

What's Next? Beyond Initial Compliance with NASD and NYSE Certification Requirements; New Branch Office Definition

By now, all broker-dealers should have taken the initial steps necessary to comply with the certification reporting requirements imposed by NASD Rules 3013(b), IM-3013, and 3012(a)(1) and, as applicable, New York Stock Exchange ("NYSE") Rule 342.30 (collectively, the "Rules"). Although congratulations may have been in order back in April, broker-dealer compliance with the Rules is not "finished."

The Rules' certification and reporting requirements are designed as the culmination of a year-long process. Whether they know it or not, broker-dealers are in the midst of a new compliance cycle. What follows is summary of the Rules and a practical look at steps that broker-dealers should take during this stage of the current certification and reporting cycle.

Compliance Certification

NASD Rule 3010 – Supervisory System.

NASD Rule 3010 requires every NASD member firm to have a supervisory system in place reasonably designed to achieve compliance with applicable securities laws and NASD Rules.¹

¹ NASD Rule 3010(a) provides that: "Each member shall establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules."

NASD Rule 3013 – Annual Certification.

In 2004, the Securities and Exchange Commission ("SEC" or the "Commission") approved² new NASD Rule 3013, which requires the chief executive or equivalent officer ("CEO") of a broker-dealer to make a formal annual certification to the NASD regarding its compliance program. The firm's CEO must have made the initial certification by no later than April 1, 2006.³

The certification has four basic components. First, the CEO must certify that, pursuant to Rule 3013(b), the member has in place processes to:

- Establish, maintain, and review policies and procedures that are reasonably designed to achieve compliance with applicable NASD rules, MSRB rules, and federal securities laws and regulations

² See *Dechert OnPoint*, "SEC Approves NASD CEO Compliance Certification Rule," October 2004, Issue 28. See also *Dechert OnPoint*, "SEC Approves Changes to NASD and NYSE Supervision and Related Rules," November 2004, Issue 31.

³ Firms were required to comply with NASD Rule 3013 and make their initial certifications by no later than January 31, 2006 (one year after the rule's effective date), but could elect to make their initial certifications by no later than April 1, 2006, with all future certifications being due no later than annually thereafter. See NASD Rule 3013 at n. 1.

- Modify such policies and procedures as business, regulatory, and legislative changes and events dictate
- 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 regulations⁴

Second, the CEO must certify that he or she “has conducted one or more meetings with the CCO in the preceding 12 months, the subject of which satisfy the obligations set forth in IM-3013.”⁵ Third, the CEO must certify that the member’s processes “are evidenced in a report reviewed by the CEO, CCO, and such other officers as the member may deem necessary to make this certification, and submitted to the member’s board of directors and audit committee.”⁶ Finally, the CEO must state that he or she “has consulted with the CCO and other officers as applicable and such other employees, outside consultants, lawyers and accountants, to the extent deemed appropriate, in order to attest to the statements made in [the] certification.”⁷

NASD Rule 3012 – Supervisory Control Policies and Procedures

NASD Rule 3012, also approved by the SEC in 2004,⁸ requires member firms to designate and specifically identify to the NASD one or more principals charged with establishing, maintaining, and enforcing a system of “supervisory control policies and procedures” that:

⁴ IM-3013.

⁵ *Id.*

⁶ *Id.* Understanding that some members may not utilize board and audit committee structures, members must nonetheless have the report viewed by their governing bodies and committees that serve similar functions. *Id.* at n.3.

⁷ *Id.*

⁸ SEC Release No. 34-49883 (June 17, 2004). On September 30, 2004, the SEC granted accelerated approval to additional changes to the NASD’s new supervisory controls rule that more closely conform the NASD’s rules to those of the NYSE (SEC Release No. 34-50477 (Sept. 30, 2004)).

