

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-50347; File No. SR-NASD-2003-176)

September 10, 2004

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Amendments Nos. 1 and 2 Thereto by the National Association of Securities Dealers, Inc. Relating to Chief Executive Officer Certification and Designation of Chief Compliance Officer

I. Introduction

A. Background

On November 28, 2003, 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”)¹ and Rule 19b-4 thereunder,² a proposed rule change relating to Chief Executive Officer Certification and Designation of Chief Compliance Officer. The proposed rule change was published for comment in the Federal Register on December 31, 2003.³ The Commission received six comment letters in response to the proposed rule change.⁴

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Exchange Act Release No. 48961 (Dec. 23, 2003), 68 FR 75704 (December 31, 2003). Subsequently, the Commission designated a longer period for Commission action and extended the comment period. Exchange Act Release No. 49129 (January 27, 2004), 69 FR 5228 (February 3, 2004).

⁴ See letters to Jonathan G. Katz, Secretary, Commission from: Laura Singer, Vice President and General Counsel, E*Trade Brokerage Holdings, Inc. dated February 11, 2004 (E*Trade Letter); George R. Kramer, Vice President and Acting General Counsel, Securities Industry Association, Paul A. Merolla, Executive Vice President, SIA Compliance and Legal Division, and Paul Saltzman, Executive Vice President and General Counsel, The Bond Market Association dated February 6, 2004 (“SIA/TBMA Letter”); Joan Hinchman, Executive Director, President, and CEO, National Society of Compliance Professionals, Inc. dated February 5, 2004 (“NSCP Letter”); and Christiane G. Hyland, Senior Vice President and General Counsel, Empire Corporate FCU dated January 21, 2004 (“Empire Letter”); Stephen A. Batman, CEO, 1st Global Capital Corp. dated January 21, 2004 (“1st Global Letter”); and Herbert A. Pontzer, SVP/Chief Compliance Officer, NFP Securities, Inc. dated February 4, 2004 (“NFP Letter”). The comments are available online at www.sec.gov/rules/sro/nasd/nasd2003176.shtml.

On March 8, 2004, NASD filed Amendment No. 1 to the proposed rule change.⁵ On July 15, 2004, NASD filed Amendment No. 2 to the proposed rule change.⁶

On August 3, 2004, Amendments No. 1 and 2 were published for comment in the Federal Register.⁷ The Commission received eight comment letters in response to these amendments.⁸ For the reasons discussed below, the Commission is approving the proposal as amended.

B. NASD Notice to Members 03-29

In June 2003, NASD issued Notice to Members 03-29, seeking comment on a proposal to require members to designate a Chief Compliance Officer (“CCO”) and have their CCOs and Chief Executive Officers (“CEOs”) annually certify 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.”⁹ The proposal

⁵ See letter from Philip A. Shaikun, Assistant General Counsel, NASD, to Catherine McGuire, Chief Counsel, Division of Market Regulation, Commission, dated March 8, 2004 (“Amendment No. 1”). In Amendment No. 1, NASD proposed to add a requirement that the mandated meetings between the CEO and CCO include discussion of compliance system deficiencies, risks and resources.

⁶ See letter from Philip A. Shaikun, Assistant General Counsel, NASD, to Catherine McGuire, Chief Counsel, Division of Market Regulation, Commission, dated July 15, 2004 (“Amendment No. 2”). In Amendment No. 2, NASD eliminated the CCO certification requirement and added to the accompanying interpretive material a description of the CCO’s role in the member’s compliance scheme and the CEO certification required under this proposed rule.

⁷ Exchange Act Release No. 50105 (July 28, 2004), 69 FR 46603 (August 3, 2004).

