



NASD Small Firm Conference

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Best Practices of Very Small Firms

Speakers

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Topics for Today's Discussion

- Outsourcing
- Small Firm Resources
- Material Changes in Business
- Net Capital Issues
- NASD Rule 3012 Testing and Supervision Issues; 3013 Annual Certification
- Questions and Answers



Outsourcing

Outsourcing

The NASD and NYSE conducted a survey in 2004 to determine what types of functions were being outsourced by firms. Frequently outsourced functions included:

- Accounting/finance (payroll, expense account reporting, etc.)
- Legal and compliance
- Information technology (IT)
- Operations functions (e.g., statement production, disaster recovery services, etc.)
- Administration functions (e.g., human resources, internal audits, etc.)

Outsourcing (cont.)

In response to the survey, NASD issued Notice to Members 05-48 to provide the following guidance:

- Accountability and Supervisory Responsibility for Outsourced Functions
 - If a member outsources activities that are covered by securities laws and regulations, it must have supervisory procedures on its outsourcing practices that include, without limitation:
 - ◆ a due diligence analysis of its third-party service providers to determine whether the providers are capable of performing the outsourced functions
 - ◆ Monitoring of the service providers' performance, including compliance with the terms of agreements
 - ◆ Assessments of the service providers' continued fitness and ability to perform the outsourced activities
 - NASD and other regulators must have the same complete access to the service provider's work product for the firm, as would be the case if the activities had been performed directly by the firm

Outsourcing (cont'd)

- Activities and Functions that are Prohibited from being Outsourced
 - Activities that require QUALIFICATION AND REGISTRATION cannot be deemed to have been outsourced because the person performing the activity will be considered an associated person of the member irrespective of whether the service provider is registered with the member.
 EXCEPTION: a third-party service provider is separately registered as a broker-dealer and the contracted arrangement between the member and the service provider is contemplated by NASD rules, MSRB rules, or applicable federal securities laws or regulations. EXAMPLE: a clearing agreement executed pursuant to NASD Rule 3230 between a member and a clearing broker-dealer.

Outsourcing (cont'd)

- Activities and Functions that are Prohibited from being Outsourced (cont'd)
 - Supervisory and compliance activities. EXAMPLE: Firms cannot outsource for Qualified Supervisors for the purposes of Rule 3010 and 3012.
 - ◆ CAVEAT: a member may outsource activities that support the performance of its supervisory and compliance responsibilities. EXAMPLE: a supervisory system designed by another party which could include a computer software program that detects excessive trading in customer accounts
 - ◆ HOWEVER: a member implementing such a system must determine on its own that the system will achieve compliance as required under Rule 3010. This may include, for example, monitoring the system to ensure that it functions as designed and that such design is of an adequate nature and breadth.



Small Firm Resources

Electronic Resources

NASD Small Firm Web Page: www.nasd.com/smallfirms

- Provides information of importance to the small firm community
- Updated regularly with current and past communications, links of interest to small firms, and other timely information
- Email NASD your comments and questions through this Web page
- Other electronic resources:
 - NASD Weekly Notification E-mails (see www.nasd.com/subscriptions)
 - Notices to Members
 - NASD News Releases

Small Firm Advisory Board

Small Firm Advisory Board Info: www.nasd.com/sfab

- The Small Firm Advisory Board (SFAB) acts to ensure that issues of particular interest and concern to smaller member firms, and the potential impact on smaller firms of regulatory and market structure initiatives, will be effectively communicated to and considered by the NASD Board of Governors.
- Contact information for all SFAB members can be found on this Web page.

Letters to Small Firm Members on Current Issues: www.nasd.com/ltn

- Letters, dating back to 2001 from the SFAB Chairman, highlight priority issues that are unique to small firms.

