

BDQUARTERLY

“Checks and balances are critical in this environment. You should insist on absolute compliance with policies and procedures, there should be no possibility of ‘suspending’ compliance.”

— SEC OCIE Director Lori Richards, National Society of Compliance Professionals Conference in Philadelphia, PA, October 2008

NASD Rules 3010, 3012 and 3013...Understanding the Overarching Relationship¹

NASD Rules 3010, 3012 and 3013 all address a broker-dealer’s supervisory policies and procedures; however, there is often confusion regarding the differences between the three rules.² Although the rules are closely related, their requirements are complementary, not duplicative, in nature. The three rules essentially come together to form an overarching regulatory scheme for the supervision of broker-dealer activities.

Overarching Relationship

According to FINRA interpretive guidance on these rules, the relationship between the three rules is as follows:

NASD Rule 3010 requires the establishment of a supervisory system for a broker-dealer’s business activities, including the adoption of written supervisory procedures (“WSPs”) reasonably designed to

achieve compliance with applicable securities laws and regulations and FINRA rules.³ NASD Rule 3012 states that each broker-dealer must (CONTINUED)

1– Effective December 15, 2008, NASD Rule 3013 (Annual Certification of Compliance and Supervisory Processes) and IM-3013 (Annual Compliance and Supervision Certification) will become FINRA Rule 3130 in the Consolidated FINRA Rulebook without material change. See FINRA Regulatory Notice 08-57.

2– The FINRA rulebook currently consists of both NASD Rules and certain NYSE Rules that FINRA has incorporated. Firms that were only members of NASD as of July 30, 2007 remain subject only to NASD Rules. A firm that becomes a new member of FINRA only (and not a member of NYSE) will be subject only to NASD Rules. All FINRA members are subject to the FINRA By-Laws and Schedules to the By-Laws. FINRA’s Consolidated Rulebook will result in new FINRA Rules that apply to all FINRA members and will be proposed in phases to the SEC. As rules approved by the SEC become effective, they will replace the existing NASD Rules and incorporated New York Stock Exchange (NYSE) Rules. See FINRA Information Notice Rulebook Consolidation Process (March 12, 2008).

3– See FINRA 2012 Report “Frequently Asked Questions” Guidance, <http://www.finra.org/Industry/Issues/SupervisoryControl/P037999>.

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establish supervisory control procedures that support the WSPs established pursuant to NASD Rule 3010. Each broker-dealer is required to ensure WSPs are maintained, as well as establish a control process for insuring these procedures are adequate and current. The established supervisory system implemented pursuant to the requirements of NASD Rules 3010 and 3012 should provide the basis and rationale for the broker-dealer's annual CEO certification required under NASD Rule 3013.

NASD Rule 3013 requires the CEO of a broker-dealer to certify that the broker-dealer has adopted compliance policies and supervisory procedures reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA rules. Under NASD Rule 3013, the CEO is certifying that processes are in place, although NASD Rule 3013 does not require that the adequacy of such processes be certified. However, it is important to note that NASD Rule 3012 requires the broker-dealer to adopt supervisory control processes and procedures (outlined in NASD Rule 3010) and to report on the effectiveness of those procedures as a result of annual testing. As a result, it is recommended that broker-dealers conduct a detailed review of their business activities, which should be formalized into a report submitted to the CEO prior to completion of the annual certification.⁴

Practical Implementation of NASD Rules 3010, 3012, and 3013

Based on FINRA senior staff comments, it appears that FINRA envisions future rulemaking will be a "hybrid" of principle-based and rule-based regulation.

4- FINRA Interpretative Material 3013 (IM-3013) permits submission of the final report to a firm's governing bodies to take place either before or after the execution of the certification, provided that the board of directors and audit committee (or equivalent bodies) receive the report at the earlier of their next scheduled meetings or within 45 days after execution of the certification. This requirement will remain unchanged as part of FINRA's Rulebook consolidation process.

[Rule 3012] is really a reflection and a writing down of a common-sense conclusion that you can't have effective procedures internally governing what you do at your firm unless you step back and take a look at them, and determine whether they're effective and whether there are holes. We don't tell you exactly what those procedures need to be. We tell you, you have to have them for the businesses that you're in, and we tell you, you have to review them. Yes, NASD Rule 3012 is a principle-based rule.⁵

Regardless of the degree to which principle-based regulation is implemented, FINRA will still adopt specific rules to achieve desired regulatory outcomes. Because of the hybrid nature of NASD Rules 3010, 3012, and 3013, broker-dealers should expect to continue to follow these rules and anticipate similar rulemaking in the future.