⁸ See Letters to Jonathan G. Katz, Secretary, Commission from: Pamela Fritz, CCO, MWA Financial Services, Inc. dated August 6, 2004 (“MWA Letter”); Stephen A. Batman, CEO, 1st Global, Inc. dated August 23, 2004 (“1st Global-2 Letter”); R. Bredt Norwood, General Counsel, NFP Securities, Inc. dated August 23, 2004 (“NFP-2 Letter”); Barry S. Augenbraun, Senior Vice President and Corporate Secretary, Raymond James Financial, Inc. dated August 24, 2004 (“Raymond James Letter”); S. Kendrick Dunn, Assistant Vice President, Pacific Select Distributors dated August 24, 2004 (“Pacific Select Letter”); John Polanin, Jr., Chairman, SIA Self-Regulation and Supervisory Practices Committee, and Paul A. Merolla, Executive Vice President, SIA Compliance and Legal Division dated August 24, 2004 (“SIA Letter”); Dale E. Brown, CAE Executive Director, CEO Financial Services Institute dated August 24, 2004 (“FSI Letter”); Gregory E. Smith, President, Sunset Financial Services, Inc. dated August 24, 2004 (“SFS Letter”). The comments are available online at www.sec.gov/rules/sro/nasd/nasd2003176.shtml.

⁹ NASD Notice to Members 03-29. Notice to Members 03-29 is available online at www.nasdr.com/pdf-text/0329ntm.txt.

would have required, among other things, that the CCO and CEO have a reasonable basis to certify that a member was in compliance with all applicable laws, rules and regulations at a fixed moment in time. Interpretive material included in the rule proposal clarified that the signatories to the certification would incur no additional liability as a consequence of the certification, provided there was a reasonable basis to certify at the time of execution.

NASD received 166 comments on the proposal, most of which disfavored the proposal.¹⁰ According to NASD, commenters contended, among other things, that the proposal was duplicative of existing requirements. They also complained that the proposal could impose liability on the signatories in an unfair manner. Finally, they criticized the potential breadth of the certification.

Although NASD disputed most of the criticism with the proposal, it acknowledged the difficulty in certifying to absolute compliance at any given moment in the face of dynamic regulatory and business environments. As a result, in its initial filing of this rule proposal with the Commission, in response to comments it received on Notice to Members 03-29, NASD changed the focus of the proposed certification from whether the member had “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.¹¹

II. Description

A. Description of the Proposal

¹⁰ Exchange Act Release No. 48961 (December 23, 2003), 68 FR 75704, 75706 (December 31, 2003).

¹¹ Exchange Act Release No. 48961 (December 23, 2003), 68 FR 75704 (December 31, 2003).

NASD's proposal seeks to provide a mechanism to compel substantial and purposeful interaction between senior management and compliance personnel to enhance the quality of members' supervisory and compliance systems. Specifically, NASD proposes to adopt new Rule 3013 requiring (1) that each member designate a principal to serve as CCO and (2) each member's CEO to certify annually to having in place processes to establish, maintain, review, modify, and test policies and procedures reasonably designed to achieve compliance with applicable NASD rules, MSRB rules, and federal securities laws and regulations.

With respect to the certification, the proposed rule change also would require the CEO¹² to certify annually that senior executive management has in place processes to (1) establish, maintain and review policies and procedures reasonably designed to achieve compliance with applicable NASD rules, MSRB rules and federal securities laws and regulations; (2) modify such policies and procedures as business, regulatory and legislative changes and events dictate; and (3) test the effectiveness of such policies and procedures on a periodic basis, the timing of which is reasonably designed to ensure continuing compliance with NASD rules, MSRB rules and federal securities laws and regulations. The proposed rule change further would require the CEO to certify that those processes are evidenced in a report that has been reviewed by the CEO and submitted to the member's board of directors and audit committee.¹³ The processes, at a minimum, must include one or more meetings annually between the CEO and CCO to (1) discuss and review the matters that are the subject of the certification; (2) discuss and review the

¹² The rule proposal originally filed by NASD with the Commission called for both the CEO and CCO to sign the certification but in response to comments, the CCO certification requirement was removed by Amendment No. 2. See Exchange Act Release No. 50105 (July 28, 2004), 69 FR 46603, 46603 (August 3, 2004) at footnote 3.

member's compliance efforts as of the date of such meetings; and (3) identify and address significant compliance problems and plans for emerging business areas.

The proposed rule change also would create IM-3013, which sets forth the language of the CEO certification and gives further guidance as to the requirements and limitations of the proposed rule. The proposed interpretive material recognizes that responsibility for discharging compliance policies and written supervisory procedures rests with business line supervisors. The proposed interpretive material clarifies that consultation on the certification does not, by itself, establish a signatory as having such line supervisory responsibility.

