

BD Hot Buttons

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I. INTRODUCTION

This panel will cover the following four topics:

1. Responsibilities and liabilities of CCOs;
2. Front line supervisor activities and responsibilities;
3. Branch Office Oversight and New Form BR; and
4. New SEC IA/BD rule.

II. RESPONSIBILITIES AND LIABILITIES OF CCOS

A. Background

As the scandals have unfolded on Wall Street during the past several years, the role of Compliance Departments and compliance officers has come under increasing scrutiny. Regulators and, most recently, the securities industry, have talked about the important role played by compliance officers. Highlights of these discussions are outlined below.

B. Remarks of Regulators on Compliance Departments, Programs, and Officers

Over the past few years, regulators have frequently commented on the role played by Compliance Departments, compliance programs, and compliance officers.

1. Compliance Professionals Play Proactive Defense, Lori A. Richards (October 18, 2001)

Calling for compliance officers to be “proactive.”

2. The Vital Role of Effective Comprehensive Compliance Controls of Broker-Dealers, Mary Ann Gadziala (February 4, 2004)

“Effective compliance programs include those where compliance issues are tracked, updated and reported to senior levels; compliance officers are members of new products committees; compliance staff sit in business areas for constant monitoring; and compliance staff dedicated to business units have expertise in the area.”

3. The Future of Self Regulation, Richard G. Ketchum (Nov. 11, 2004)

“Firms have to recognize that their legal and compliance staffs are their lifelines to building [a] compliance foundation. Access to senior management must be regular and unconditional. More than that, the conversations have to go beyond a discussion of current events to a genuine analysis of compliance risks across the business.”

4. Remarks before the 2004 Investment Company Institute Securities Law Developments Conference, Stephen Cutler (Dec. 6, 2004)

“The chief compliance officer has a unique role within the investment management organization in identifying and addressing risks in the organization before they become legal violations, promptly uncovering and remedying compliance failures when they do occur, and fostering a culture of compliance throughout the firm.”

5. Compliance: Some Core Principles, Lori A. Richards (April 20, 2005)

“Chief compliance officers play a critical role in ensuring an overall effective compliance program, and as regulators we will hold them to their responsibilities.”

“The [April 2005 IOSCO paper entitled “Compliance Function at Market Intermediaries”] sets forth the need for high caliber people to perform compliance. It states:

‘Staff exercising compliance responsibilities should have the necessary qualifications, experience and professional and personal qualities to enable them to carry out their duties effectively.’

Of course, this is a universal truth – the nature of the compliance function dictates that it be performed by highly capable individuals. The Commission has said that CCO’s must be “competent and knowledgeable” concerning the securities laws. And of course it’s understood that they should possess necessary qualifications and experience. What does it mean though, to say that they should possess the necessary “personal qualities” to enable them to carry out their duties? Doesn’t being effective in the compliance profession require a skeptical attitude, an innate curiosity about how firm employees and others might be trying to circumvent the law or the firm’s policies and procedures? Doesn’t it require the ability to interact effectively with others, particularly when raising difficult issues? Doesn’t it require an ability to be persistent, even relentless, when investigating issues and in raising them with senior management? Compliance is not and never was a haven for passive box-checkers.”

6. Remarks before the National Society of Compliance Professionals National Membership Meeting, Lori Richards (Oct. 25, 2005)

“The people in this room understand that Compliance Matters. But, unless we convince business managers, top level executives, and others, our collective efforts will not be effective. I recently said that for a firm to be compliant “it takes a village.” What I meant by that was that compliance professionals are not guarantors for the firm’s compliance with the law. They aid, educate, guide, detect, and check, but the firm’s business-line

employees are first and foremost responsible for their own conduct. Supervisors and managers, and indeed, all employees must view compliance with the law as a given in all forms of business, and they must view compliance professionals as indispensable in helping them to do that.”