Conducting Annual Reviews using a Risk Based Approach

Since the overarching relationship among the rules incorporates both principle and rule-based regulation, broker-dealers are permitted to apply the rules practically and conduct annual reviews incorporating "risk based" testing and sampling. When conducting risk based testing and sampling, broker-dealers should utilize the following three documents to assess risk (based on approved business activities and overall revenues):

- FINRA Membership Agreement;
- Current balance sheet; and
- FOCUS Reports for the previous 12 months.

When reviewing these documents, compliance officers should consider:

- What are the broker-dealer's major sources of revenue based on percentage? (CONTINUED)

5- Excerpt from the FINRA Senior Staff Response, 2007 Spring Securities Conference "Ask Senior Staff" Session, May 23, 2007.

- Are there any revenues derived from activity outside the membership agreement?
- Do the broker-dealer's WSPs address all approved business lines?

Based on the responses, the broker-dealer can target its review to its highest revenue stream, which is a standard similar to that which is applied by FINRA examination staff during on-site reviews. With respect to additional revenue sources, the broker-dealer can dedicate more time to properly analyzing the effectiveness of its procedures as they relate to the "risk" posed by each revenue source.

A critical component of the broker-dealer's testing is the ability to document properly the firm's testing. This includes any additional on-going compliance reviews conducted throughout the year. A determining factor in assessing the overall effectiveness of a broker-dealer's NASD Rule 3012 review is often the firm's ability to illustrate that its sampling addresses its major business activities.

The aforementioned risk analysis can be conducted in broad based areas such as anti-money laundering, branch office activities, advertising, and Regulation S-P.

Conclusion

The requirements outlined by NASD Rules 3010, 3012 and 3013 indicate regulatory authorities consider it to be the role of senior management to promote a strong culture of compliance within their own broker-dealer. FINRA has continued to cite member firms for various violations related to NASD Rule 3012, including failure to conduct an adequate or timely test, and failure to evidence proper testing. As the regulatory landscape changes and broker-dealers have had more time to adopt and implement supervisory programs, it is anticipated that FINRA will apply enhanced scrutiny in assessing the adequacy of a firm's internal compliance reviews. To ensure that your firm's ongoing monitoring program and NASD Rule 3012 annual review remains compliant, it is also necessary to assess continuously the regulatory environment in relation to your firm's business activities.

Four Months into FINRA Rule 2821: Status Update

May 5, 2008 marked the effective date for a portion of newly adopted FINRA Rule 2821. Paragraphs (a), (b), and (e) of the rule, which apply to covered products, recommendation requirements and suitability standards, and special training programs, became effective on this date.

In contrast, FINRA sought and received SEC approval to delay the implementation of paragraphs (c) and (d) of the rule. Paragraph (c) in particular contained controversial requirement for principal review and approval, while paragraph (d) would have required specific written supervisory procedures surrounding such principal review and approval.

FINRA filed a notice of a proposed rule change with the SEC on June 4, 2008 (Release No. 34-57920) to amend certain provisions of Rule 2821, including:

- Revise the scope of the rule to apply to "recommended" purchases and exchanges of deferred variable annuities ("d-VAs") and "recommended initial" subaccount allocations (Paragraph (a));
- Require prompt transmittal of the application to an OSJ following receipt of "correct and complete" information (Paragraph (b));
- Amend the rule to require performance of the principal review and approval within seven days following OSJ receipt of a "complete and correct" application and document evidence of (CONTINUED)

- suitability determination prior to transmitting a customer's application to the issuer for processing (Paragraph (c)); and
- Provide clarification on:
 - receipt, handling, and transmittal of customer funds;
 - making a reasonable effort to determine exchange activity within the past 36 months; and
 - sharing information used in suitability reviews with the insurer (Supplementary Material).

Commenters continue to raise issues that may result in further delay of the final rule implementation, including:

- Trigger date for principal approval;
- Circumstances under which the issuer may hold customer funds in advance of the broker-dealer completing the suitability review, including conditional use of suspense accounts;
- Financial and operational burdens; and
- Constraints regarding the current 180 day implementation timetable.

Despite the current pending status of portions of Rule 2821, certain 2008 SEC and FINRA examination priorities relate to the sale and supervision of variable annuities and should not be overlooked. Examiners are currently reviewing:

- Adequacy of supervisory systems and documentation of policies and procedures associated with the sale of d-VAs;
- The process by which firms identify individuals or business areas requiring heightened supervision;
- Sales to seniors, including suitability of certain products; and
- Review procedures associated with NASD Rules 3010, 3012, and 3013.

Written Supervisory Procedures...Don't Overlook the Human Element

NASD Rule 3010(a)(1) and Section 15(f) of the Exchange Act

One of the primary requirements applicable to all broker-dealers is the requirement to establish WSPs pursuant to NASD Rule 3010(a)(1). Each broker-dealer's WSPs must establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA Rules. Section 15(f) of the Exchange Act requires broker-dealers to establish, maintain and enforce written policies and procedures reasonably designed to prevent the misuse of material nonpublic information. How each firm accomplishes the establishment and implementation process concerning the supervision

of its activities should be based on each firm's approved business activities.