The proposed interpretive material also discusses what information must be included in the report that must evidence a member's compliance processes. It states that the report must be produced prior to execution of the certification and be reviewed by the CEO, CCO, and such other officers as the member deems necessary. The report also must include the manner and frequency in which the processes are administered and identify those officers and supervisors with responsibility for such administration. The proposed interpretive material further explains that the report need not contain conclusions that result from following the specified processes. Additionally, the proposed interpretive material states that the report may be combined with other reports required by a self-regulatory organization, provided the report is made annually, clearly indicates in the title that it contains the information required by proposed NASD Rule 3013, and that the entire report is provided in response to any regulatory request for all or part of the combined report.

B. Comment Summary

¹³ Members that do not employ a board of directors or audit committee or other similar bodies in their governance and management would not be subject to this requirement.

The proposal was published for comment in the Federal Register on December 31, 2003.¹⁴ The SEC received six comment letters in response to the proposed rule change.¹⁵

Three commenters generally supported requiring members to identify CCOs, prepare annual compliance reports, hold CEO/CCO meetings on the compliance function, and present the annual compliance report to their boards of directors and audit committees.¹⁶

Three commenters opposed the proposed rule change in its entirety.¹⁷ They argued it was duplicative of existing rules requiring members to establish and maintain supervisory systems.

Two commenters opposed the proposed CEO/CCO certification requirement included in the proposed rule change.¹⁸ They argued this certification was unnecessary in light of existing rules. These commenters also contended that CEO/CCO certification would weaken compliance by diverting compliance personnel from their day-to-day functions, and would increase CEO and CCO exposure to arbitration claims and legal actions.

One commenter opposed requiring the CCO to sign the certification alongside the CEO, and called for further study on whether to have a CEO certification requirement.¹⁹ This commenter argued requiring CCO certifications could compromise the ability of compliance officers to endorse novel approaches to new business or regulatory challenges.

¹⁴ Exchange Act Release No. 48961 (December 23, 2003), 68 FR 75704 (December 31, 2004).

¹⁵ See note 4 supra.

¹⁶ See SIA/TBMA Letter; NSCP Letter; and E*Trade Letter.

¹⁷ See Empire Letter; NFP Letter; and 1st Global Letter.

¹⁸ See SIA/TBMA Letter; and E*Trade Letter.

¹⁹ See NSCP Letter.

In response to these comments and following additional discussions with SEC staff, NASD submitted Amendments No. 1 and 2, which, among other things, propose to eliminate the CCO certification requirement and incorporate into the accompanying interpretive material language that describes the obligations of the CCO with respect to a member's compliance scheme and the role the CCO must play to enable the CEO to make the certification that a member has in place compliance processes. The proposal, as amended by Amendment Nos. 1 and 2, was published for comment in the Federal Register on August 3, 2004. The SEC received eight comment letters in response to the proposed rule change.²⁰

The comments generally reiterated arguments made by earlier commenters. Four commenters supported the proposed rule change's requirement for designation of a CCO but opposed the proposed rule's requirement for CEO certification.²¹ Three commenters opposed the proposed rule change by reiterating arguments that the proposal was duplicative of existing rules and would place member CEOs and CCOs at undue liability risk.²² In a telephone conversation with staff, NASD staff stated its belief that as a general matter, the commenters' concerns discussed above had been raised previously and had already been addressed in Amendment Nos. 1 and 2.²³

One commenter supported the proposed rule change but expressed concern that some language in the Interpretive Material describing areas of expertise attributable to the CCO may create confusion if that language is compared with other language in the IM, and in other SRO

²⁰ See note 8 supra.

²¹ See FSI Letter; Raymond James Letter; SFS Letter; and NFP-2 Letter.

²² See 1st Global-2 Letter; Pacific Select Letter; and MWA Letter.

rules, that recognize the possibility of allocation of some aspects of compliance functions to other firm personnel.²⁴

NASD staff stated that they believed other language in the Interpretive Material, including the statement that the CCO should have an expertise in “evidencing the supervision by the line managers who are responsible for the execution of compliance policies” rendered the language questioned by the commenter unambiguous. NASD staff also indicated they would monitor the implementation of the rule, and 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.²⁵

C. Discussion

The Commission finds the proposed rule change is consistent with the Act and in particular with Section 15A(b)(6) of the Act, which requires, among other things, that NASD's rules 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.²⁶ The Commission believes that the proposed rule change is consistent with the provisions of the Act noted above in that it will enhance focus on members' compliance and supervision systems, thereby decreasing the likelihood of fraud and manipulative acts and increasing investor protection.