7. Integrating Audit and Compliance Disciplines within the Risk Management Framework, Mary Ann Gadziala (Nov. 30, 2005)

“Effective compliance personnel . . . have certain attributes. They are independent from the business operations and have appropriate expertise, experience, authority, and resources to conduct their compliance responsibilities. Compliance responsibilities should be clearly articulated and persons should be accountable for fulfilling their specific responsibilities. There should also be an effective system to track and resolve compliance issues. Where problems arise or controls are found to be weak, appropriate resolution and improvements should be effectuated.”

C. Recent Regulatory Pronouncements Regarding the Role of Compliance Officers

In connection with the adoption of the CEO certification rule (NASD Rule 3013), the NASD promulgated IM-3013, which states, in part, that “the chief compliance officer is the primary advisor to the member on its overall compliance scheme and the particularized rules, policies, and procedures that the member adopts.” In contrast, the IM also states that “The NASD Board of Governors recognizes that supervisors with business line responsibility are accountable for the discharge of a member’s compliance policies and written supervisory procedures.”

Similarly, in connection with the adoption of rules requiring the designation of investment adviser and mutual fund chief compliance officers, the SEC stated that “having the title of chief compliance officer does not, in and of itself, carry supervisory responsibilities.”

D. The July 2005 Securities Industry Association Compliance and Legal Division White Paper on the Role of Compliance

Last year, the SIA’s Compliance and Legal Division published an important paper describing the role of compliance in the securities industry. The paper reports that Compliance Departments play an advisory, surveillance, and educational role within firms in an effort to support managers who are charged with overall supervisory responsibilities. While the functions of Compliance Departments can vary, the paper identifies 13 functions that are typically carried out within such units. They are:

1. advisory (compliance officers regularly provide regulatory and compliance advice to broker-dealer management)
2. policies and procedures (compliance officers often assist management in the creation of policies and procedures)

3. education and training (compliance officers frequently conduct training programs in an effort to educate employees about policies and procedures and new regulatory developments)
4. monitoring and surveillance (a core role of the Compliance Department is to perform regular monitoring and surveillance of a firm's business activities)
5. business unit compliance reviews (Compliance Departments may perform targeted reviews of a firm's business units to assess compliance with firm policies and regulatory requirements)
6. centralized compliance functions (these functions include operation of a "control room" and administration of anti-money laundering programs)
7. licensing, registration, and employment-related functions (Compliance Departments are often responsible for the administration of the licensing and registration of firm personnel)
8. internal inquiries and investigations (compliance officers, in coordination with legal counsel, often conduct internal reviews and investigations)
9. regulatory examinations, reporting, and investigation (compliance officers typically act as liaisons with regulators conducting examinations or inquiries)
10. fostering regulatory relationships (compliance officers routinely engage in dialogue with regulators about important issues facing the industry)
11. promoting a culture of compliance (compliance officers play a critical role in assisting senior executives in promoting a culture of compliance within a firm)
12. assessment of existing business activities and emerging trends (compliance officers monitor the development and approval of new rules and regulations and assess the impact on a firm's business activities and compliance efforts)
13. chaperoning (as part of the research and investment banking global settlement, certain firms are required to chaperone communications that occur within and between research and investment banking).

E. Compliance Officer Liability

As stated in the SIA's White Paper, "only in limited circumstances have the Commission and SROs brought failure to supervise actions against non-line personnel, such as Compliance Department Officers. These enforcement actions arise only when Compliance Department personnel have been specifically delegated, or have assumed, supervisory authority for particular

business activities or situations, and therefore have ‘the requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.’”

