

NSCP CURRENTS

A Publication of the NATIONAL SOCIETY OF COMPLIANCE PROFESSIONALS

Developments Under NASD Rule 3012 – Supervisory Control Systems

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This is the second in a series of five articles focusing on recent developments in broker-dealer compliance. This first article, "Annual Compliance and Supervision Certification: Lessons Learned by Broker-Dealers," was published in the May 2006 NSCP Hotline Memo. Our second article will address developments under NASD Rule 3012 – Supervisory Control Systems.

INTRODUCTION

NASD Rule 3012, which specifies the supervisory control systems firms must have in place, is a frequent topic of discussion among compliance officials and at regulatory conferences because of its all-encompassing requirements affecting all aspects of the business of every broker-dealer, no matter how large or small. A handful of topics have proved to be among the most debated and challenging faced by compliance officials and their efforts to comply with the requirements of Rule 3012, including appropriate testing and verification, adequate

review of producing managers, heightened supervision requirements, and an efficient methodology for the development of policies and procedures. Based upon our recent client inquiries, we believe that the NASD has begun a heightened supervision sweep. To assist in your supervisory control analysis, we have set forth a number of practical practice tips that compliance officers may find helpful in addressing these often confusing topics.

I. TESTING AND VERIFICATION

Rule 3012 requires a firm to "(A) test and verify that the member's supervisory procedures are reasonably designed with respect to the activities of the member and its registered representatives and associated persons, to achieve compliance with applicable securities laws and regulations, and with applicable NASD rules and (B) create additional or amend supervisory procedures where the need is identified by such testing and verification."

In NTM 05-29, the NASD provided specific guidance regarding Rule 3012's requirement that members test and verify the adequacy of their supervisory procedures. The NASD emphasized that its guidance is not a checklist of steps guaranteed to constitute an adequate supervisory control system or a substitute for a system tailored to the particular needs of the firm. In other words, adopting

wholesale the NASD's guidance will not provide a safe harbor — the testing and notification must fit the firm.

In the NASD's view the steps necessary for appropriate testing and verification include:

1. conducting an inventory of the firm's business, including its various products deserving of separate attention, and of the laws and regulations applicable to that business;
2. analyzing the applicable legal requirements to determine what conduct is required of the firm and prohibited to the firm, including particular attention to new (or terminated lines) of business and products, new regulatory requirements, and new personnel;
3. determining *how* the firm will meet those requirements and prohibitions, *who* will be responsible, and *what* methods will be followed;
4. considering how the firm's internal policies and restrictions will impact the required procedures; and

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5. deciding what changes to existing procedures are needed to fill in any gaps and deficiencies identified in the testing.

This process should review all existing procedures as well as new matters. As the NASD pointed out, a firm's system of supervision is not static.

For purposes of the Rule, a firm must test and verify (and amend where needed) its written supervisory control policies and procedures as well as its written procedures to supervise. Some practice tips for developing a methodology to test and verify in your firm are described below in Section III.

II. SENIOR OR "OTHERWISE INDEPENDENT" PERSON TO REVIEW PRODUCING MANAGER

In NTM 04-71, the NASD announced the elimination of Rule 3010(a)(8) and the creation of Rule 3012, which requires members, in part, to have a "person senior or 'otherwise independent' to a producing manager perform the day-to-day supervisory reviews of the producing manager's account activity." Rule 3012 (a)(2)(A)(ii) clarifies that in order to be an "otherwise independent" person, one may not:

1. report directly or indirectly to the producing manager;
2. be situated in the same office of the producing manager;
3. have supervisory responsibility over the activity being reviewed (including not being directly compensated based in whole or in part on the revenues accruing for those activities); and
4. review the producing manager's activities for more than two years.

This "otherwise independent" requirement is designed to avoid possible conflicts of interest that may exist to undermine objective and comprehensive supervision of the producing manager's customer activity.

The NASD knows that broker-dealers are unique in size and

resources. Therefore, in the Rule, the NASD provided for an exception. If due to size the firm does not have anyone who is "otherwise independent," then a principal who is knowledgeable of the member's supervisory control procedures may conduct the review. Most commonly this situation may exist where the member has only one office or in the independent contractor business model where there are not a sufficient number of independent associated persons to conduct the review. Should members rely upon a "limited size and resource" exception for conducting producing managers' supervisory reviews, they must report this electronically to NASD and document the control processes at the firm.

For additional information regarding reporting requirements and specific documentation guidelines, please refer to NASD Notice to Members 06-04.

III. DEVELOPMENT OF POLICIES AND PROCEDURES

The annual compliance report period provided an opportunity for broker-dealers to test, verify and further enhance policies and procedures within the organization. It also gave members the opportunity to develop a working committee to discuss and implement new supervisory control processes. Looking back, here are some of the challenges members faced, lessons we've learned and business risk management tips to consider.