- Test and verify that a member’s supervisory procedures are reasonably designed with respect to its activities to achieve compliance with the federal securities laws and NASD rules by the member, its registered representatives and associated persons; *and*
- Create additional or amended supervisory procedures where a need for such procedures is identified by such testing⁹

At least once annually, the principal(s) designated under Rule 3012 must submit a report to senior management that details the firm’s supervisory control policies and procedures, summarizes the results of testing, and identifies significant exceptions, and discusses additional or amended procedures implemented in response to such testing.¹⁰ As with Rule 3013, firms were required to submit their initial reports no later than January 31, 2006 (one year after the new rule’s effective date), but could elect to submit their initial reports by no later than April 1, 2006, with all future reports being due no later than annually thereafter.¹¹

The NASD has summarized this process as follows:

First, you have Rule 3013, which requires a member’s CEO to certify that the member has a *process* to adopt compliance policies and supervisory procedures that are reasonably designed to achieve compliance with applicable securities laws, regulations, and NASD rules. Then, you have Rule 3010, which 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 the applicable laws and rules. . . . The establishment of this system should be a result of the processes certified under Rule 3013. Finally, you have Rule 3012, which requires firms to (1) have supervisory control procedures that test and verify that those supervisory procedures are reasonably designed to achieve compliance with those applicable

⁹ NASD Rule 3012(a)(1).

¹⁰ *Id.*; see also NYSE Rule 342.30.

¹¹ *Id.* at n.1 and 3.

laws and rules, and (2) where necessary, amend or create additional supervisory procedures.¹²

NYSE Rule 342.30 – Annual Certification and Report

In 2005, the SEC approved¹³ a number of amendments to NYSE Rule 342.30, which, among other things, now requires NYSE members to submit to the Exchange a report on the member's supervision and compliance efforts during the preceding year and on the adequacy of its ongoing compliance processes and procedures.¹⁴ This report must include a tabulation of reports pertaining to customer complaints during the preceding year; identification and analysis of significant compliance programs, plans for future systems to prevent and detect violations, and an assessment of the member's efforts in this regard during the preceding year; and a discussion of the previous year's compliance efforts, new procedures, and educational programs.¹⁵ In addition, the member's CEO must make a certification that is similar to the four-part certification required by NASD Rule 3013 and IM-3013 as de-

¹² NASD Supervisory Control Amendments Workshop Telephone Transcript, Dec. 16, 2004, at 39.

¹³ SEC Release No. 34-52780 (Nov. 16, 2005). In 2004, the SEC had approved additional amendments to Rule 342, which required member firms to develop and implement written policies and procedures to independently supervise sales managers and other supervisory personnel who service customer accounts (new Rule 342.19) and to develop and maintain adequate controls over each of their business activities (new Rule 342.23). SEC Release No. 34-49882 (June 17, 2004); File No. SR-NYSE-2002-36. See also New York Stock Exchange Information Memo 04-38.

¹⁴ NYSE Rule 342.30. In New York Stock Exchange Information Memo 06-8 ("Information Memo 06-8"), the Exchange explains the mechanism for filing this report. NYSE Members must respond to the survey issued via the Electronic Filing Platform ("EFP"). Among other things, the survey requires Members to file their annual reports electronically in PDF format. Information Memo 06-8 also makes clear that the firm's board of directors and audit committee must receive the report referred to in Rule 342.30(e)(iii) (an internal firm report designed to support the CEO's certification) but need not review or approve it prior to the CEO's certification.

¹⁵ *Id.* Topics to cover, if applicable, include antifraud and trading practices, investment banking activities, sales practices, books and records, finance and operations, supervision, internal controls, and anti-money laundering.

scribed above.¹⁶ NYSE Rule 342.30 requires that the annual report and certification be completed by April 1 of each year.

Firms that are members of the NASD and the NYSE ("dual members") need not create three separate reports to satisfy the reporting requirements of each of the Rules. Dual members may, if they choose, create a single report, provided that it clearly identifies and addresses all of the requirements set forth in the Rules.¹⁷ This accommodation is designed to avoid unnecessary duplication of effort.