²³ Telephone call dated August 26, 2004 between Brian Baysinger, Special Counsel, Division and Philip Shaikun, Associate General Counsel, NASD.

²⁴ See SIA Letter.

²⁵ Telephone call dated August 26, 2004 between Brian Baysinger, Special Counsel, Division and Philip Shaikun, Associate General Counsel, NASD.

²⁶ 15 U.S.C. 78o-3(b)(6).

The proposal's requirements for designation of CCOs, annual CEO certifications, mandatory meetings of the CCOs and CEOs, annual compliance reports, and provision of the compliance reports to member boards of directors and audit committees should increase members' senior management's focus on the effectiveness of member compliance efforts with applicable NASD rules, MSRB rules, and federal securities laws. The requirement that the person designated as CCO be a principal helps ensure a person with appropriate stature within the member organization will in fact hold this responsibility at each member.

The proposed requirement that the CEO certify the member has in place processes to establish, maintain, review, modify and test policies and procedures reasonably designed to achieve compliance with applicable NASD rules, MSRB rules and federal securities laws and regulations will help to ensure that members have in place a compliance framework that will allow the member to adapt its compliance efforts to the ever-changing business and regulatory environment. Especially helpful in this regard is the requirement that the processes, at a minimum, must include one or more meetings annually between the CEO and CCO to (1) discuss and review the matters that are the subject of the certification; (2) discuss and review the member's compliance efforts as of the date of such meetings; and (3) identify and address significant compliance problems and plans for emerging business areas. The Commission believes it is appropriate that the proposed interpretive material recognizes that responsibility for discharging compliance policies and written supervisory procedures rests with business line supervisors. The Commission also believes it is appropriate that the proposed interpretive material clarifies that consultation on the certification does not in itself establish a signatory as having such line supervisory responsibility. In this respect, the proposal should encourage full cooperation throughout the member organization in meeting the requirements of proposed

NASD Rule 3013 without assigning regulatory obligations on member employees that is not commensurate with their responsibilities in the organization.

The requirement for annual CEO certifications and preparation of a related report will help motivate firms to keep their compliance programs current with business and regulatory developments. Notwithstanding comments to the contrary²⁷ the Commission believes the proposal supplements rather than duplicates current member compliance obligations. In particular, the proposal would complement and underscore the closely related obligations that currently exist under NASD rules that require each member to designate principals who must review the member's supervisory systems and procedures and recommend to senior management appropriate action to ensure the systems are designed to achieve compliance with applicable rules and regulations.²⁸

The Commission also believes that Amendments Nos. 1 and 2, as well as NASD's oral assurances to provide necessary clarification if requested adequately and appropriately addresses commenters' concerns regarding the originally proposed CCO certification (which NASD has omitted) and the potential inconsistencies in the interpretive materials regarding CCO obligations.²⁹ The requirement that the annual report be provided to members' boards of directors and audit committees will further enhance member focus on the need for strong and effective compliance programs.

²⁷ See note 21 supra.

²⁸ The Commission recently approved a proposed rule change requiring members, among other things, to designate one or more principals who will establish, maintain, and enforce a system of supervisory control policies and procedures that test and verify that the members' supervisory procedures are reasonably designed to achieve compliance with applicable securities laws and NASD rules. Exchange Act Release No. 49883 (June 17, 2004), 69 FR 35092 (June 23, 2004) (approving SR-NASD-2002-162).

²⁹ See SIA Letter and summary of NASD staffs' oral response in text accompanying footnote 23 above.

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act³⁰ that the proposed rule change (File No. SR-NASD-2003-176) as amended by Amendment Nos. 1 and 2 be, and hereby is, approved.³¹

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³²

Jill M. Peterson
Assistant Secretary

³⁰ 15 U.S.C. 78s(b)(2).

³¹ In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. 78c(f).

³² 17 CFR 200.30-3(a)(12).