Enforcement Actions

Historically, enforcement actions against compliance professionals have only been taken in rare instances of egregious misconduct, usually involving knowing and intentional violations of the law or intentional inaction when aware of the presence of such violations. Although actions against a member of a broker-dealer's management for procedural deficiencies are rare, a review of such instances indicates a common pattern or factor present in each action's overall circumstances, namely, the broker-dealer's inability to effectively demonstrate how it documented the implementation of its processes outlined in the WSPs.

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Recent Actions

In June 2008, Chanin Capital LLC (“Chanin”) was fined \$75,000 by the SEC as a result of charges that the firm failed to properly establish policies and procedures to prevent employees and others from misusing inside information.⁶ The SEC’s action noted that Chanin demonstrated efforts towards improving and honoring its own policies after September 2003 and even revised its compliance procedures on two instances during the review period. Although Chanin appeared to take corrective action, the SEC noted Chanin’s enhancements still lacked the necessary policies and procedures to maintain and enforce its revised compliance program.

Along with this action, the SEC also settled an administrative action against Chanin’s Chief Financial and Compliance Officer, A. Carlos Martinez, censuring him and fining him \$25,000 for aiding and abetting Chanin’s violations of Section 15(f) of the Exchange Act.⁷

Human Element

Linda Chatman Thomsen (“Thomsen”), the SEC’s Enforcement Chief, addressed the aforementioned action in a June 2008 speech.⁸ Thomsen’s speech provided further insight to the SEC staff’s overall rationale and approach concerning broker-dealer supervision and procedural expectations. In her comments regarding the Chanin action, Thomsen stated:

As imposing as these procedures were on paper, something was missing: the human element, the hand that collected the signed acknowledgement paper, the eye that met the employee’s gaze and saw that he understood and accepted the responsibilities

enumerated in that paper. And without that person ensuring that those policies were a living, breathing trust between employer and employee, well, the law was not being upheld.

These recent regulatory actions and comments made by Thomsen appear to indicate that it is not enough to merely establish WSPs and require all employees to attest to their receipt; rather, the SEC staff will place a greater emphasis on overall supervisory ownership of each broker-dealer’s WSPs, specifically the supervisory controls outlining responsibility levels.

The one factor that is critical to avoiding personal liability is the ability of compliance professionals to apply the “human element” within their policies and procedures. Thomsen further noted,

You, as compliance professionals, provide the human element that brings compliance policies to life and ensures that they are enforced. So basic, so simple, yet, so important. And this applies not merely to insider trading, but to all the policies you enforce.

Although the human element is not specifically referenced in NASD Rule 3010 or Section 15(f) of the Exchange Act, it is clear that this element is implied. In order to meet these requirements, broker-dealers need to customize existing WSPs to the overall approved business activities of the broker-dealer. The established WSPs should clearly outline the supervisory reporting responsibilities along with identifying how senior management is routinely apprised of the broker-dealer’s on-going compliance efforts.

Finally, broker-dealers should ensure that the annual reviews of the broker-dealer’s business activities required pursuant to NASD Rule 3010 and 3012 are comprehensively analyzing existing controls.

6– Exchange Act Release No. 34-57755, May 1, 2008.

7– SEC Administrative Proceeding File No. File No. 3-13032, May 1, 2008.

8– Linda Chatman Thomsen Director, Division of Enforcement, Speech by SEC Staff: *It’s Always Something at the U.S. Securities and Exchange Commission*. Compliance Week Conference, Washington, D.C., June 4, 2008.

Regulatory Notices, Updates, and Rule Changes

Financial Industry Regulatory Authority – Regulatory Notices/Notices to Members September

Regulatory Notice 08-51 SEC Approves Amendments to FINRA's Transaction Reporting Rules to Require Prompt Last Sale Reporting of Transactions in Foreign Securities; Effective Date: October 27, 2008

Regulatory Notice 08-50 Procedures for Submitting Written Attestation of Bona Fide Market Making Relating to Fail-to-Deliver Positions. Effective Date: Immediately

Regulatory Notice 08-49 FINRA Announces Effective Date for Expansion of NASD IM-2110-2 to OTC Equity Securities and Revised Minimum Price-Improvement Standards in IM-2110-2; Effective Date: November 11, 2008

Regulatory Notice 08-47 Changes to Customer Complaint Reporting Procedures Under NASD Rule 3070(c) and NYSE Rule 351(d); Effective Date: October 1, 2008

Regulatory Notice 08-46 Interpretive Guidance on Capital Treatment of Introducing Broker-Dealers' Clearing Deposits; Effective Dates: Immediately with respect to Interpretation I; January 5, 2009, with respect to Interpretation II

August

Regulatory Notice 08-43 SEC Approves Expanding Disseminated Real-Time TRACE Data; Effective Date: November 3, 2008

Regulatory Notice 08-42 Guidance on Transactions in TRACE-Eligible Securities under SEC Rule 144.