#1: How to develop testing and verification processes – what to review and how frequently

When testing your firm's policies and procedures, it is important to not only review your written supervisory procedures (WSPs) for accuracy but also to examine the control measures you have established for ensuring that processes are capturing what you expect it to. By increasing sampling sizes, increasing the number of focused reviews, conducting unannounced supervisory reviews

and broadening the scope of activities reviewed, the member will be able to verify the effectiveness of its internal controls.

Some areas that principals may want to consider when conducting testing and verification include interviewing key firm members for knowledge of policies and current procedures, understanding the business structure and sales practices of the member, regulatory deficiency letters received, types of recent customer complaints, credit report and registration disclosures, trade cancel and corrects and audit deficiency findings. Many broker-dealers have elected to conduct these reviews on a periodic basis with more in-depth and frequent reviews occurring as potential red flags are discovered. For example, where a more comprehensive review is needed for a particular producing manager, consider placing him/her on pre-approval, issue a letter of caution, contact the client or conduct a surprise examination. Regardless of the methodology, be sure to document all reviews in accordance with the firm's books and records requirements.

#2: How to best utilize the unique roles of the audit and surveillance teams

Within most organizations, there are two areas primarily responsible for testing and verification: internal audit and compliance. For most broker-dealers the two compliance divisions are primarily responsible for overseeing supervisory controls: the audit team and surveillance group. Rule 3010 provides comprehensive guidance for audit teams to follow during its examinations. Producing managers are to be examined to ensure they are establishing and enforcing procedures reasonably designed to ensure supervision of its representatives within the branch. Though examination checklists, inspection of books and records and interview processes, the auditor can access the producing manager's culture of compliance and if needed,

will provide training, guidance and deficiency notifications, including possible disciplinary measures, to ensure the producing manager abides by the policies and procedures outlined by the firm.

On the other hand, the surveillance team relies on guidance through Rule 3012 to develop the processes for its surveillance control processes. The surveillance group is responsible for looking into possible sales abuses of its associated persons. Through automated reports, required disclosure documents and sales transaction surveying, the member can design a control environment for detecting when a producing manager may be attempting to circumvent a firm policy or industry regulation and/or when a supervisory control process has a “gap.” By evaluating trends/patterns within your surveillance reports, members can address red flags that are noted and assess whether further action is required. Throughout the process, the surveillance team should document issues as they are discovered and escalate to management, as needed, to address or amend the supervisory procedure.

#3: Recordkeeping – what to record and how

As the regulatory environment evolves, member firms have fine-tuned their recordkeeping processes. During this progression, some broker-dealers have struggled with what to record and how to record deficiencies, gaps and red-flags as they are found. For example, should members maintain only those records required by federal, state and self-regulatory rules and regulations or is it better to keep everything, including all working papers, to evidence the historic robustness of their compliance program? There are different approaches members have taken to demonstrate the firm’s testing and verification of supervisory controls and overall effectiveness of the compliance program. Dependent upon the area tested, most broker-dealers

utilize a combination of recordkeeping approaches. Since there is not a “one-size-fits-all” model to follow, firms have developed a series of reports, checklists, spreadsheets and databases for capturing their supervisory control reviews. Doing so allows the firm to illustrate its methodology and process to the regulators who ultimately will evaluate the adequacy of the member’s supervisory control measures. What to record and how to record it is left to the discretion of the individual firm.

#4: Distinguishing Heightened Supervision Processes from Producing Manager Oversight

Heightened supervision is distinguished from the oversight requirement for producing managers. In addition, there are different contexts of the term “heightened supervision.” For example, in the independent contractor model, heightened supervision may be required for those non-OSJs who are responsible for 20% or more of the revenue generated by the OSJ. This type of “heightened supervision” would require an “otherwise independent” principal to review the activities of this non-OSJ. In such situations, the individuals under heightened supervision may not be a “problem” employee; they merely require a more thorough review of their sales activities. For this type of heightened supervision, members may want to focus their “heightened” reviews on the product mix of the non-OSJ, the number of times the non-OSJ requested an exception to firm policy, the number of times the non-OSJ “hit” your surveillance reports, and concerns other business areas may have about this individual’s sales practices. If “red flags” are discovered during this process, consider implementing the following heightened supervision best practices.

IV. HEIGHTENED SUPERVISION

In addition to what was discussed above, heightened supervision involves establishing and updating adequate systems of control to address situations where the circumstances call

for heightened evaluation. This level of supervision is usually required for so-called “problem” employees with a history of customer complaints or troubled regulatory and compliance records. It is a matter of client protection and self-protection for the firm.

