

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-52799; File No. SR-NASD-2005-084)

November 18, 2005

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change and Amendment Nos. 1 and 2 Thereto Relating to Amendments to the Rule Regarding Supervisory Control Systems, Rule 3012, to Require Notification of Reliance on “Limited Size and Resources” Exception

I. INTRODUCTION

On June 23, 2005, the National Association of Securities Dealers, Inc. (“NASD”) filed with the Securities and Exchange Commission (“SEC” or “Commission”), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> a proposed rule change amending the rule regarding supervisory control systems, Rule 3012, to require members relying on the “limited size and resources” exception to Rule 3012’s general supervisory requirement for conducting producing managers’ supervisory reviews to report electronically to NASD their reliance on the exception. On July 8, 2005, NASD submitted Amendment No. 1 to the proposed rule change.<sup>3</sup> On July 27, 2005, NASD submitted Amendment No. 2.<sup>4</sup> The proposed rule change, as amended, was published for comment in the Federal Register on August 9, 2005.<sup>5</sup> The Commission received one comment on the proposal. For the reasons discussed below, the Commission is approving the proposed rule change, as amended.

II. DESCRIPTION OF THE PROPOSED RULE CHANGE

A. Description of the Proposal

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

<sup>3</sup> Amendment No. 1 clarified the rule’s text.

<sup>4</sup> Amendment No. 2 replaced and superseded Amendment No. 1. Amendment No. 2 further clarified the rule’s text.

<sup>5</sup> See Exchange Act Release No. 52195 (Aug. 3, 2005), 70 FR 46242 (Aug. 9, 2005) (the “Notice”).

Rule 3012 (Supervisory Control System) requires members to have a system of supervisory control policies and procedures that tests and verifies that a member's supervisory procedures are reasonably designed with respect to the activities of the member and its registered representatives and associated persons to achieve compliance with applicable securities laws and regulations, and with applicable NASD rules, and to amend those supervisory procedures when the testing and verification demonstrate a need to do so. Rule 3012 also requires that a member's supervisory control policies and procedures include, among other things, procedures that are reasonably designed to review and supervise the customer account activity conducted by a member's producing managers.

Generally, only a person senior to or "otherwise independent" of a producing manager may conduct the producing manager's reviews. However, Rule 3012 provides a limited exception for any member firm that is so limited in size and resources (the "limited size and resources" exception) that the member does not have independent associated persons who can conduct the required supervisory reviews. In such situations, a principal who is sufficiently knowledgeable of the member's supervisory control procedures may conduct the required supervisory reviews.

In its Order approving Rule 3012, the SEC specified that NASD must notify the SEC of those members that elect to rely on Rule 3012's "limited size and resources" exception.<sup>6</sup> To fulfill this obligation, NASD will need to identify those members relying on the exception. Accordingly, NASD is filing this rule change requiring firms that rely on the "limited size and resources" exception to notify NASD of their reliance on the exception. In Notice to Members

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<sup>6</sup> See Exchange Act Release No. 50477 (Sept. 30, 2004), 69 FR 59972 (Oct. 6, 2004) (SR-NASD-2004-116).

04-71 (October 2004), the Notice announcing the SEC's approval of the Supervisory Control Amendments, NASD advised its members of its intent to file this rule change.

The proposed rule change will require a member that has determined that it must rely on the "limited size and resources" exception to Rule 3012 to conduct any of its producing managers' supervisory reviews, to notify NASD electronically (or through any other process prescribed by NASD) within thirty (30) days of the date on which the member first relies on the exception.<sup>7</sup> Afterwards, the member will need to notify NASD of its continued reliance on the exception on an annual basis. Members must ensure that each ensuing annual notification is effected no later than on the anniversary date of the previous year's notification. If a member determines that it no longer needs to rely on the "limited size and resources" exception to Rule 3012 to conduct any of its producing managers' supervisory reviews, the member must notify NASD electronically (or through any other process prescribed by NASD) within thirty (30) days of ceasing to rely on the exception.

NASD has recently designed an electronic reporting system that will enable members to notify NASD of their reliance on the exception. Members will be able to access this reporting system on the effective date of this proposed rule change.

NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be 30 days following publication of the Notice to Members announcing Commission approval.

