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Annual Compliance and Supervision Certification: Lessons Learned by Broker-Dealers

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A. Introduction

Over the past year and a half, broker-dealers have received a great deal of guidance on their compliance policies and supervisory control procedures. With the promulgation of and subsequent amendments to Rule 3012 (Supervisory Control System), Rule 3013 (Annual Certification of Compliance and Supervisory Processes) and IM-3013 (Annual Compliance and Supervision Certification), broker-dealers' compliance programs have direction on how to become more robust.

NASD member firms now are required to designate a Chief Compliance Officer (CCO) who is to meet with the firm's Chief Executive Officer (CEO) at least once per year to discuss its compliance program. The CCO shares his/her assessment as to whether the firm's written supervisory procedures are reasonably designed to prevent violation of all applicable regulatory requirements. This process allows for purposeful interaction between the business units and compliance officers and enables the CEO (or other equivalent officer) to certify whether the member has "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."¹ However, the Rule is not designed to make the CEO responsible for the execution of the policies and procedures. Operational processes should remain the responsibility of the various business units. Given this, what have broker-dealers learned through the first certification process?

B. What We Learned

1. The Role of the CCO

Effective December 1, 2004, members were required to designate to NASD on Schedule A of Form BD a principal to serve as CCO. The CCO plays a critical role to the CEO. The CCO shepherds the compliance program helping to ensure that the member's internal controls are

¹ NASD Notice to Members 04-79 and Interpretive Material 3013 (IM-3013); also, *see* NASD Notice to Members 06-22, 06-04, 05-75 for various amendments thereto. Additional resource materials to reference include Rule 3010 (Supervision), Rule 2510 (Discretionary Accounts), Rule 3110 (Books and Records), and IM-3110 (Customer Account Information).

reasonably designed to ensure investor protection, market integrity and compliance with industry rules and regulations. In addition, the CCO serves as the “primary advisor to the organization on its overall compliance scheme.”² Therefore, the CCO designated must have expertise in the process of compliance. The individual must have a thorough understanding of the member’s products and service, play an integral role in the overall business risk management structure and have knowledge (or consult with those who have such knowledge) of relevant rules and regulations required of the member firm.

Through the certification process, the role of the CCO was further defined throughout the firm. Personnel saw that the CCO was to evidence line managers’ adequate supervision of the member’s managers and agents. In addition, the CCO was to test the member’s compliance with policies and written supervisory procedures and address significant “gaps” that were found. While the CCO could hold another position at the organization, the individual selected was to perform the CCO duties in light of her or his other additional roles and responsibilities.

2. Steps the CCO and CEO Took Prior to Certification

Prior to certification the CCO met with the firm’s management team for training and tasked them to review their specific areas of supervisory responsibility thoroughly. Supervisors identified and reviewed their subject areas requiring compliance policies and written supervisory procedures (WSPs). If new to this process, supervisors received training on how to author WSPs and submitted to them to compliance for review and comment as required. If WSPs already were in existence, supervisors reviewed the WSPs to determine whether the written documents were accurate or not; i.e., were these written processes being executed by the firm and its associates. If enhancements to the WSPs were needed, the manager revised the WSPs and supplied them to compliance for review.

As the CCO (and his/her designated staff) reviewed WSPs, they made sure that the WSPs identified and provided the following:

- The specific area(s) the WSP addressed
 - *Example:* opening new accounts, internal surveillance of share classes, approval of transactions, outside business activities, option confirmations, best execution, etc.
- The purpose of the procedures
 - *Example:* Assume that the subject area is best execution and the department responsible for supervision is the Trading Desk. The Head of Trading should ensure that the WSP articulates that the purpose of the WSP is “to establish supervisory review guidelines to determine firm’s compliance with NASD Conduct Rule 2320.”
- A brief background on the rules governing the WSPs
 - *Example:* if the subject area is best execution, a summary of 2320 should be recited.
- The Policy
 - Under this section, the firm’s policy, as stated in the firm’s compliance manual, should be provided.
- The Procedure

² Id.

- Under this section, the firm's supervisory procedure should be articulated. Information that should be provided includes:
 - The Principal designated as responsible for compliance with this rule
 - Who conducts the supervisory review
 - When/how often the review is conducted
 - How the review is conducted
 - What document(s) are reviewed
 - How the review is evidenced/documentated

Following these steps allowed the CCO to understand clearly the responsibilities and duties of each area and identified the line supervisors responsible for these areas. Outlining clear WSPs assisted the management team, staff, and regulators during their examinations to understand the firm's structure, how its policies comply with industry rules and regulations and who is responsible for ensuring that supervisory procedures are followed. Taking this approach allowed the firm to identify any gaps or areas which required improvement. It also held management and staff accountable for their specific areas.

