

NASD NOTICE TO MEMBERS 04-71 (N0000914)

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The Securities and Exchange commission (SEC) approved rule changes (Supervisory Control Amendments) proposed by the NASD that both create and amend certain rules and interpretive materials to address a member's supervisory and supervisory control procedures.¹ On September 30, 2004, the SEC granted accelerated approval to proposed rule changes to the Supervisory Control Amendments to conform certain parts of the new rule requirements to the New York Stock Exchange's (NYSE's) recently approved internal control amendments.² In their entirety, the approved rule changes:

Eliminate Rule 3010(a)(8), which required a member to identify one or more principals who will review the member's supervisory system, procedures, and inspections and take or recommend action to achieve the member's compliance with applicable securities laws and regulations and with NASD rules;

Create Rule 3012 to require a member to designate one or more principals who will establish, maintain, and enforce a system of supervisory control policies and procedures that test and verify that the member's supervisory procedures are reasonably designed to comply with applicable securities laws and NASD rules and amend those supervisory procedures where necessary. Rule 3012 also requires that a person senior or "otherwise independent" to a producing manager perform the day-to-day supervisory reviews of the producing manager's account activity.

However, if a member is so limited in size and resources that it cannot comply with this general supervisory requirement, the member may have a knowledgeable principal perform the supervisory reviews. In addition, a member must have in place heightened supervisory procedures for the supervision of a producing manager who is responsible for 20 percent or more of the revenue generated by the business units supervised by the producing manager's supervisor.

Amend Rule 3010(c) to codify the minimum inspection cycles for a member's offices and to require that office inspections include, without limitation, the testing and verification of the member's policies and procedures, including supervisory policies and procedures in certain specified areas. There is a general requirement that an office inspection may not be conducted by the branch office manager for that office, any person within that office who has supervisory responsibilities, or any individual who is directly or indirectly supervised by such persons.

However, if a member is so limited in size and resources that it cannot comply with this limitation, the member may have a knowledgeable principal perform the inspections. Depending upon the position of the person within the member who conducts the inspection, a member must have in place heightened inspection procedures for the inspection of an office where the producing manager is responsible for 20 percent or more of the revenue generated by the business units supervised by the producing manager's supervisor.

Amend Rule 3110 to require that before any customer order is executed, the account name/designation must be placed upon the memorandum for each transaction. Additionally, no changes to the account name/designation can be made unless previously authorized by a member or a person designated under NASD rules (who must pass a qualifying principal exam). Such person, prior to giving such approval, must be informed of the essential facts and indicate his/her approval in writing on the order or similar record. The facts relied upon by the person in approving the change must be documented in writing and preserved for a period of not less than three years, with the documentation preserved for the first two years in an easily accessible place, as the term "easily accessible place" is used in SEC Rule 17a-4.

Amend Rule 2510(dXI) to require that time and price discretionary authority is limited to the day it is granted, absent a specific, written indication signed and dated by the customer. The limitation does not apply to time and price discretion exercised for orders in an institutional account pursuant to valid Good-Till-Cancelled instructions issued on a "not held" basis. Any exercise of time and price discretion must be reflected on the order ticket.

This Notice provides interpretive guidance on these rule changes. The Notice also explains the relationship between recently approved (but not yet effective) Rule 3013 and Rules 3012 and 3010. The text of the amendments is set forth in Attachment A and becomes effective on January 31, 2005.~ A table of contents has been provided for readers' convenience.

Background

Adequate supervisory systems play an important role in assuring investor protection and the integrity of the markets. Operational and sales practice abuses can stem from ineffective supervisory and supervisory control procedures. The 2002 Gruttadauria case, which involved a branch office manager's misappropriation of approximately \$40 million of customer funds,⁴ brought tremendous attention to the ongoing problem of operational and sales practice abuses at firms and the importance of ensuring that firms effectively monitor the activities of their employees.

In light of the concerns raised by the Gruttadauria case with respect to inadequate supervisory systems, NASD has amended certain rules and interpretive materials and has created new Rule 3012 (Supervisory Controls System). This Notice explains and describes those amendments and the provisions of Rule 3012. This Notice also explains how recently approved Rule 3013 (Annual Certification of Compliance and Supervisory Processes) and IM-3013 (Annual Compliance and Supervision Certification) interact with Rule 3012 and amended Rule 3010 (Supervision).

Relationship between Rules 3010, 3012, and 3013

New Rule 3013 requires each member firm's chief executive officer (CEO) to certify annually that senior executive management has in place processes to: (1) establish, maintain, and review policies and procedures reasonably designed to achieve compliance with applicable NASD rules, Municipal Securities Rulemaking Board (MSRB) rules, and federal securities laws and regulations; (2) modify such policies and procedures as business, regulatory, and legislative changes and events dictate; and (3) test the effectiveness of such policies and procedures on a periodic basis, the timing of which is reasonably designed to ensure continuing compliance with NASD rules, MSRB rules, and federal securities laws and regulations. IM-3013 sets forth the language of the CEO certification and gives further guidance as to the requirements and limitations of Rule 3013.

