

BY JOHN F.X. PELOSO AND BEN A. INDEK

## SEC Approves the NASD's CEO Certification Rule

Last year, in our regular column for The New York Law Journal, we commented on a proposal by the National Association of Securities Dealers (NASD) to adopt a new rule requiring each of its members' chief executive officers (CEO) and chief compliance officers (CCO) jointly to certify annually that the firm has in place adequate compliance and supervisory policies and procedures reasonably designed to comport with applicable regulatory and statutory rules and regulations.<sup>1</sup>

NASD received more than 166 comments on the proposed rule, most of which were unfavorable. Commenters, among other points, disputed the need for the proposal in light of rules and regulations already in place and questioned whether the proposal would lead to increased litigation, heightened liability risks and result in the cost of compliance outweighing the proposal's potential benefits.

In our prior article, we also raised concerns with:

- (1) the ambiguous scope of the certification,
  - (2) whether, under the proposed certification, the potential liability of CEOs and CCOs would be determined by a "reasonableness" standard or by the less-clearly delineated "high standards of commercial honor and just and equitable principles of trade,"
  - (3) whether the proposed rule would turn CCOs into line supervisors, and
  - (4) the potential that the proposed certification could result in a waiver of the attorney-client privilege.
- In response to the many comments, the NASD amended its proposal and the Securities and Exchange Commission (SEC) approved the adoption of the rule as amended (Rule 3013) on Sept. 10, 2004.<sup>2</sup>

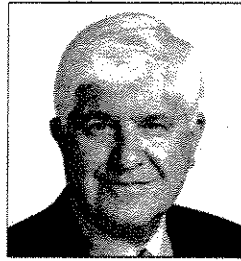
While the rule as approved has addressed some of the more troubling aspects of the initial proposal, questions still remain about how the rule will be complied with and interpreted.

### Timing of the Effectiveness of the New Rule

At the outset, we observe that the timing of the first certification, which was not clear under the initial proposal, has been clarified. According to the NASD, it will publish a Notice to Members regarding Rule 3013 "around" Nov. 1, 2004 and the effective date of the rule will be 30 days following publication of that notice. Firms are required to designate a CCO (who must be a principal) by the effective date and CEOs must execute their first certification within one year of that effective date. Therefore, the first certification will be due in early December 2005.

### The Rule as Approved

Rule 3013 embodies significant revisions from the initial proposal, which address to a large extent concerns raised not only in our prior article, but also by the indus-



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try. As approved, Rule 3013 states:

(a) Designation of Chief Compliance Officer. Each member shall designate and specifically identify to NASD on Schedule A of Form BD a principal to serve as chief compliance officer.

(b) Annual Certification.

Each member shall have its chief executive officer (or equivalent officer) certify annually, as set forth in IM-3013, that the member has in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable NASD rules, MSRB rules and federal securities laws and regulations, and that the chief executive officer has conducted one or more meetings with the chief compliance officer in the preceding 12 months to discuss such processes.<sup>3</sup>

This revised rule reflects the positive reaction of the NASD to many of the comments made to the initial proposal.

### Joint Certification Not Required

To begin with, although the rule requires firms to designate a CCO, he or she will not be required to join in the annual certification as the original proposal would have required. However, while the CEO alone is to make the annual certification, in an effort to "foster regular and significant interaction" between senior management and the CCO, Rule 3013 requires that the CEO conduct one or more meetings with the CCO in the preceding 12 months to discuss the firm's processes that are the subject of the certification. The Interpretive Material provided by the NASD (IM-3013) describes the meetings between the CEO and the CCO as being to: (1) discuss the issues to be addressed in the certification; (2) review the firm's compliance record at the time of the meeting; and (3) ascertain and resolve significant compliance problems. The importance of these meetings is stressed by IM-3013, which notes,

[t]he periodic and content requirements for meetings between the [CEO] and [CCO] ... are intended to indicate the unique and integral role of the [CCO] both in the discharge of certain compliance processes and reporting requirements that are the subject matter of the certification and in providing a reliable basis upon which the [CEO] can execute the certification.<sup>4</sup>

The certification required by Rule 3013, which is set out in IM-3013, requires the preparation of a report prior to the execution of the certification that must be reviewed by the CEO and CCO, and may be reviewed by any other officers that the firm, in its judgment, deems necessary in order for the CEO to make the certification. The report must also be provided to the company's board of directors and audit committee or similar governing bodies or committees. The report, in addition to documenting the broker-dealer's "processes for establishing, maintaining, reviewing, testing and modifying compliance policies," should also include a discussion of how, and how often, the protocols are

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administered, and must identify those officers and supervisors who are responsible for carrying out the firm's compliance policies and supervisory procedures. Notably, the report is not required to contain any "conclusions produced as a result of following the processes set forth therein." The report may be combined with other compliance reports or similar reports required by any other self-regulatory organization (i.e., the annual compliance report required by New York Stock Exchange Rule 342.30) if: (1) such report is clearly labeled to reflect that it is responsive to the requirements of the certification and IM-3013; (2) the broker-dealer that submits a report for review in response to an NASD request must submit the entire report; and (3) the firm makes such report in a timely manner (i.e., annually).

