Securities Industry Association

February 6, 2004

Mr. Jonathan G. Katz
Secretary
U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-0609

Re: Release No. 34-48981; File No. SR-NASD-2003-176 -- Comment on Proposed Chief Compliance Officer and Chief Executive Officer Certification Requirement

Dear Mr. Katz:

The Securities Industry Association,[1] the SIA Compliance & Legal Division[2] and the Bond Market Association[3] (collectively the "Associations") appreciate the opportunity to provide comments in response to the referenced rule filing, which solicits input on proposed amendments to NASD Rule 3010 and related interpretative material regarding certification of compliance processes and procedures by Chief Compliance Officers ("CCO") and Chief Executive Officers ("CEO").[4] We also appreciate the extension of time granted by the Commission to facilitate informed public comment on this significant proposal.[5]

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[1] The Securities Industry Association ("SIA"), established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs more than 800,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry is projected to generate $142 billion in domestic revenue and $283 billion in global revenues. (More information about SIA is available on its home page: www.sia.com.)

[2] The Compliance and Legal Division's members are primarily compliance and legal personnel associated with Securities Industry Association member firms. Among its purposes are enhancement of the integrity and reputation of the securities industry through compliance and legal education and improved communication with industry regulatory bodies.

[3] The Bond Market Association ("TBMA") represents securities firms and banks that underwrite, distribute and trade fixed income securities, both domestically and internationally. TBMA's member firms are actively involved in the funding markets for such securities, including the repurchase and securities lending markets. Further information regarding TBMA and its members and activities can be obtained from our web site (www.bondmarkets.com).

[4] Securities Exchange Act Release No. 48981 (December 23, 2003), 68 FR 75704.

[5] Securities Exchange Act Release No. 49129 (January 27, 2004), 69 FR 5228.

The NASD states that the primary objective of the proposed rule change is "to enhance investor protection by promoting regular and meaningful interaction between senior management and compliance personnel to ensure that compliance is given the highest priority by a member's senior executive officers." To that end, the proposed rule change would require (i) each member to designate a principal to serve as the CCO, and (ii) the CCO, together with the 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 the federal securities laws. Proposed IM-3013 sets out the certification language and specifies that the firm processes referenced in the certification must be evidenced in a report reviewed by the CCO and CEO, and must include one or more meetings between the CEO and CCO to discuss matters that are the subject of the certification.

I. Overview

The Associations previously submitted extensive comments in response to the NASD's initial certification proposal as contained in NASD Notice to Members 03-29.[6] As noted in that letter, we fully support efforts to foster meaningful dialogue and joint consideration of Compliance programs, initiatives, and issues by business executives and senior Compliance officials.[7] Senior management attention and commitment to strengthening supervisory and control structures is essential to the overall integrity of our member firms, as well as to restoring public trust and confidence in our capital markets, which is the bedrock of our business. Accordingly, we believe that the proposal rule change, with some modification, would promote investor protection by further supporting and enhancing firm regulatory compliance efforts. Specifically, the Associations support:

- Designation of a firm principal as Chief Compliance Officer;
- An annual compliance report, similar in nature to that required by New York Stock Exchange ("NYSE") Rule 342.30, that details, among other things, supervisory processes and significant compliance initiatives, issues and requirements;[8]

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[6] *See* Letter to Barbara Z. Sweeney, NASD, from Stuart Kaswell, SIA, John M. Ramsay, TBMA, and David A. DeMuro, SIA Compliance & Legal Division, dated July 18, 2003, available at http://www.sia.com/2003_comment_letters/pdf/NASD_CCO.pdf.

[7] The term "Compliance professionals" as used in this letter refers to individuals employed within a non-business line capacity within a firm's Compliance Department and whose role is typically advisory in nature. Compliance Department responsibility, therefore, is very distinct from and should not be confused with the more generic term "compliance" that describes the responsibilities of management personnel to whom is reserved both the authority and duty of direct supervision. Thus, when we speak of ensuring a firm-wide culture of compliance, that authority and duty ultimately rests with the CEO. For a comprehensive discussion of the role of Compliance professionals, see article by O. Ray Vass, *The Compliance Officer in Today's Regulatory Environment*, Practicing Law Institute: Corporate Law and Practice Course Handbook Series, Broker-Dealer Institute (November 12, 1987).

[8] NYSE Rule 342.30 requires NYSE member firms to prepare and deliver to the CEO an internal report by April 1st of each year covering each member organization's supervision and compliance efforts during the preceding year. This annual compliance report is specific in nature and must cover a wide range of compliance-related information. Notably because NYSE Rule 342.30 does not require certification, if approved, the NASD proposed certification would subject dual member firms to needlessly inconsistent regulation.

- Mandatory documented meetings between the CEO and CCO for the express purpose of assessing a broad range of issues relating to the structure and strength of the firms' compliance and supervisory systems, policies and procedures;[9] and
- Presentation of the compliance report by the CEO to the firm's Board of Directors (or equivalent governing body) and Audit Committee.