New Branch Office Requirements

Amendments to NASD Rule 3010: New Definition of "Branch Office"

More recently, the SEC has approved amendments to NASD Rule 3010(g)(2) (which replace the NASD's current definition of the term "branch office" with a uniform definition) and IM-3010-1 (which provides guidelines on factors that member firms should consider in conducting internal inspections of offices). IM-3010-1 provides:

In fulfilling its obligations pursuant to Rule 3010(c), each member must conduct a review, at least annually, of the businesses in which it engages, which review must be reasonably designed to assist in detecting and preventing violations of and achieving compliance with applicable securities laws and regulations and with NASD Rules. Each member shall establish and maintain supervisory procedures that must take into consideration, among other things, the firm's size, organizational structure, scope of business activities, number and location of offices, the nature and complexity of products and services offered, the volume of business done, the number of associated persons assigned to a location, whether a location has a principal on-site, whether the office is a non-branch location, the disciplinary

¹⁶ *Id.* Information Memo 06-8 states that Members must provide, as part of the electronic survey, the identity of the CEO who will be attesting to the required certification and the designated CCO.

¹⁷ SEC Release No. 34-52727 (November 3, 2005); File No. SR-NASD-2005-121.

history of registered representatives or associated persons, etc. The procedures established and the reviews conducted must provide that the quality of supervision at remote offices is sufficient to assure compliance with applicable securities laws and regulations and with NASD Rules. With respect to a non-branch location where a registered representative engages in securities activities, a member must be especially diligent in establishing procedures and conducting reasonable reviews. Based on the factors outlined above, members may need to impose reasonably designed supervisory procedures for certain locations and/or may need to provide for more frequent reviews of certain locations.

NASD Rule 3010(g)(2) and related IM-3010-1 will become effective on July 3, 2006.¹⁸ Accordingly, firms should be sure that their compliance policies and procedures reflect these new inspection criteria before that date. In addition, any existing offices that now meet this definition should be registered by July 3, 2006 using new Form BR.¹⁹

¹⁸ SEC Release No. 34-53538; File No. SR-NASD-2006-037. See also Notice to Members 05-67 (Oct. 2005). The substantially similar NYSE definition of "branch office," found in NYSE Rule 342.10, became effective on September 9, 2005. SEC Release No. 34-52402; File No. SR-NYSE-2002-34. In addition, the SEC recently approved new NYSE Rules 342.24 ("Annual Branch Office Inspection"), 342.25 ("Risk-Based Surveillance and Branch Office Identification"), and 342.26 ("Criteria for Inspection Plan"). Generally speaking, NYSE members must inspect each of their branch offices at least annually. However, members may submit to the NYSE for approval policies and procedures outlining a risk-based surveillance system which members may then use to identify certain branch offices for less frequent inspections (although members must inspect each of their branch offices at least once every three calendar years). SEC Release No. 34-53983; File No. SR-NYSE-2005-60.

¹⁹ On September 30, 2005 the SEC approved new Form BR, which replaced Schedule E of Form BD, the NYSE Branch Office Application Form (Section 6 of Form BR, completed only by NYSE members, elicits similar information), and applicable state branch office forms. SEC Release No. 34-52544; File No. SR-NASD-2005-030. New Form BR enables firms to register and manage ongoing reporting for branch offices with the NASD, NYSE, and the applicable states electronically through the CRD system. Initially, firms had until May 1, 2006 to file Forms BR for existing branch offices, but this deadline has also been moved to July 3, 2006.

What's Next?

Because the reporting and certification requirements are essentially new, the NASD and the NYSE (together, the "SROs") are likely to review member firm's initial NASD Rule 3012/NYSE Rule 342 reports without being overly-critical, *i.e.*, to ensure that the Rules' basic requirements have been satisfied. The Rules do not require that firms have in place perfect compliance systems—only that they have compliance systems in place that meet the basic requirements.²⁰ Nevertheless, if the SROs were to identify substantive problems with the contents of the reports, their inspectors or enforcement units could become involved. Serious problems (including potential violations of non-SRO rules) could be reported to the SEC or the U.S. Department of Justice. With respect to subsequent compliance cycles, the SROs may not be as lenient in their reviews of the reports. They are likely to expect to see progress and refinements with each cycle.