Checklists and Tools

Checklists and Tools to Support Small Firm Compliance:

www.nasd.com/compliancetools

- Contains checklists, templates/forms, and other tools such as:
 - 529 College Savings Plan MSRB Rule Compliance Checklist
 - BCP Repository Service
 - Books and Records Checklist (e.g. record retention requirements)
 - Breakpoints Checklist and Worksheet
 - Mutual Fund Breakpoint Search Tool
 - Mutual Fund Expense Analyzer
 - NASD Manual Online
 - OFAC Search Engine

Small Firm Related Regulatory Deadlines

Small Firms Regulatory Deadlines: www.nasd.com/smallfirm_deadlines

- Addresses regulatory deadlines of interest to small firms
- Updated regularly and as deadlines near, notices are included in the weekly email to Executive Representatives

Education and Programs: www.nasd.com/education

- Contains information about continuing education opportunities, conferences, classroom learning, NASD Institute, online learning, and phone-in workshops.
- NASD offers the Small Firm Conference Series, which is designed to help small firms identify best practices for compliance and supervision issues, with four conferences held annually around the country. See the following Web site for the 2006 conference schedule: www.nasd.com/smallfirmconf

Related Links

Small Firm-Related Links: www.nasd.com/smallfirm_links

- Contains links to pages that may be of interest to small firms, including but not limited to:
 - Annual Audit
 - Compliance Webcasts
 - CRD Small Firm Resources
 - Improving Examination Results
 - Interpretive Letters
 - NASD Notices to Members
 - OATS Small Firm Resources
 - Quarterly *Disciplinary Update*
 - Qualifications Information
 - Rule Filings



Material Changes in Business

Material Changes in Business

NASD Rule 1017: Continuing Membership Applications; NASD Notice to Members 04-10

- NASD Rule 1017(a)(5) provides that a member shall file an application for approval of any material change in business operations, as defined in Rule 1011(i).
- A firm may consult with NASD on a particular expansion of business, before making a 1017 application.
- When a firm materially expands its operations or activities, or to modify or remove restrictions, the firm must file information in accordance with this rule. NASD staff determines whether to approve, disapprove or approve with restrictions.

Material Changes in Business(cont.)

Safe Harbors Provisions (IM-1011-1; see NASD Notice to Members 00-73)

- The safe harbor is not available to any member that has disciplinary history. For purposes of this Interpretation, "disciplinary history" means a finding of a violation by the member or a principal of the member in the past five years by the Securities and Exchange Commission, a self-regulatory organization, or a foreign financial regulatory authority.
- The IM provides that for any expansion beyond the 30% limits, "a member should contact its District Office prior to implementing the change to determine whether the proposed expansion requires an application under Rule 1017.

Material Changes in Business

The Safe Harbor Provisions are as follows:

Business Expansion

Safe Harbor Increase Permitted in 12 Month Period.

- Associated Persons Involved In Sales

1-10	10 persons
11 or more	The greater of 10 persons or 30%
- Number of Offices

1-5	3 offices
6 or more	The greater of 3 offices or 30%
- Number of Markets Made

1-10	10 markets
11 or more	The greater of 10 markets or 30%

Expansions in each area are measured on a rolling 12-month basis. Members are required to keep records of increases in personnel, offices, and number of markets made to document compliance with the safe harbor.

Material Changes in Business

Information to Be Filed with District Office:

- Form BD and Description of Proposed Business Activities
- Information on Supervisory Personnel
 - Name and CRD Number
 - Description of Work Experience as it relates to new activities
 - Organizational Chart
 - Detailed Description of Responsibilities
 - Information on Disciplinary Actions
 - Description of any Remedial Actions taken by firm
 - Description of any Terminations for Cause
- Supervisory Procedures
- Net Capital Information and Source of Funds
- Additional Information as may be required
- See NASD Web site for specific information required and checklists. Call your designated “Core” examiner.



Net Capital Issues

Net Capital Issues

Items that could increase your firm's Net Capital Requirement:

- Accepting customer checks at branch locations and/or not “promptly” forwarding to the clearing firm
- Accepting customer securities
- Holding customer checks and not forwarding “promptly”
- Accepting a customer check made out to the introducing firm instead of the Clearing Firm or Escrow Agent
- Having unassociated persons as signators on firm bank accounts
- Missing PAIB Clause in Clearing Agreement
- Commission rebate/recapture



NASD Rules 3012 and 3013

NASD Rules 3012 and 3013

New NASD Conduct Rules 3012 and 3013 and Rule 3010 form a complementary supervisory scheme.

- Rule 3013 requires a CEO to **CERTIFY** that the firm has a **PROCESS** to adopt adequate Supervisory Policies and Procedures.
- Rule 3010 requires the establishment of a supervisory system and **ADOPTION** of adequate Written Supervisory Policies and Procedures.
- Rule 3012 requires firms to **TEST** and **VERIFY** supervisory procedures; and, if necessary **AMEND** policies and procedures.