Two actions in 2005 are worthy of note. First, in HPD 05-94 the NYSE censured and imposed a supervisory suspension upon a Director of Compliance and General Counsel for allegedly failing to reasonably supervise variable annuity sales. The HPD notes that Cram “was not disciplined simply because he held the title of Compliance Director or General Counsel. Holding such a title does not automatically make one a supervisor under Exchange Rule 342. Rather he was named and properly disciplined because he had lapses of personal responsibility. Whether a Compliance Director or General Counsel is or becomes a supervisor is a fact based on analysis. Here Enforcement and the Hearing Panel are convinced that the Respondent undertook certain specific responsibilities concerning BOM and failed to perform them. He also was personally and specifically put on notice by IM of problems for which he had undertaken an oversight relationship. He is therefore before the Hearing Board because he had become, as to specific problems, a failed supervisor.”

Second, in October 2005, the NASD sanctioned Janney Montgomery Scott in a case involving market timing. In addition to the alleged mutual fund violations, the NASD asserted that JMS failed to establish and maintain systems and procedures reasonably designed to conduct adequate due diligence for its responses to regulatory inquiries. In the AWC settling this matter, the NASD stated that “the firm did not have effective policies and procedures, including written procedures, to ensure that adequate inquiry and due diligence was conducted when responding to regulatory requests for information. Janney also failed to establish clear procedures for reviewing responses to regulatory requests to ensure that they were accurate.”

III. FRONT LINE SUPERVISOR ACTIVITIES AND RESPONSIBILITIES

A. Regulators’ Expectations of Senior Management

In a major address to the securities industry in April 2003, Mary Schapiro, the NASD’s President of Regulatory Policy and Oversight, provided her perspective on management responsibilities. (See Schapiro remarks of April 9, 2003 available at NASD.com.) Ms. Schapiro outlined five key measures that, in her view, must be taken by senior executives of broker-dealers to restore investor faith.

1. Management, not just compliance officers, must seek to create a culture that takes the obligation to observe high standards of commercial honor and just and equitable principles of trade seriously.
2. There must be a high level of interaction between senior business executives and compliance and legal officers.
3. Senior executives must be prepared to confront and take action against misconduct.
4. Management cannot rationalize improper conduct.

5. Even in down markets, management must resist the temptation to cut compliance programs to enhance financial results.

B. Distinction Between Compliance and Supervisory Personnel

1. Compliance officers provide advice, guidance and recommendations.
2. Business line management has the ultimate responsibility to take appropriate action to achieve compliance by hiring, firing, and otherwise affecting the conduct of brokers and others performing securities activities.

C. SEC and SRO Supervisory Rules

1. Securities and Exchange Act of 1934

Section 15(b)(4)(E) of the 1934 Act authorizes the SEC to impose sanctions on a broker-dealer or any of its associated persons if the Commission finds that such entity or person has “failed reasonably to supervise, with a view to preventing violations of [certain provisions of the federal securities laws], another person who commits such a violation, if such other person is subject to [their] supervision.”

Section 15(b)(4)(E) also provides that no firm or person shall be “deemed to have failed reasonably to supervise any other person, if (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and (ii) [the firm or the supervisor] has reasonably discharged the duties and obligations incumbent upon [them] by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.”

2. New York Stock Exchange Rule 342

Rule 342(a) states that “each office, department or business activity of a member or member organization (including foreign incorporated branch offices) shall be under the supervision and control of the member or member organization establishing it and of the personnel delegated such authority and responsibility. The person in charge of a group of employees shall reasonably discharge his duties and obligations in connection with supervision and control of the activities of those employees related to the business of their employer and compliance with securities laws and regulations.”

Rule 342(b) provides that the “general partners or directors of each member organization shall provide for appropriate supervisory control and shall designate a general partner or principal executive officer to assume overall authority and responsibility for internal supervision and control of the organization and compliance with securities’ laws and regulations.”

The rule further requires that “this person shall: (1) delegate to qualified principals or employees responsibility and authority for supervision and control of each office, department or business activity, and provide for appropriate procedures of supervision and control (2) establish

a separate system of follow-up and review to determine that the delegated authority and responsibility is being properly exercised.”

3. NASD Rule 3010

NASD Rule 3010 requires that each member organization “establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of [the NASD].”