To fulfill these ongoing reporting obligations and withstand the increased scrutiny that the SROs could bring to their future reviews, firms should begin formulating their action plans now. Doing so should lessen the rush of activity immediately prior to the reporting and certification deadlines and make the drafting of the reports much easier. To that end, we offer the following observations and recommendations:

- **Prioritize Compliance Efforts.** A broker-dealer should be considering how it directs its compliance resources. Most firms take a risk-based approach and allocate their time and attention based on firm-specific areas of concern and other matters that regulators are emphasizing. In determining firm-specific priorities for the current compliance cycle, the broker-dealer should look to the following sources: (i) the initial reports it issued under the Rules, with special attention paid to those weaknesses or problems uncovered; (ii) inspection reports; (iii) customer complaints; (iv) the reasons behind any departures of registered representatives and compliance personnel; and (v) internal and external audit reports. All of these sources offer

²⁰ The NASD notes in IM-3013 that the signatory to the certification is certifying only as to having processes in place to establish, maintain, review, test, and modify the member's written compliance and supervisory procedures.

valuable information that compliance officials should study carefully to determine areas requiring additional attention.

- **Be Alert to New Developments.** In addition, a broker-dealer should be aware of legislative and regulatory developments, changes, and statements made by securities regulators indicating points of emphasis. In fact, a broker-dealer's procedures should specify responsibility for regular checking for new developments. Currently, examiners are particularly interested in areas such as mutual fund and variable annuity sales practices, anti-money laundering, email retention, and soft dollar practices. The SEC's Director of Compliance Inspections and Examinations has recently pointed out that the SEC focuses its internal controls examinations "on selected business areas which are either new, highly profitable or viewed as possessing greater risk."²¹ Thus, the broker-dealer should be familiar with the current thinking of securities regulators. As the emphasis of regulators shift, so too should the priorities of the firm's compliance department.
- **Identify Your Own Concerns.** A good risk-based risk management system must place firm-specific concerns first. While regulators' statements are important, not all of the identified regulatory hot button issues will apply to all firms with equal force. For example, anti-money laundering is currently an important concern for regulators, and broker-dealers must ensure that their policies are current and adequate. But a small firm whose operations are local, and that has retail clients it knows well, should probably devote less of its compliance resources to this matter than an international firm with multiple business lines.
- **Evaluate Business Lines.** Firms should also consider the way in which they are evaluating their business lines or products. When the CCO or Compliance Department conducts a compliance evaluation of a business line or product, the firm should do the following: (i) identify the business line or product under review; (ii) identify the unique risks associated with this par-

ticular business line or product; (iii) determine how the firm currently addresses these risks (e.g., prohibitions on certain practices, reviews by principals) and how the risk management process is currently being documented; (iv) determine whether the current policies and procedures are adequately controlling the identified risks; (v) if necessary, create new (or amend current) policies and procedures to improve compliance and better manage risk; (vi) implement changes to policies and procedures; (vii) communicate the changes to the firm's affected employees; and (viii) monitor implementation.

- **Assign Responsibilities.** Once the firm has established priorities for the coming period (which, of course, are always subject to change), the CCO or Compliance Department should assign responsibilities for review of procedures and testing to appropriate principals. The Compliance Department should maintain written records of these assignments as part of a "To Do" list, detailing the compliance matter, the party to whom it is assigned, the target completion date, and the resolution. The Compliance Department should schedule meetings to assess progress towards completion of these matters.

Of course, the firm must follow through on the projects and be able to demonstrate significant progress. While some of these assigned compliance tasks will be *ad hoc*, the CCO or Compliance Department should work with management to assign principals to certain lines of business and products on a permanent basis. Once assigned, the firm must be able to rely on these principals to understand current policies and procedures; monitor the regulatory landscape; and recommend changes to policies and procedures when warranted. Principals must be involved and proactive, and they should not await prompting and prodding by the CCO or Compliance Department.