Much of the increased emphasis on heightened supervision grew out of the Joint Regulatory Sales Practice Sweep Report issued on March 18, 1996, and discussed at length in NTM 97–19. Deficient supervision and supervisory procedures was the most common violation reported by the Sweep Report, and it recommended that firms exercise heightened or special supervision over representatives with disciplinary histories.

In summary, the Sweep Report’s recommendation included:

- improved hiring procedures to identify and, where appropriate, exclude problem representatives;
- enhanced supervision of problem representatives; and
- branch manager compensation tied to the manager’s effective supervision of the branch’s registered representatives.

Registered representatives that should be considered as candidates for heightened supervision include those whose records reflect disciplinary actions involving sales practice abuse; a history of customer complaints and/or arbitrations that were not resolved in favor of the registered representative.

NTM 97–19 stated that a firm hiring registered representatives with profiles discussed above should recognize that: “...it has heightened supervisory responsibilities that will require it, at a minimum, to examine the circumstances of each such case and make a reasonable determination whether its standard supervisory [structure] [is] adequate to address the issues raised by the record of any such

registered representative.”

If registered representatives with problem histories engage in further sales practice violations, “...securities regulators will closely evaluate whether the firm itself should be subject to disciplinary actions for a failure to supervise the registered representative, beginning with the decision-making process that led to the individual being hired.”

The principal means of identifying registered representatives who may require special supervision is a review of representatives’ complaint and disciplinary-related history disclosed individually on Forms U-4 and U-5 filed with the Central Registration Depository (“CRD”). The need for a heightened level of supervision may be appropriate for those registered representatives whose CRD reports disclose several sales practice problems and not merely an isolated instance of a customer complaint.

Ordinary supervisory procedures generally will not be sufficient to ensure compliance with federal securities laws and SRO rules when registered representatives with “problem profiles” are hired or such profiles develop. Where the profile develops or new problems arise after hiring, the firm must have a procedure to escalate the level of supervision if necessary. Firms must modify their ordinary supervisory procedures in all such cases, by developing and implementing special supervisory procedures structured on an *ad hoc* basis. Thus, the procedures developed should be based on the areas that were the subject of the representative’s previous customer complaints, disciplinary actions or arbitrations. For example: firms may require a registered representative and the direct supervisor to sign an acknowledgement indicating their understanding and their agreement to be subject to specifically identified special supervisory procedures for a defined time period; or firms that regularly require supervisors to

provide a signoff on daily activity could require supervisors of registered representatives subject to special supervisory arrangements to expressly include those arrangements in such a sign-off, or to periodically attest in writing that they have carried out the terms of the special supervision.

Beyond those supervisory procedures already mandated by NASD rules, factors to be considered in devising programs of heightened supervision include:

1. determining the conduct that resulted in the registered representative’s history of customer complaints, disciplinary actions or arbitrations and what type of supervision might best control and limit such type of risk;
2. training implemented with an eye on particular trends in order to avoid future complaints;
3. where warranted, “closer than normal control” over the establishment of new customer accounts or certain accounts where any of the conduct leading to the previous regulatory problems might be an issue (e.g., where a registered representative has a history of complaints involving initial transactions in accounts or prohibiting trading until the account information or the order information could be independently verified with the customer);
4. focusing on and prohibiting a registered representative from engaging in transactions involved in prior problems or requiring supervisory approval of all such transactions in advance of execution; and
5. developing exception reports designed to detect transactions uncharacteristic in size or volume, unusual increases or decreases in a broker’s commissions, transactions between accounts or excessive or suspicious corrections.

Some specific examples of procedures a firm may wish to consider are:

1. A supervisor of a registered

representative subject to heightened supervisory procedures should monitor customer transactions in light of the customer’s current investment objectives and require the representative to revise and resubmit new account forms or other forms regarding a customer’s objectives each time the customer’s investment objectives change.

2. To meet supervisory obligations, a supervisor of a registered representative subject to heightened supervisory procedures must make additional, personal contacts with the representative’s customers.
3. For a designated period of time following hiring or a particular sales practice incident, a registered representative subject to heightened supervisory procedures can be required to obtain a supervisor’s approval before entering orders of the type involved in conduct giving rise to the heightened supervision.
4. A supervisor of a registered representative subject to heightened supervisory procedures should periodically monitor the representative’s contacts.
5. A supervisor of a registered representative subject to heightened supervisory procedures should conduct regular and frequent reviews of the representative’s customer accounts and monitor the representative’s profit levels.
6. Compliance or legal personnel should perform a thorough review of selected customer accounts of a registered representative subject to heightened supervision whenever he or she is named in a credible customer complaint alleging sales practice abuses.

When implemented, these best practices will provide for supervisory controls that will protect the client, the member firm and its associated persons. □

NSCP CURRENTS

is published by the

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