### Scope Significantly Changed

A second major revision is that the scope and content of the certification have been significantly modified from the original proposal, both in the text of Rule 3013 and in the interpretative material. The initial proposal would have required both the CEO and the CCO jointly to certify annually that the member "has in place *adequate* compliance and supervisory policies and procedures reasonably designed to comport with applicable NASD rules, MSRB rules and federal securities laws and rules."<sup>5</sup> In response to many commenters' objections to the use of the word "adequate," NASD acknowledged the "difficulty in certifying to absolute compliance at any given moment in the face of dynamic regulatory and business environments," and amended the language in Rule 3013 to change the focus of the certification from "adequate" compliance and supervisory policies to whether the member had in place "processes to establish, maintain, review, test, and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with applicable NASD rules, MSRB rules and federal securities laws and regulations ..."<sup>6</sup>

We also remarked in our NYLJ article last year that the proposed rule and the accompanying executive summary contained an ambiguity in the use of the phrase "compliance and supervisory policies and procedures" in the proposed rule, and the use of the phrase "compliance and supervisory systems" in the executive summary, noting that there is a distinction between "policies and procedures," which normally refers to a firm's written materials, and a "supervisory system," which may constitute the entire compliance apparatus and necessarily includes, as an integral part, those written policies and procedures.

establish, maintain, review, test and modify *written* compliance policies and *written* supervisory procedures reasonably designed to achieve compliance with applicable NASD rules, MSRB rules and federal securities laws and regulations ...."<sup>7</sup>

### Liability Clarified Under Rule

The interpretive material submitted along with NASD's initial proposal emphasized that "no liability will accrue to the signatories of the certification ... as a consequence of their certification provided that at the time they execute the certification they have a reasonable basis for doing so and do so in a manner that comports with high standards of commercial honor and just and equitable principles of trade."<sup>8</sup> That language raised the question under what standard liability for CEOs and CCOs signing the certification would be judged — would it be the more clearly delineated "reasonableness" standard, or the less clearly defined "high standards of commercial honor and just and equitable principles of trade"?

In a statement accompanying the Aug. 3, 2004 amendments to the proposed rule, NASD noted that, while the previous proposal would have required that the CEO and the CCO have a reasonable basis to certify that the member was in compliance with applicable laws, rules and regulations at the time of making the certification, "[b]y contrast," the rule as amended (and as adopted) requires only a certification to having "processes in place to establish, maintain, review, modify, and test policies and procedures reasonably designed to achieve compliance" with applicable securities laws, rules, and regulations. However, while a signatory is no longer faced with having to certify to absolute compliance at the time of the certification, IM-3013 does make clear that a CEO who signs a certification after the CCO has concluded, after consultation, that there is an inadequate basis for making the certification, acts inconsistently with "the observance of high standards of commercial honor and the just and equitable principles of trade" and is subject to a potential action under Rule 2110.

### Business Line Duties

We observed last year that the proposal contained troubling language equating the CCO with other "supervisors" such that the proposal could be interpreted as subjecting CCOs to liability for "failure to supervise" under applicable laws and regulations. While we recognize that, in certain circumstances, personnel at firms without direct line-supervisory authority may be subject to liability for a failure to supervise if, for example, that person takes on more direct responsibility for the actions of a registered person, as a general rule, those without the ability to directly

Recognizing what we believe is a clear line of authority beginning with the SEC's decisions in *In re Huff* and *In re Gutfreund*,<sup>9</sup> holding that compliance officers or other similarly situated persons are not subject to claims of failing to supervise simply by virtue of their positions within the company, Rule 3013 and IM-3013 as adopted, do not have the original proposal's ambiguity of implying that compliance personnel have "supervisory" responsibilities. Rather, IM-3013 refers to CCOs as being the "primary advisor" to the firm on compliance issues and the firm's particular rules, policies and procedures. Moreover, NASD recognizes that "supervisors with business line responsibility are accountable for the discharge of a member's compliance policies and written supervisory procedures," and therefore "[t]he 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 policies and procedures and the execution of this certification and any consultation rendered in connection with such certification *does not by itself establish business line responsibility*."<sup>10</sup>

• *The Potential Waiver of the Attorney-Client Privilege Has Not Been Clarified.* Finally, we note that Rule 3013 does not directly address our concerns that the provision of the certification that the CEO has consulted with the CCO "and such other employees, outside consultants, lawyers and accountants, to the extent deemed appropriate, in order to attest to the statements made in this certification," should the certification be challenged, creates a distinct possibility that there could be a waiver of the attorney-client privilege as to the subject matter of the certification.<sup>11</sup> Because Rule 3013 has now been adopted, further revisions through the rulemaking process are not available to redress this issue.<sup>12</sup> However, the NASD has indicated to the SEC that "if aspects of the rule were confusing to members, NASD staff would consider developing Questions and Answers to clarify any aspects of the rule confusing to members." The question of the possible waiver of the attorney-client privilege should be among the issues addressed in any such Questions and Answers.

1. John F.X. Peloso and Ben A. Indek, "National Association of Securities Dealers' Certification Proposal," *The New York Law Journal*, June 27, 2003.

2. SEC Exchange Act Release No. 34-50347, 69 Fed. Reg. 56107 (Sept. 17, 2004).

3. 69 Fed. Reg. 46603 (Aug. 3, 2004).

4. 69 Fed. Reg. at 46604.

5. NASD Special Notice to Members 03-29 (June 4, 2003) (emphasis added).

6. Emphasis supplied.

7. SEC Exchange Act Release No. 34-50105, 69 Fed. Reg. 148, 46603 (Aug. 3, 2004) (emphasis added).

8. See Note 5, *supra*.

9. *In re Huff*, 1991 SEC LEXIS 551, 50 SEC 524 (1991); *In re Gutfreund*, 1992 SEC LEXIS 2939, 51 SEC 93 (1992).

10. Exchange Act Release No. 34-50105, 69 Fed. Reg. at 46604 (emphasis added).

11. 69 Fed. Reg. 56109 (Sept. 17, 2004).