NASD Rules 3012 and 3013 (cont'd)

New Rule 3013 (Annual Certification of Compliance and Supervisory Processes) (NASD Notice to Members 04-79)

- Designate a CCO and report this individual on its Form BD and on the NASD Firm Contact System.
- The member's CEO must certify annually that the member has a process to establish, maintain, review, test and modify written compliance and supervisory policies and procedures that are reasonably designed to achieve compliance.

Deadline Extension to Execute Initial Rule 3013 CEO Certification (NASD Notice to Members 05-75)

- Members may execute their first Rule 3013 CEO certification any time between December 1, 2005 through April 1, 2006, and annually thereafter by the same date chosen for the initial certification. Example: A member chooses to execute its initial Rule 3013 CEO certification on March 1, 2006. Each ensuing annual certification must be made on March 1st of that year.

NASD Rules 3012 and 3013 (cont'd)

New Rule 3012 (Supervisory Control System) (NASD Notice to Members 04-71)

- Designate principal(s) who will:
 - Establish, maintain, and enforce a supervisory control system that will test and verify that the member's supervisory procedures are reasonably designed to comply with all applicable laws, rules, and regulations; and
 - Submit an annual report to senior management on the member's supervisory controls system, the test results, and resulting changes. (NASD Notice to Members 05-29)

Deadline Extension for Initial Rule 3012 Annual Report (NASD Notice to Members 05-75)

- Members may submit to senior management the initial Rule 3012 report any time between January 31, 2006 through April 1, 2006.

NASD Rules 3012 and 3013 (cont'd)

New Rule 3012 (Supervisory Control System) (cont'd)

- Designate principal(s) who will:
 - The initial Rule 3012 report must cover the period from January 31, 2005 (Rule 3012's effective date) up to the submission date (or a reasonable period of time immediately preceding the submission date, i.e., one month prior to the submission date). Example: an initial Rule 3012 report submitted on April 1, 2006 must cover the period from January 31, 2005 to at least February 28, 2006.
 - Each subsequent Rule 3012 report must cover a period no greater than 12 months from the date of the preceding Rule 3012 report.
 - Dual members complying with substantially similar requirements of the NYSE may comply with Rule 3012's reporting requirement by completing the NYSE Rule 342.30 Annual Report.

NASD Rules 3012 and 3013 (cont'd)

New Rule 3012 (Supervisory Control System) (cont'd)

- Have people who are senior or “otherwise independent” of a producing manager perform the day-to-day supervisory reviews of the producing manager’s account activity. (NASD Notice to Members 05-08 – definition of “producing manager”)
 - “Limited Size and Resources exception” – If a firm cannot meet this requirement, a firm can have a principal who is sufficiently knowledgeable of the member’s supervisory control procedures conduct the supervisory reviews.
 - ◆ New Notification Requirement (NASD Notice to Members 06-04) Effective Date 2/14/06. Notify NASD within 30 days on which the member first relies on the exception. If already relying on the “limited size and resource” exception prior to February 14, 2006, notify NASD by March 16, 2006.
 - ◆ Notify NASD of continued reliance on the exception on an annual basis. Each ensuing annual notification must be effected no later than on the anniversary date of the previous year’s notification. If no longer relying on the “limited size and resources” exception, notify NASD within 30 days of ceasing to rely on the exception.
 - ◆ Rule 3012 Exception Notification System (www.nasd.com/RegNotes 3012). Use the user ID and password received from the NASD Entitlement Program.

NASD Rules 3012 and 3013 (cont'd)

New Rule 3012 (Supervisory Control System) (cont'd)

- Impose heightened supervision over the activities of producing managers who are responsible for generating 20% or more of the revenue of the business units supervised by their supervisors over the course of a rolling, 12-month period.
- Have procedures that are reasonably designed to review and monitor certain activities (e.g., transmittals of funds or securities from customers to third party accounts, customer changes of address, customer changes of investment objectives, etc.).
 - These procedures must include a means or method of customer confirmation, notification, or follow-up that can be documented.

For additional information, please refer to the Supervisory Control Web Page:
www.nasd.com/SupervisoryControl

Questions

