Notice to Members

SEPTEMBER 2003

SUGGESTED ROUTING

Legal & Compliance

Senior Management

KEY TOPICS

Rule 3010

Supervisory Systems

REQUEST FOR COMMENT **ACTION REQUESTED BY OCTOBER 10, 2003**

Supervision Rules

NASD Requests Comment on Proposed Amendments to Rule 3010 to Require Heightened Supervision Plans for Associated Persons with a Specified Threshold of Industry/Regulatory-Related Events; **Comment Period Expires October 10, 2003**

Executive Summary

NASD requests comment on proposed amendments to Rule 3010 (Supervision) to require members to adopt heightened supervision plans for those associated persons who have met or exceeded specified threshold numbers of industry/regulatory-related events, or to document their rationale (which must be reasonable) for not doing so. Rule 3010 generally requires members to establish and maintain supervisory systems for each of their associated persons that are reasonably designed to achieve compliance with applicable securities laws and NASD rules. However, the rule does not specifically address supervision of associated persons with a history of industry/regulatory-related events. The proposed rule change is intended to bolster investor protection by promoting earlier and more effective detection, and thus prevention, of future sales practice and other regulatory abuses by the associated person(s) requiring heightened supervision. In connection with the heightened supervision requirement, NASD seeks comment on the types and frequency of incidents that should be considered in requiring that persons be subject to heightened supervision plans.

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NASD further requests comment on amendments that would require that the registered person responsible for supervising the activities of the associated person(s) subject to the plan approve in writing the heightened supervision plans. As part of the approval of the plan, the supervisor would acknowledge responsibility for execution of the plan. This rule change is intended to ensure effective implementation of the heightened supervision plans and coordination between the personnel responsible for hiring and compliance personnel by encouraging more awareness and careful consideration of a person's background during the hiring process.

Questions/Further Information

Questions regarding this *Notice to Members* may be directed to Grace Yeh, NASD Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-6939.

Request for Comment

NASD requests comment on the proposed amendments to Rule 3010 described in this *Notice*. Members wishing to comment must make a submission that is received by **October 10, 2003**. Members and interested persons can submit their comments using the following methods:

- mailing in written comments
- e-mailing written comments to *pubcom@nasd.com*
- submitting comments online at the NASD Web Site (*www.nasd.com*)

Written comments submitted via hard copy should be mailed to:

Barbara Z. Sweeney

NASD
Office of the Corporate Secretary
1735 K Street, NW
Washington, DC 20006-1500

Important Note: The only comments that will be considered are those submitted by mail, e-mail, or via the NASD Web Site.

Before becoming effective, any rule change developed as a result of responses received to this *Notice* must be approved by the Securities and Exchange Commission (SEC).

Background and Discussion

Supervisory systems are a basic component of self-regulation within the securities industry. An effective supervisory system plays an essential role in the prevention of sales practice and other abuses and, thus, enhances investor protection and market integrity. As such, it is essential that firms monitor the regulatory histories of their associated persons and establish additional measures to supervise the activities of those associated persons with greater potential of creating customer harm.

Persons who have engaged in certain types of serious misconduct become subject to statutory disqualification under the federal securities laws and NASD rules and are required to undergo an eligibility proceeding.[1] In such a proceeding, NASD may seek to prevent the entry or continuance in the securities industry of persons subject to a statutory disqualification, or may permit them to work if the employment is consistent with the public interest and protection of investors. NASD, in virtually every instance where continued employment is permitted, will condition employment of the individual on the establishment of safeguards, including enhanced supervision by the employer member of the individual's business activities.

Neither the federal securities laws nor NASD rules, however, explicitly address members' supervisory obligations with respect to associated persons who have a history of industry/regulatory-related incidents, but who fall short of triggering the statutory disqualification provisions. Rule 3010 generally requires members to establish and maintain supervisory systems for each of their associated persons that are reasonably designed to achieve compliance with applicable securities laws and NASD rules, but the rule does not specifically address supervision of associated persons with a history of industry-related events.[2] *Notices to Members* issued in this area have provided guidance for members concerning heightened supervision plans for associated persons with these types of histories, but the guidance has not been incorporated into NASD rules.[3]