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<sup>7</sup> Because the "limited size and resources" exception became effective on January 31, 2005, a member may already be relying on the exception prior to the effective date of the proposed rule change and, consequently, will be unable to comply with the rule change's requirement that NASD be notified within thirty (30) days of the date on which the member first relies on the exception. In such instance, the proposed rule change would require the member to notify NASD within thirty (30) days of the rule change's effective date.

## B. Comment Summary

The proposal was published for comment in the Federal Register on August 9, 2005.<sup>8</sup> We received one comment on the proposal. The commenter, Lincoln Investment Planning, Inc. (“Lincoln”), expressed concern that the proposed annual notification requirement for members that rely on Rule 3012’s “Limited Size and Resources” exception would impose an undue burden on members to remember the anniversary date of the initial notification.<sup>9</sup> Instead, Lincoln stated that this burden could be reduced by requiring members relying on this exception to only provide an initial notification of their reliance and a second notification when they cease to rely on it. Alternatively, Lincoln also suggested that NASD consider making the notification requirement a part of the quarterly updated NASD Control System.<sup>10</sup>

In response to the Lincoln letter, NASD stated that “[t]he annual notification requirement helps NASD to provide the SEC with the most accurate information possible. To aid members in completing their annual notification requirement, the electronic reporting system that NASD has designed for members to use, records and displays the date of the member’s previous notification.”<sup>11</sup> Furthermore, to mitigate any concerns regarding a member’s obligation to remember the anniversary date of its reliance of the exception, NASD stated that it “expects to provide members with reminders, electronic or otherwise, in advance of the members’ anniversary date for notification of continued reliance on the exception.”<sup>12</sup>

## III. DISCUSSION AND FINDINGS

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<sup>8</sup> See Notice, *supra* note 3.

<sup>9</sup> See e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov) from Deidre B. Koerick, Lincoln Investment Planning, Inc., dated Aug. 30, 2005.

<sup>10</sup> *Id.*

<sup>11</sup> See letter from Patricia M. Albrecht, Assistant General Counsel, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated Oct. 4, 2005.

<sup>12</sup> *Id.*

After careful review, the Commission finds that the proposed rule change, as amended, is consistent with the provisions of Section 15A(b)(6)<sup>13</sup> of the Act, which require, among other things, NASD's rules to be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

Rule 3012 requires independent supervisory reviews of producing managers. It is designed to prevent fraudulent and manipulative practices and to protect investors. In approving the rule, the Commission said it expected that Rule 3012

will reduce potential conflicts of interests in situations where the producing branch manager is responsible for generating substantial revenues for the benefit of his supervisor. The Commission believes that such heightened supervisory procedures should help address the potential conflicts of interest with sufficient flexibility so as not to create undue burdens and costs on members.<sup>14</sup>

The rule recognizes, however, that certain firms may conduct their business with significant limitation in size and resources, and accounted for this limitation by approving a "Limited Size and Resources" exception. The Commission concluded that the "Limited Size and Resources" exception was consistent with Section 15A(b)(6) because it accommodated the smallest NASD members that lack the resources to implement a full scale program to conduct supervisory reviews.<sup>15</sup> However, in approving this exception, the Commission expected NASD to monitor closely the use of this exception to prevent its abuse or use by members other than those for which it was intended.<sup>16</sup>

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<sup>13</sup> 15 U.S.C. 78o-3(b)(6).

<sup>14</sup> See Exchange Act Release No 49883 (June 17, 2004).

<sup>15</sup> See Exchange Act Release No. 50477 (Sept. 30, 2004).

<sup>16</sup> Id.

NASD proposed this amendment to Rule 3012 to provide an efficient measure for monitoring the use of the exception. The Commission believes that this proposed rule change, as amended, accomplishes the goals of Section 15(A)(b)(6) by enabling NASD and the Commission to efficiently monitor members that rely on the “Limited Size and Resources” exception in Rule 3012.

IV. CONCLUSION

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act<sup>17</sup> that the proposed rule change, as amended (SR-NASD-2005-084), be, and hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>18</sup>

Jonathan G. Katz  
Secretary

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<sup>17</sup> 15 U.S.C. 78s(b)(2).

<sup>18</sup> 17 CFR 200.30-3(a)(12).