- **Don't Confuse Compliance and Supervision.** This process of assigning tasks and responsibilities reflects an important fact: in larger firms, the CCO cannot reasonably be expected to handle personally every compliance task and maintain primary oversight of all business lines and products. Firms should have up-to-date organizational charts with clear lines of responsi-

²¹ Lori Richards, Remarks before the Securities Industry Association, Internal Auditors Division 2005 Annual Conference (October 18, 2005).

bility. A clear organizational structure facilitates the assignment of compliance responsibilities and makes clear that the full burden of maintaining a strong compliance culture does not rest solely with the CCO and Compliance Department. Principals supervise, and Compliance monitors. The Compliance Department and business managers must all work together and view their primary functions as complementary:

The role of the Compliance Department is to advise businesses on how to comply with applicable laws and regulations and to monitor business activities and employee conduct to identify violations (or potential violations) of rules, regulations, policies, procedures and industry standards. . . . The Compliance Department plays an integral support function for firm compliance programs, but only senior management and business line supervisors ultimately are responsible for ensuring firm compliance with laws and regulations.²²

- **Cooperate and Collaborate.** Recognizing the critical differences in functions and responsibilities between business and compliance, the firm's business side and compliance personnel must work together to achieve the common goal of good firm compliance. Without that cooperation, even the best compliance program will be of limited use. Creating a written compliance meeting schedule now and setting agendas for the meetings will encourage that cooperation and collaboration.
- **Make Records of Compliance Efforts.** Participants in the compliance process should memorialize key aspects of their efforts. For example, at each meeting, an assigned participant should keep a log of the date of the meeting, the attendees, the compliance matters discussed, the work that remains to be done and the parties responsible, and target completion dates (where applicable). This information should also be included on a continuously updated "To Do" list. Aside from being good practice, these logs

²² Securities Industry Association, Compliance & Legal Division, White Paper on the Role of Compliance, Oct. 2005, at 10.

will provide needed support for the NASD and NYSE reports and certifications.²³

- **Anticipate New Business Initiatives.** Management should advise the Compliance Department of its expansion plans. If the firm plans to enter into a new line of business, management and compliance should work together to determine whether this change will require the firm to establish new policies and procedures (or the modification of existing policies and procedures), the assignment of new principals to the line of business, and new testing procedures.
- **Plan for Your Next Reports.** When drafting the reports required by the Rules, the broker-dealer should do the following:
 - State at the outset the lines of business in which it engages and the scope of its operations. This will help avoid confusion on the part of the regulators and provide a proper context in which they can evaluate the reports and the broker-dealer's operations.
 - Consider requiring certain key individuals to provide periodic internal certifications as well. This can be a useful means of providing greater support to the certifications and reports. The firm can tailor these certifications (and the materials used to support the certifications) to the individual's line of business and area of supervision.
 - Consider whether it should file its NASD report at or around the same time next year. While a firm cannot set its calendar to include a period of time greater than twelve months, nothing precludes a firm from shortening its compliance cycle. From a business or operational standpoint, it may make sense to deviate from a compliance cycle that ends on April 1. By completing one shortened cycle that ends at a more convenient point in the calendar year, the firm could then subsequently place itself on

²³ Of course, there is the risk that examiners will use such records to identify a firm's failures in the compliance program. Record keepers must exercise good judgment, producing reports that are accurate, brief, and exclude minutia. Despite some risks, the complete failure to keep track of, and assign responsibility for, compliance efforts is more likely to lead to regulatory failure.

a consistent twelve-month certification and reporting cycle that is more to its liking.

We suggest that a broker-dealer should be wary of asserting in its internal reports or in its reports to the SROs that its testing and review of its procedures uncovered no weaknesses or problems, unless (as is unlikely) this is in fact the case. Such statements could have the effect of inviting increased attention from regulators. Even if a broker-dealer makes such a statement in good faith, it could suggest to regulators that the broker-dealer's testing and review were not sufficiently rigorous.

Conclusion

Although the creation and submission of the Rules' reports and certifications are distinct events, the work on which they are based is ongoing. Firms' initial efforts in these areas may have been harried, especially during the few months leading up to the deadlines.

Taking the actions outlined above and focusing on the process now should help to ensure a better, more orderly reporting and certification program. As noted above, regulators are expected to become more exacting in their reviews, and will likely expect broker-dealers to improve the execution of their compliance programs from year to year. An investment in time and energy now should help improve the process as the next round of deadlines approaches.



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