

Session I(b)
BD Supervisory Rule Requirements

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National Society of Compliance Professionals, Inc.
2005 NSCP Southern Regional Meeting
Atlanta, Georgia
February 28, 2005

Panel Agenda

- Effective implementation of procedures required by the “Supervisory Control Amendments”
- Branch office registration and reviews
- Role of the compliance professional in this ever-changing regulatory environment
- Sales practice standards and reviews for variable annuities

Supervisory Control Rule Amendments

- Independent Testing and Verification of Supervisory Procedures
- Supervision of “Producing Managers”
- Supervisory Control Procedures For Particular Activities
- Internal Inspections
- Discretionary Authority Limitations
- Customer Account Supervision

New Rule 3012

- Requires firm's to designate and specifically identify one or more principals who will establish, maintain, and enforce a system of supervisory control policies and procedures that test and verify that the firm's supervisory procedures are sufficient and to amend or create additional supervisory procedures, as identified during testing and verification
- Requires a person senior or "otherwise independent" to a "producing manager" perform the day-to-day supervisory reviews of the producing manager's activity

Who Am I?

- Supervision of Producing Managers
- Who is a Producing Manager?
 - “Producing”
 - ❖ Services customer accounts in a capacity requiring registration
 - ❖ No de minimus exception
 - “Manager”
 - ❖ Branch office managers, sales managers, regional or district managers, or any person performing a similar supervisory function

Who Am I? (Continued)

- Who Can Supervise a Producing Manager?
 - Senior, or “Otherwise Independent”
- “Senior”
 - PM not my boss
 - PM does not control my paycheck
 - Not in same chain of authority as PM
 - Authority to Fix Problem

Who Am I? (Continued)

■ “Otherwise Independent”

- PM not my boss
- PM not in my office
- I don't have supervisory responsibility over activity
- I switch off every two years with another person who has found himself or herself

What Should I Review?

- Day-to-day customer account activity
 - Check disbursements
 - Wire transfers
 - Journal entries
- Other supervision
 - Customer telephone calls
 - Customer correspondence
 - Customer complaints

When Must I Do More?

- Heightened Supervisory Requirements
 - If the producing manager is responsible for generating 20% (10% for NYSE members) or more of the revenue of the business units supervised by the producing manager's supervisor over the course of a rolling, 12-month period
- Determining the 10%/20% threshold
 - Revenues (before deductions or offsets)
 - Business units
 - No Negative Safe Harbor

When Must I Do More? (Continued)

- Those procedures that are designed to avoid conflicts of interest that serve to undermine complete and effective supervision because of economic, commercial, or financial interests that the supervisor holds in the associated persons and business being supervised.

When Must I Do More? (Continued)

■ Examples:

- Unannounced supervisory reviews
- Larger samples
- Increased number of reviews by different viewers within the same time period
- Broader scope of activities reviewed
- Multiple principal approval of reviews

Supervision Of Customer Account Activity

- Supervisory control policies and procedures reasonably designed to review and monitor:
 - Transmittal of Customer Funds From customers to
 - ❖ Third-party accounts
 - ❖ Outside entities
 - ❖ Locations other than the customer's primary address
 - Address Changes
 - Changes in investment objectives
 - Documented means of customer confirmation, notification or follow-up

Internal Inspections

■ Mandatory Inspection Cycles

– Annual Inspection Cycles

- ❖ OSJs

- ❖ Supervisory Branch Offices

– Inspections Every Three Years

- ❖ Non-Supervisory Branch Offices

– Periodic and Regular Inspections

- ❖ Non-Branch Locations

- (e.g., “offices of convenience”)

■ “Limited Size and Resources” Exception

Inspection Report Content And Recordkeeping Requirements

- Must prepare a written report for each office inspection with testing and verification of policies and procedures, in areas of:
 - Safeguarding customer funds and securities
 - Maintaining books and records
 - Supervising customer accounts serviced by branch managers
 - Transmitting funds between customers and RR's and third parties
 - Validating address changes
 - Validating changes in customer account information

Heightened Inspection Requirements

- Required when the person conducting the inspection reports to the branch office manager's supervisor *or* works in an office supervised by the branch manager's supervisor, *and*
- The branch manager generates 20% or more of the revenue of the business units supervised by the branch office manager's supervisor

Heightened Inspection Procedures

- Examples may include

- Unannounced office inspections
- Increased frequency of office inspections
- Broadened scope of activities inspected
- Having one or more principals review or approve the inspection

Other Rule Changes

■ Discretionary Authority Limitations

- One day limit for time/price discretionary authority without written authorization
- Written authorization required for greater discretionary authority
- Not required GTC instructions on “not held” basis for “institutional accounts.”

Other Rule Changes (Continued)

■ Customer Account Supervision

- Before customer order is executed, account name(s) must be placed on the order memorandum
- Changes in account name or designation must be approved by a designated principal, who will document and retain the essential facts relied upon in approving the changes

Other Rule Changes (Continued)

- Conditions and term limits for holding customer mail.
 - Two months if vacationing or traveling domestically
 - Three months if vacationing or traveling outside of U.S.

Other Rule Changes (Continued)

- CEO must certify annually that:
 - Member has in place processes to:
 - ❖ Establish, maintain, and review policies and procedures reasonably designed to achieve compliance with Federal securities laws, SRO rules
 - ❖ Modify Procedures to address business, regulatory, legislative changes
 - ❖ Test on a periodic basis
 - CEO has met with CCO in last 12 months

Other Rule Changes (Continued)

■ CCO Designation

- Designate on Schedule A of Form BD a principal to serve as CCO
- CCO may hold other positions with member (including CEO), so long as does not impede person from executing CCO responsibilities.

Sales Practice Standards And Reviews For Variable Annuities

- NASD proposal (June 2004)
 - Specific Suitability Standards
 - ❖ Customer informed of unique features
 - ❖ Long-term investment objective
 - ❖ VA in its entirety and the underlying sub-accounts are suitable
 - ❖ Determination documented and signed by RR.
 - Disclosure and Prospectus Delivery
 - ❖ Separate plain-English risk disclosure
 - ❖ Provided regardless of whether VA was recommended

Sales Practice Standards And Reviews For Variable Annuities (Continued)

■ Principal Review

- All transactions by next business day
- Must consider suitability
- Approve suitability document by next business day
- Approve exchanges/replacements by next business day

■ Specific WSPs

■ Training