3. CEO Report to the Board of Directors and Audit Committee

Rule 3013 requires the CEO and CCO to meet at least once in the proceeding 12-months to discuss the assessment of the member's compliance program. The Rule also requires the member to prepare a report documenting the processes used for establishing, maintaining, reviewing, testing and modifying written compliance policies and procedures reasonably designed to achieve compliance with applicable rules and regulations. While any principal may prepare the report, the CEO and CCO are required to review the report prior to certification. The report should include, among other things:

- The manner and frequency in which compliance processes are administered
- The officers and supervisors with responsibility for administration of the processes
- Compliance report(s) or other similar reports required by an SRO, so long as the latter is clearly titled, the report is made at least annually and the report is produced in its entirety if requested by the SEC or NASD.

The certification process fostered the consultation between the CCO and CEO about the member's compliance program. It allowed the parties to evaluate the comprehensiveness of the program and the reasonableness of the member's policies and procedures. Through this interaction, and meetings with other senior management business line managers, the CEO gained a better understanding of the compliance processes and could attest to the conclusions reached in the certification.

C. The Certification

Once it was time for certification (which now must be conducted annually), the CEO reviewed the member's report describing the compliance program. The CEO conducted at least one meeting with the CCO in the past year and consulted with the CCO, other officers, employees, consultants and attorneys as necessary to attest to the statements in the certification. The CEO certified this and attested that the member has in place processes to establish, maintain, review and modify policies and procedures reasonably designed to achieve compliance with applicable NASD rules, MSRB rules, and federal securities laws and regulations. While the report did not

need to be submitted to the NASD or SEC, the member maintained the certification for future inspections.

D. Consequences for False Certification

During the certification process, the CEO may have discovered that the compliance program was inadequate. Should this occur, the CEO could not make a compliance and supervisory certification, for to do so “would be, without limitation, conduct inconsistent with the observance of the high standards of commercial honor and the just and equitable principals of trade – a violation of Rule 2110.”³

E. Conclusion

Over the last 18-months, broker-dealers have utilized the certification period to become organized, efficient and proactive in ensuring their WSPs accurately define current processes. As we look forward to the next annual compliance and supervision certification in 2007, consider utilizing these best practices and risk management tips.

Tip #1: The compliance department generally should be responsible for the oversight of the supervisory process. All business units share the responsibility for writing, establishing and enforcing the firm’s policies and procedures. In accordance with NASD Rule 3010, broker-dealers must establish a comprehensive supervisory system to reasonably ensure registered representatives are effectively complying with the firm and industry rules and regulations. With that said, supervisory responsibilities should exist at all levels of the firm. This system allows for the CCO to effectively train and delegate supervisory responsibilities onto other departments of the firm, thereby creating a “culture of compliance” throughout the organization.

Tip #2: Regulators expect firms to have WSPs for every area of the firm. However, since these policies and procedures reflect the supervisory responsibilities of the business managers, WSPs should be maintained separately from the firm’s compliance manual, which is distributed to employees and financial advisers as applicable. Within the compliance manual, include the roles and responsibilities of the registered representatives and OSJ Managers. This will achieve an additional layer of supervision at the field level. This is most helpful when a broker-dealer’s business model is for independent contractors.

Tip #3: As compliance policies and supervisory control procedures are established, it is prudent to conduct reviews of the WSPs on a regular basis. As WSPs are reviewed and updated, consider maintaining a checklist to document the review. Additionally, consider creating a working committee to review material policy and procedure changes. This allows senior management the opportunity to learn new regulatory requirements, understand the reasons for the policy change and to weigh-in on the procedures proposed, considering the impact of the new process to the firm and its representatives. This structure provides an opportunity for the CCO to get “buy-in” from the top, and helps in the implementation and enforcement of new WSPs. When having committee meetings, be sure to take minutes to capture the topics and issues discussed. This helps evidence that there is shared responsibility across the firm’s business units and illustrates the firm’s approach to ensure its compliance with industry rules and regulations.

³ Id.

Tip #4: Prior to the annual certification, each WSP should be carefully examined to ensure the procedures are current and that new industry rules are applied. Consider creating a “compliance calendar” for department manager supervisors. This may help ensure that each WSP is methodically examined and if needed, updated timely. It also provides internal audit and the CCO with a guideline and opportunity to test the WSP areas and provide periodic updates to the CEO on the compliance program well before the next annual certification deadline is due.

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