Regulatory Notice 08-40 Technology Changes for Reporting Certain Complaint and Disclosure Information; Effective Date: October 20, 2008

July

Regulatory Notice 08-38 FINRA Provides Clarification on SEC Guidance Regarding Emergency Orders Concerning Short Selling.

Regulatory Notice 08-36 SEC Approves Amendments to Expand the Scope of NASD Rule 2440 and IM-2440-1 to All Securities Transactions; Effective Date: June 13, 2008

Regulatory Notice 08-35 SEC Approves Amendments to NASD Rule 2810 (Direct Participation Programs); Effective Date: August 6, 2008

Regulatory Notice 08-34 SEC Approves Amendments to the Rule 9700 Series to Streamline Existing Procedural Rules Applicable to General Grievances Related to FINRA Automated Systems; Effective Date: August 1, 2008

Securities and Exchange Commission July

Release No 34-58092 Commission Guidance and Amendment to the Rules Relating to Organization and Program Management Concerning Proposed Rule Changes Filed by Self-Regulatory Organizations Effective Date: July 11, 2008

Municipal Securities Rulemaking Board September

MSRB Notice 2008-38 Reminder Regarding the Application of Rule G-37 to Federal Election Campaigns of Issuer Officials.

August

MSRB Notice 2008-34 Notice on Bank Tying Arrangements, Underpricing of Credit and Rule G-17 on Fair Dealing

July

MSRB Notice 2008-32 Amendments Approved to Rules G-11, G-12 and G-8

Financial Crimes Enforcement Network August

FinCEN announces the release of a revised RMSB Form 107 for Money Services Business Registration is effective September 1, 2008 (08/25/2008)

July

FinCEN Reminds Public to be Aware of Financial Scams (07/18/2008)

Conferences/ Roundtables/Webcasts

Roundtables

Roundtable

January 2009 • Dallas, TX

February 2009 • Washington, DC

April 2009 • Chicago, IL

Webcasts

Broker Dealer Rule Updates

November 19, 2008

David Jonson, Partner, K&L Gates

Leigh Vazquez, Managing Director,

ACA Compliance Group

Best Execution

December 11, 2008

James E. Anderson, Partner, WilmerHale

Robert Stype, Managing Partner,

ACA Compliance Group

Latest GIPS Guidance and New Requirements for 2008 and 2009

December 16, 2008

Justin Guthrie, CFA, CPA, ACA Compliance Group

Filing Dates

2008 Monthly/Quarterly FOCUS Part II/IIA Filings

Month Ending	Due Date
October 31, 2008	November 25, 2008
November 30, 2008	December 23, 2008
December 31, 2008	January 27, 2009

2008/2009 Annual Audit Filings

Fiscal Year End	Due Date
October 31, 2008	December 30, 2008
November 30, 2008	January 29, 2009
December 31, 2008	March 2, 2009

2008 Customer Complaint Filings

Quarter Ending	Due Date
4th quarter 2008	January 15, 2009

In Case You Missed It!

FINRA's two part podcast series entitled, AML - Customer Identification Programs, Part I and II, emphasized that member firms are required to adopt risk-based procedures that take into account risk factors such as the firm's size, location, customer base, and account-opening methods.

Did You Know?

The Financial Services Authority exercises statutory powers in the United Kingdom in relation to the regulation of deposit taking, insurance and investment business.

One of its responsibilities is to consider any information that comes to its attention suggesting that a person may be acting in breach of the Financial Services and Market Act 2000 (“the Act”).

unless that person is authorized or the contents of the communication have been approved by an authorized person. Buying and selling shares and providing investment advice constitutes investment activity.

Section 21 of the Act provides that a person must not, in the course of business, communicate an invitation or inducement to engage in investment activity

It is a criminal offense in the UK to breach Section 21 and other associated sections of the Act, punishable by up to two years in prison, or a fine, or both.

ACA Compliance Group (ACA) is a full-service compliance consulting firm committed to offering unparalleled regulatory compliance and GIPS verification services designed to satisfy the needs of investment advisers, private funds, investment companies, insurance companies and broker-dealers.

In these uncertain times, compliance officers must closely monitor changing regulations while fulfilling their current compliance obligations. As an alternative to increasing their compliance staff, leading financial services firms choose to partner with ACA.

ACA clients benefit from the creation of customized compliance programs that meet the increasingly complex regulatory requirements. Please contact us to discuss how ACA’s team of former FINRA, NYSE and SEC regulators can help you effectively manage your compliance burden.

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