Accordingly, to address regulatory concerns raised by associated persons with these histories, NASD is seeking comment on the adoption of rule amendments to require explicitly that members adopt heightened supervision plans for those associated persons who meet or exceed threshold numbers of industry/regulatory-related incidents (such as customer complaints, arbitration proceedings, terminations for cause, and disciplinary actions). Along with numerical threshold tests, NASD recognizes that a qualitative analysis of the associated persons' activities also is an important tool for identifying whether they require heightened supervision. As such, the proposed amendments would provide firms with the flexibility not to impose a heightened supervision plan on a particular individual based upon a qualitative review of the activities of that individual. If a member decides not to impose heightened supervisory procedures on a person who has met one or more of the triggers, the member must document a clear, well-reasoned rationale supporting its determination. NASD requests comment on whether firms that have a certain number of associated persons who meet the heightened supervision requirements should not be allowed to opt-out of the heightened supervision requirement, and, if so, what this threshold number should be.

As required by Rule 3010, any supervision plan should be reasonably designed to ensure compliance with applicable securities laws and regulations and NASD rules. However, members would have the flexibility to tailor the plans to fit the firm's business and to address the nature of the concerns raised by the associated person's industry/regulatory-related incidents. Members also would have discretion in determining the duration of a heightened supervision plan, based on the member's reasonable assessment of the facts and circumstances surrounding the particular associated person's activities. While a member would be expected to maintain any heightened supervision plan imposed until such time that the associated person no longer meets any of the triggers for heightened supervision, the member may determine to eliminate such plan earlier provided the member provides a reasonable rationale for the earlier termination.

The proposed amendments would require that the plans be approved in writing by the person responsible for supervising the associated person subject to the plan. As part of the approval of the plan, such supervisor would acknowledge responsibility for execution of the plan. NASD believes that requiring approval and acknowledgement by a supervisor would help to ensure effective implementation of the plans as well as an even more careful consideration of an associated person's background in the hiring process. In addition, as required by Rule 3010(b)(4), members would need to maintain such plans in their firm records. NASD staff would review the plans as part of the examination program.

As part of this initiative, NASD staff has reviewed CRD data regarding industry/regulatory events for persons currently registered with NASD to determine what numerical tests would be appropriate as triggers to require firms to assess whether to impose a heightened supervision plan. A preliminary review of existing data as reported to the CRD system indicates that 29,500 out of the 663,000 persons currently registered with NASD (approximately four percent of currently active registered persons) have been subject to one or more customer complaints and arbitrations within the last five years. Of this number, 2,751 persons (.41 percent of all registered persons) have had three or more complaints and arbitrations.[4]

Based on this preliminary data, NASD proposes that members be required to impose (or document their rationale, which must be reasonable, for not imposing) heightened supervision plans on any associated person subject to three or more customer complaints and arbitrations within the past five years, given that three or more complaints and arbitrations is an unusually high number of complaints and arbitrations in the industry. Similarly, NASD proposes that members be required to impose heightened supervision plans on their associated persons who, within the previous five years, were subject to three or more pending, adjudicated, or settled regulatory actions or investigations,[5] or two or more terminations relating to regulatory or compliance issues or internal reviews initiated by an employing member firm to examine whether an individual engaged in misconduct.[6] The preliminary universe of persons reported in this *Notice* who would trigger the heightened supervision requirement include some overlap between categories as well as overlap due to a positive reporting in more than one category based on the same incident. NASD intends to periodically review the methodology to ensure that the appropriate associated persons are identified for heightened supervision.

Finally, while the proposed amendments would require members to adopt heightened supervision plans (unless members document their rationale for not imposing heightened supervision) if certain triggers are reached, members would continue to be obligated to review those associated persons with lower numbers of the events discussed in this *Notice*, other regulatory and litigation events, or other instances where they are the subject of internal actions by members to caution, discipline, or limit their activities, to determine whether heightened supervision plans or other measures are needed.

Endnotes

1 Events triggering statutory disqualification include, for example, certain enumerated misdemeanor and all felony criminal convictions for a period of ten years from the date of conviction; temporary and permanent injunctions (regardless of their age) involving a broad range of unlawful investment activities; bars (and current suspensions) ordered by the SEC or a self-regulatory organization (SRO); and findings that a person willfully has made or caused to be made false statements of a material fact to an SRO. *See* Sections 3(a)(39) and 15(b)(4)(A) of the Securities Exchange Act of 1934; NASD By-Laws Article III, Section 4. Persons who are or become subject to a statutory disqualification may seek to enter, reenter, or in the case of incumbents, continue in the securities industry.