Because Rules 3010 and 3012 also address a member firm's supervisory policies and procedures, firms have questioned whether these rules impose duplicative requirements regarding the establishment of a firm's supervisory policies and procedures. Although Rules 3010, 3012, and 3013 are closely related, their obligations are complementary, not duplicative, in nature. The three rules essentially come together to form an overarching regulatory scheme for the supervision of member firms. First, Rule 3013 requires the CEO of each member to certify that they have a process to adopt compliance policies and supervisory procedures reasonably designed to achieve compliance with applicable securities laws and regulations and NASD rules. Rule 3010 requires the establishment of a supervisory system for the firm's business activities, including the adoption of policies and procedures reasonably designed to achieve compliance with applicable securities laws and regulations and NASD rules. The establishment of the supervisory system required to be adopted in Rule 3010 should result from the processes that are the subject of the certification of Rule 3013. Finally, Rule 3012 requires firms to (i) have supervisory control procedures that test and verify that the members' supervisory procedures are reasonably designed to achieve compliance with applicable securities laws and regulations and NASD rules, and (ii) where necessary, amend or create additional supervisory procedures. In sum, NASD's new regulatory supervisory scheme consists of process, supervision, and adoption of policies and procedures, and testing and amendment of such policies and procedures.

Rule 3012 — Supervisory Control System

Testing and verification of a Member's Supervisory Procedures

New Rule 3012 requires that a member designate and specifically identify one or more principals who will establish, maintain, and enforce supervisory control procedures that will test and verify that the member's supervisory procedures are sufficient and amend or create additional supervisory procedures where the need is identified by such testing and verification.⁶ Of course, NASD expects that the designated principals will test and verify the adequacy of the supervisory control procedures in a manner that is independent of any business considerations that are countervailing to full compliance with applicable securities laws and regulations and NASD rules.

Senior or "Otherwise Independent" Person to Review Producing Manager Rule 3012's supervisory control policies and procedures must include procedures that are reasonably designed to review and supervise on a day-to-day basis the customer account activity conducted by the member's branch office managers, sales managers, regional or district sales managers, or any person performing a similar supervisory function.⁷ A person who is senior to or "otherwise independent" of the producing manager must perform these day-to-day supervisory reviews.⁸ An associated person is considered a producing manager regardless of the amount of customer account activity the producing manager conducts. Accordingly, if the president of a member firm manages only a few accounts on behalf of the president's family and friends, that person is considered a producing manager for purposes of Rule 3012.

NASD understands that the determination of seniority for the purpose of deciding who should conduct a producing manager's supervisory reviews is a facts and circumstances test. A person who does not report to the producing manager, whose compensation is not determined in whole or part by the producing manager, and who is not in the same chain of authority may be considered senior to the producing manager if that person has the authority to oversee, direct, and correct the activities of the producing manager and take all necessary remedial actions, including termination, if and when necessary.

Similarly, a member must consider certain factors in determining whether a person is an "otherwise independent" person for purposes of conducting a producing manager's day-to-day supervisory reviews. An "otherwise independent" person who may conduct supervisory reviews may not report either directly or indirectly to the producing manager under review. In addition, the otherwise independent person must be situated in an office other than the office of the producing manager, must not otherwise have supervisory responsibility over the activity being reviewed (including not being directly compensated based in whole or in part on the revenues accruing from those activities), and must alternate such review responsibility with another qualified person every two years or less.⁹

The ability of member firms to use individuals who are either senior to or "otherwise independent" of the producing manager to conduct the producing manager's day-to-day supervisory reviews allows member firms the flexibility to structure their supervisory review policies and procedures in a manner that both accords with their various business models and achieves the best customer protection practices. For example, if a member firm has a person who is senior to the producing manager assigned as the producing manager's supervisor but determines that, for customer protection purposes, the producing manager's supervisor should not conduct the day-to-day supervisory reviews of the producing manager's customer account activity because the supervisor is located in the producing manager's office, the member firm may have a person who meets the definition of an "otherwise independent" person conduct the day-to-day supervisory reviews of the producing manager's customer account activity.

Heightened Supervision Requirements

In addition, Rule 3012's supervisory control policies and procedures require a member to have procedures that are reasonably designed to provide heightened supervision over the activities of the producing manager if the producing manager is responsible for generating 20 percent or more of the revenue of the business units supervised by the producing manager's supervisor over the course of a rolling, twelve-month period.¹⁰ NASD views this 20 percent threshold as a trigger for determining when

a member must put in place heightened supervisory procedures. For purposes of determining the 20 percent threshold, a member must look at all revenue generated by or credited to the producing manager or the producing manager's office, and that amount shall be included as part of the overall revenues of the business units supervised by the producing manager's supervisor irrespective of a member's internal allocation of such revenue. Rule 3012 requires the 20 percent threshold to be calculated on a rolling, twelve-month basis. The standard for heightened supervision in Rule 3012 does not create a negative safe harbor, i.e., the inspection of offices falling below the 20 percent threshold does not create a presumption that heightened supervision is not required. A member may need to employ heightened supervision in connection with reviews based on other facts and circumstances.

