duties. Over a period of 3 years, he was able to embezzle over \$2,000,000 from elderly clients by selling off their bonds, depositing the proceeds into his own personal accounts, altering their statements and continuing to pay dividends from the proceeds.