D. Liability for Supervisors

Supervision cases typically arise in one of five situations.

1. A failure or inadequate effort to complete firm-mandated reviews.
2. A failure to notice “red flags.”
 - a. Regulators often allege - - with 20/20 hindsight - - that a supervisor should have noticed a problem when reviewing various reports or the conduct of subordinates.
3. Inadequate follow-up on “red flags.”
 - a. Regulators have repeatedly stated that supervisors must respond vigorously and with the utmost diligence to any indications of irregularities.
4. The unreasonable delegation of duties.
 - a. In general, a line supervisor has supervisory responsibilities for those employees under him or her unless and until he or she reasonably delegates supervisory duties to another. In certain cases, the SEC has alleged that the delegation of duties to another became unreasonable due to the failures of the delegate.
5. A failure to develop and implement adequate policies and procedures.

E. The Development of Written Supervisory Procedures

One key aspect of any supervisory system is the development and implementation of written supervisory procedures. Guidance issued by regulators relating to such procedures is described below.¹

¹ The discussion below refers to guidance issued by the NASD. However, the NYSE’s guidance parallels that of the NASD.

1. Written supervisory procedures vs. compliance guidelines. As a preliminary matter, it is critical to understand the distinction between written supervisory procedures and compliance guidelines. Compliance policies generally set forth the relevant rules and firm protocols that must be adhered to and describe specific prohibited practices. Written supervisory procedures, however, document the supervisory system that has been established to reasonably prevent and detect improper conduct.
2. The importance of written supervisory procedures. The NASD has articulated several reasons why it believes written supervisory procedures are important:
 - a. Written procedures provide firm personnel subject to the supervisory system, as well as supervisors, a document that explains the supervisory system and each person's specific duties and responsibilities.
 - b. Written procedures provide "stability and continuity" within a firm as employees assume different responsibilities and/or leave.
 - c. Written procedures allow senior management to determine whether employees are complying with the supervisory system by examining for compliance with the written procedures.
3. The keys to creating written supervisory procedures
 - a. The NASD has identified four keys to creating written supervisory procedures: (1) identification of responsible individuals; (2) a description of the supervisory tasks; (3) a statement of the frequency of the reviews to be conducted; and (4) documentation of the completion of the required actions.²
 - b. Written supervisory procedures should *identify the specific individual(s) responsible for supervision* -- either by name or by title and position. The NASD has stated that "[a] member must keep a record of each associated person who has supervisory responsibilities and the date each person was assigned those responsibilities."³
 - c. The NASD has noted that one purpose of this requirement is so that regulators can easily determine who is responsible for

² See NASD Notice to Members 98-96 (guidance concerning procedures for market making activities). The broad principles contained in this NTM may be useful in developing procedures for other business areas and activities.

³ NASD Notice to Members 99-45.

supervising a particular area and the time period for which the person was assigned the supervisory responsibility.

- d. Written supervisory procedures should *describe the supervisory reviews and actions to be completed* by the appropriate supervisor. While this part of the procedures need not be detailed, it should identify any exception reports and/or other materials or information being reviewed and the substantive area being reviewed. Where a firm uses automated systems, such systems should also be described generally in the procedures.
- e. Written supervisory procedures should *describe the frequency* of all reviews. The description should be more specific than providing for “a review” or “a review from time to time.” The frequency of reviews should be specified in the procedures (e.g., daily, weekly, monthly, quarterly, or annually). How frequently a firm conducts any given review depends upon the nature, type, or level of activity.
- f. Written supervisory procedures should *describe how reviews* should be *documented* (e.g., initialing order tickets and/or trade blotters or completing logs or checklists that identify those reviews). The procedures should also provide for the documentation of steps taken by the supervisor as a result of the reviews (e.g., busted trades, contact with customer, etc.) The NASD “recognizes that there are a variety of ways, in addition to those noted, that reviews can be documented as having been conducted, particularly where the review is conducted on-line. Firms should document reviews in a manner sufficient to demonstrate to firm management and regulators that a review has been conducted.”⁴
- g. In reviewing written supervisory procedures, the NASD has identified certain deficiencies. Of interest is the following key finding: the NASD noted failures to preserve and maintain the documentation evidencing that a supervisory review has been completed.