For purposes of Rule 3012, the term "heightened supervision" means those supervisory procedures that are designed to avoid conflicts of interest that serve to undermine complete and effective supervision because of the economic, commercial, or financial interests that the supervisor holds in the associated persons and businesses being supervised.¹⁷ Heightened supervisory procedures may include such elements as unannounced supervisory reviews, an increased number of supervisory reviews by different reviewers within a certain period, a broader scope of activities reviewed, and/or having one or more principals approve the supervisory review of such producing managers. These examples are meant to illustrate the type of procedures a member may want to include in its heightened supervisory procedures and are not meant to be an exclusive or exhaustive list of heightened supervisory procedures a member may need to put in place.

Member firms should note that an "otherwise independent" person is not considered to be the producing manager's supervisor for purposes of determining whether a producing manager is responsible for generating 20 percent or more of the revenue of the business units supervised by the producing manager's supervisor, such that the member firm must put in place heightened supervisory procedures. Accordingly, if an "otherwise independent" person conducts a producing manager's supervisory reviews, the firm will not be required to put in place heightened supervisory procedures. The heightened supervision requirement is designed to avoid any conflicts of interest that may undermine an objective and comprehensive review of the producing manager's customer activity. The factors that define an "otherwise independent" person already protect against the possibility that any conflicts of interest may exist that might adversely affect the producing manager's supervisory reviews, especially the restriction that an "otherwise independent" person not be directly compensated based in whole or in part on the revenues accruing from the activities being reviewed.

"Limited Size and Resources" Exception

Rule 3012 provides a limited exception for any member firm that is so limited in size and resources (the "limited size and resources" exception) that the member does not have associated persons who can conduct supervisions and are senior or "otherwise independent" from the producing managers. In such situations, a member may have the reviews conducted by a principal who is sufficiently knowledgeable of the member's supervisory control procedures." Whether a member firm may use the "limited size and resources" exception depends on the facts and circumstances surrounding each member firm. In some instances, the size of a member firm will generally determine that the member firm does not have the ability to conduct the supervisory reviews for any of its producing managers. For example, a sole proprietor or a member with only one small office will be eligible to use the "limited size and resources" exception.

In other instances, a member may be able to use the "limited size and resources exception for part, but not all, of its supervisory obligations. For example, a member firm may have the size and resources to have a person senior or "otherwise independent" conduct the reviews of the branch manager of each office but may need to use the exception in connection with the supervision of the customer account activity of producing supervisors up the chain of command up to and including the CEO. Nevertheless, members should be mindful that they can avail themselves of the "limited size and resources" exception only where a person senior or "otherwise independent" of the producing manager is not available to conduct supervision of the producing manager's customer account activity. Having someone available but who may find it difficult to conduct the supervisory reviews is not sufficient to use the "limited size and resources" exception. Members that do qualify to use the exception may, nevertheless, want to consider whether it would be

in the best interests of the firm to prohibit its senior persons from servicing accounts.

Because the "limited size and resources" exception is designed for those firms that genuinely need relief from the general supervisory requirement applicable to producing managers, NASD expects the "limited size and resources" exception to be narrowly construed. Moreover, there is no initial allowance (as discussed below in the context of Rule 3010) for any particular business model to be permitted to be deemed of "limited size and resources" solely because of its business model. As noted further below, each firm using the exception, regardless of business model, will need to evidence its being of such "limited size and resources" that it cannot comply with the general requirement. Firms that either construct their business models specifically to take advantage of the "limited size and resources" exception or that have the size and resources to comply with the general requirement and yet fail to comply with the general requirement will be in violation of Rule 3012.

Any supervisory reviews conducted using the "limited size and resources" exception must still comply, to the extent possible with the general requirement, that someone who is either senior or "otherwise independent" conduct the reviews.³ For example, if a firm does not have someone who is senior to a producing manager but does have persons who would be considered "otherwise independent" except for the fact that there is an insufficient number to meet the requirement that they conduct the supervisory reviews on a two-year rotation, the member firm must use these qualified persons to conduct the producing manager's supervisory reviews rather than using a principal who is sufficiently knowledgeable of the member firm's supervisory control procedures but who does not meet the factors of the "otherwise independent" definition.

A member using the "limited size and resources" exception must also document in its supervisory control procedures the factors used to determine that complete compliance with all of the provisions of the general supervisory requirement is not possible and that the required supervisory system and procedures in place with respect to any producing manager comply, to the extent practicable, with the general supervisory requirement.⁴ For instance, a member firm using the "limited size and resources" exception to conduct the day-to-day supervisory reviews of its most senior personnel who are also considered producing managers but that has the resources to use the general supervisory requirement to conduct the day-to-day supervisory reviews of the rest of its producing managers, must document factors, such as the lack of sufficiently qualified personnel to conduct supervisory reviews of its senior persons, and how, to the extent practicable, the persons who are conducting the senior persons' supervisory reviews meet some, if not all, of the provisions of the "otherwise independent" definition.
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