2 Rule 3010(a)(7) requires that members conduct annual meetings with their registered representatives at which compliance matters relevant to the activities of the representatives are discussed, but does not require that members take supervisory steps tailored to specific incidents concerning the registered representatives.

3 *See Notice to Members 97-19* (April 1997) stating that a member with a registered representative who develops a history of customer complaints, final disciplinary actions involving sales practice abuse or other customer harm, or adverse arbitration decisions should consider developing special supervisory procedures for that registered representative. *See also Notice to Members 98-38* (May 1998) indicating that unexpected supervisory visits to offices with personnel who have disciplinary records may be appropriate.

4 The preliminary data show that of the 29,500 persons subject to customer complaints within the last five years, 3.3 percent of all registered persons (22,003 persons) were subject to 1 complaint, .71 percent of all registered persons (4,726 persons) were subject to 2 complaints, .22 percent of all registered persons (1,487 persons) were subject to three complaints, .09 percent of all registered persons (568 persons) were subject to four complaints, and .04 percent of all registered persons (290 persons) were subject to 5 complaints.

5 Preliminary data indicate that .52 percent of all persons currently registered with NASD (3,446 persons) have been subject to regulatory actions or investigations within the last five years. Of those subject to such actions/investigations, only .03 percent of all registered persons (216 persons) were subject to three or more.

6 Preliminary data indicate that .37 percent of all registered persons (2,475 persons) have been terminated or been the subject of an internal review initiated by the firm based on alleged investment-related misconduct. Of those persons, .18 percent of all registered persons (1,198 persons) had two or more such incidents.

ATTACHMENT A

New language is underlined; deletions are in brackets.

3010. Supervision

(a) No change.

(b) Written Procedures

(1) and (2) No change.

(3) Heightened supervisory procedures

(A) Each member that either is notified by NASD or otherwise has knowledge that any of its associated persons meets one of the criteria in paragraph (b)(3)(D) shall establish, maintain, and enforce special written procedures for supervising the activities of such associated persons.

(B) The member must establish and implement the supervisory procedures required by this paragraph within 30 days of receiving notice from NASD or obtaining actual knowledge that it is subject to the provisions of this paragraph.

(C) The procedures required by this paragraph must be appropriate for the member's business, size, structure, and customers and must be reasonably designed to supervise the types of activities that gave rise to the special supervision required by this paragraph.

(D) Members shall be required to adopt special supervisory procedures over the activities of the following associated person(s):

- The associated person has been subject to three or more customer complaints and arbitrations (as reported on Item 14I on Form U-4) in the previous five years;

- The associated person has been subject to three or more pending, adjudicated, or settled regulatory actions or investigations by the Commission, the Commodity Futures Trading Commission, a federal, state, or foreign regulatory agency, or a self-regulatory organization in the previous five years; or

- The associated person has been subject to two or more terminations for cause or internal reviews for alleged investment-related misconduct in the previous five years.

(E) A member must maintain the special supervisory procedures until such date that the associated person no longer meets any one of the criteria in paragraph (b)(3)(D), unless the member documents reasonable rationale for earlier termination of such procedures.

(F) If a member determines not to adopt special supervisory procedures for an associated person who meets one or more of the criteria in paragraph (b)(3)(D), the member must have a reasonable basis for its determination, which must be documented.

(G) The special supervisory procedures established under this paragraph must be approved, in writing, by a person supervising the associated person subject to the special supervisory procedures. The approving supervisor must also acknowledge responsibility for implementation and execution of the special supervisory procedures.

(4) [(3)] The member's written supervisory procedures shall set forth the supervisory system established by the member pursuant to paragraph (a) above, and shall include the titles, registration status and locations of the required supervisory personnel and the responsibilities of each supervisory person as these relate to the types of business engaged in, applicable securities laws and regulations, and the Rules of this Association. The member shall maintain on an internal record the names of all persons who are designated as supervisory personnel and the dates for which such designation is or was effective. Such record shall be preserved by the member for a period of not less than three years, the first two years in an easily accessible place.

(5) [(4)] A copy of a member's written supervisory procedures, or the relevant portions thereof, shall be kept and maintained in each OSJ and at each location where supervisory activities are conducted on behalf of the member. Each member shall amend its written supervisory procedures as appropriate within a reasonable time after changes occur in applicable securities laws and regulations, including the Rules of this Association, and as changes occur in its supervisory system, and each member shall be responsible for communicating amendments through its organization.

(c) - (g) No change.