F. Implementation of Written Supervisory Procedures

There are several keys to implementing supervisory procedures that managers should keep in mind when performing their duties. These important issues are as follows:

⁴ NASD Notice to Members 98-96.

1. Be involved in the process of developing -- and changing-- the procedures so that when finalized they are practical, useful and appropriately tailored to your business.
2. Can the procedures be reasonably accomplished?
 - a. Maxim: The only thing worse than having no written procedures is not following those developed by the firm.
3. Are the necessary tools available to perform the review?
 - a. Does the report contain the necessary information to detect the relevant issues?
 - (i) Example: A report for marking the close -- does the report contain the times of order entry and execution?
4. Are there other things that should be reviewed?
 - a. Managers know their business better than anyone else. Are there sales practices that should be monitored for that are not in the procedures?
5. Understand exactly what is expected in carrying out the duties and responsibilities, including:
 - a. What reviews are to be undertaken?
 - (i) What reports or other records are supposed to be checked?
 - (ii) How frequently are the reviews supposed to be accomplished?
 - (iii) What documents are to be used?
 - (iv) What is supposed to be looked for?
6. How are reviews supposed to be documented?
 - a. electronically?
 - b. signing or initialing the documents?
 - c. putting check marks near certain trades?
 - d. filling out a log or checklist?
7. How long are documents to be saved?

8. What steps should be taken where a potential problem is noticed?
 - a. To whom should issues be escalated? Senior management? Legal and compliance? Both?
 - b. Document the actions.
9. If duties are delegated, it must be done properly.
 - a. Make sure the delegate fully understands what he or she is expected to do.
 - (i) Talk to the delegate to make sure he or she understands what is expected.
 - b. Properly document the delegation.
 - c. Monitor the performance of the delegate.
 - (i) Ask questions.
 - (ii) Check their work.
 - d. Where remedial action is necessary, make sure that the delegate actually carries out the planned steps.
10. Continually think about how the procedures should be changed in light of new business, changed practices or regulatory issues.

IV. BRANCH OFFICE OVERSIGHT AND NEW FORM BR

A. Branch Office Registration

1. During 2005, both NASD and NYSE adopted a uniform definition of “branch office” and a new Form BR, which broker-dealers must use to register branch offices through the CRD System.
2. The uniform definition describes a “branch office” as any location where one or more associated persons of a broker-dealer regularly conducts the business of effecting any transactions in, or inducing or attempting to induce the purchase or sale of, any security, or that is held out as such a location. However, the uniform definition also excludes the following locations from registration as a branch office: (a) a location that operates as a non-sales location/back office; (b) a representative’s primary residence provided it is not held out to the public and certain other conditions are satisfied; (c) a location, other than the primary residence, that is used for less than 30 business days annually for securities business, is not held out to the public as an office, and which satisfies certain of the

conditions set forth in the primary residence exception; (d) a location of convenience used occasionally and by appointment; (e) a location used primarily for non-securities business and from which less than 25 securities transactions are effected annually; (f) the floor of an exchange; and (g) a temporary location used as part of a business continuity plan.

B. Branch Office Oversight

1. In 2004, the SEC approved rule proposals by NYSE and NASD to require broker-dealers to strengthen controls over their supervisory systems and producing sales managers. Among other things, member firms' supervisory control policies and procedures must include procedures 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. NASD Rule 3012(a)(2)(A); NYSE Rule 342.19. (Dual members of the NASD and NYSE may choose to comply with either NASD Rule 3012(a)(2)(A) or NYSE Rule 342.19.)
2. Additionally, broker-dealers must have procedures that are reasonably designed to provide heightened supervision over the activities of "producing managers" who are responsible for generating a threshold percentage of the revenue of the business units supervised by the producing manager's supervisor over the course of a rolling, 12 month period. For NYSE firms the revenue percentage threshold amount is 10%, whereas the threshold for NASD firms is 20%. NASD Rule 3012(a)(2)(C); NYSE Rule 342.19(a). A person who is senior to or "otherwise independent" of the producing manager must perform these day-to-day supervisory reviews. NASD Rule 3012(a)(2)(A)(i); NYSE Rule 342.19(a).
 - a. A "producing manager" is a branch office manager, a sales manager, a regional or district sales manager or any person who performs a similar supervisory function and who services customer accounts in a capacity requiring registration.
 - b. A person is senior to a producing manager if: (i) the person does not report to the producing manager; (ii) the person's compensation is not determined in whole or part by the producing manager; (iii) the person is not in the same chain of authority; and (iv) the 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.
 - c. A person is "otherwise independent" of a producing manager if: (i) the person does not report either directly or indirectly to the producing manager; (ii) the person is situated in a different office

than that of the producing manager; (iii) the person 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 (iv) the person alternates such review responsibility with another qualified person every two years or less.

C. Effective Dates

1. Uniform Definition of Branch Office

a. NYSE: September 9, 2005

b. NASD: May 1, 2006

2. Form BR:

NYSE and NASD: As of October 31, 2005, broker-dealers are required to file a Form BR to register any new branch office opened on or after October 15, 2005. Broker-dealers with branch offices in existence prior to the close of business on October 14, 2005 have until May 1, 2006 to comply with the Form BR requirements for those branch offices.

3. Supervisory Control Requirements

a. NYSE: December 17, 2004

b. NASD: January 31, 2005

D. Backup Materials

1. NASD NtMs 05-66, 05-67, and 06-12 (Branch Office Definition and Form BR); NtMs 04-71, 05-08, and 05-29 (Supervisory Controls Rules).

2. NYSE Information Memos 05-74, 05-75, and 06-13 (Branch Office Definition and Form BR); Information Memo 04-38 (Supervisory Controls Rules).

V. BROKER-DEALER/INVESTMENT ADVISER RULE

A. Under Section 202(a)(11)(C) of the Advisers Act, a broker-dealer is not required to register as an investment adviser if its performance of advisory services is solely incidental to its brokerage services and the broker-dealer does not receive special compensation for the advisory services. On April 12, 2005, the SEC adopted Rule 202(a)(11)-1 under the Advisers Act to address the question of when a broker-dealer's investment advisory activities require the broker-dealer to be a registered investment adviser.

- B.** *Discretionary Brokerage:* Rule 202(a)(11)-1 provides that a broker-dealer provides investment advice that is not solely incidental to the conduct of its business as a broker-dealer if it: (a) exercises investment discretion over a customer's account; or (b) charges a separate fee or separately contracts for advisory services.
- C.** *Asset-Based Fees:* Rule 202(a)(11)-1 provides that a broker-dealer is providing advice that is solely incidental to its brokerage services if the broker-dealer charges an asset-based or fixed fee (rather than a commission, mark-up, or mark-down) for its services, provided the broker-dealer makes certain disclosures about the nature of its services.
- D.** *Financial Planning:* Rule 202(a)(11)-1 provides that when a broker-dealer provides advice as part of a financial plan or in connection with providing planning services, the advice is not solely incidental to the broker-dealer's brokerage services if the broker-dealer: (a) holds itself out to the public as a financial planner or as providing financial planning services; (b) delivers to its customer a financial plan; or (c) represents to the customer that the advice is provided as part of a financial plan or financial planning services.
- E.** **Effective Date: January 31, 2006**
- F.** **Backup Materials**
1. SEC Adopting Release
 2. SEC Staff Letter to SIA