Regrettably, even under the most recent formulation, the proposed certification remains problematic in that it would not advance, and in some respects could detract from, the stated goals of the rule. As discussed in detail below, the Associations believe that certification: (i) is unnecessary in light of existing rules and additional pending proposals designed to enhance broker dealer supervisory controls; (ii) could potentially weaken the Compliance function, by, among other things, requiring cumbersome bureaucratic measures that divert Compliance personnel from their critical day-to-day functions; and (iii) will expose CEOs and CCOs to increased arbitration claims and legal actions. The Associations therefore urge the Commission to approve the substantive elements of the proposed rule change identified above, and to defer consideration of the proposed certification until such time as the efficacy of other recent regulatory initiatives has been evaluated.

II. Certification May Adversely Impact the Compliance Function and Will Create Unwarranted Burdens

As legal and Compliance professionals dedicated to promoting best practices and investor protection within our firms, we welcome pointed regulatory initiatives that enhance Compliance Department visibility and facilitate meaningful interaction with senior management. The proposed certification, however, does not advance -- and may actually move away from -- this commendable result. A better approach, we believe, is one that addresses specifically the desired conduct through substantive measures that build upon, and further improve the evolving regulatory framework within this area. To that end, the SROs have already implemented and proposed additional rule changes that achieve directly the consultation, consideration of issues, and management accountability sought by the current proposal.

A. Certification is Unnecessary in Light of the Existing Regulatory Framework and Proposed Additional Controls

The duty to supervise is a key aspect of the federal securities regulatory scheme. Rules of the various SROs, as well as the federal securities laws, require firms to develop a system of supervision to promote effective compliance with federal laws and SRO rules based on the nature of the firm's business. Currently, NASD Rule 3010 and NYSE Rule 342 require member firms to establish, maintain, and enforce written procedures to supervise the activities of the firm and its registered representatives, and to prevent violations of the various securities laws and NASD rules. In that regard, broker-dealers must designate qualified personnel, including registered principals, to carry out the firm's supervisory obligations, to have adequate controls in

[9] As recommended in our initial comment letter, the Associations support an added measure that would require firms to evidence the joint meetings' occurrence. This could include, for example, documents reflecting meeting dates, participants, and agendas. As with other firm records, these documents would be available to regulators for review.

place to identify potential problems and sales practice abuses, and to conduct a review of firm activities on a periodic basis through internal inspection of their various office locations.[10]

SROs and the SEC oversee firms' supervisory efforts and structure through regulatory inquiries and the examination process[11] and address potential shortcomings through deficiency letters and, in egregious cases, disciplinary actions. Moreover, the SEC is authorized to sanction firms whose supervision falls below a minimum standard of reasonableness. Section 15(b)(4)(E) of the Securities Exchange Act provides for the imposition of a sanction against an individual who has failed reasonably to supervise another person who commits such a violation and is subject to the broker-dealer's supervision. Thus, firms are constantly reminded of the need for effective internal control and their supervisory obligations through regulatory oversight, the examination process and enforcement actions when warranted.

To further enhance the current regulatory framework, NASD recently proposed to adopt new NASD Rule 3012 and to amend other rules regarding member firms' supervisory control obligations.[12] These comprehensive amendments would require, among other things, that NASD member firms designate and specifically identify one or more principals who will establish, maintain, and enforce a system of supervisory controls that test and verify that the firm's supervisory policies and procedures are reasonably designed to achieve compliance with applicable NASD rules, securities laws and regulations.[13] The proposed rule also would require the designated principal(s) to amend or create additional procedures where testing and verification indicates a need for them. Additionally, the principal(s) would have to submit an annual report to the member's management detailing the supervisory control system, the summary of the test results, and any additions or amendments created in response to the test results.[14]

Taken together, therefore, the instant rule change and proposed Rule 3012 would require the following:

- Designation of a CCO;
- Designation and specific identification of the designated principal(s) at the firm who will establish, maintain, and enforce a system of supervisory controls that test and verify that the firm's supervisory policies and procedures are reasonably designed to achieve compliance with applicable NASD rules, securities laws and regulations;
- An annual compliance report, prepared by the CCO and presented to the CEO;

[10] NASD Rule 3010; see also NASD Membership and Registration Rule 1014 (requiring firms to create and maintain internal controls and operational procedures designed to prevent and detect violations of federal securities laws.); See also, NASD By-Laws IV, Section (c)(requiring continuing compliance on an ongoing basis with standard for admission established by NASD).

[11] An SRO examines every broker-dealer on a periodic cycle, ranging from annually to once every four years, depending on the business of the firm.

[12] SR-NASD-2002-162, Securities Exchange Act SEC Release No. 48298 (August 7, 2003), 68 FR 48421.

[13] Proposed New NASD Rule 3012(a)(1)(B)

[14] Id.

- Regular meetings between the CEO and CCO, to occur no less than once a year, for the express purpose of assessing a broad range of issues relating to the structure and strength of the firms' compliance programs, needs and issues; and
- Presentation of the report by the CEO to the firm's Board of Directors (or equivalent governing body) and Audit Committee.

We respectfully submit that a regime with these characteristics is robust and meaningful, and reflects the type of constructive regulatory directives that effect better industry adherence to regulatory obligations. By strengthening the annual reporting requirement and mandating regular documented meetings between senior management and the CCO, these rules will ensure meaningful interaction and joint consideration of firm compliance issues. The rules will also create industry-wide standards that require firms to reinforce the responsibility and accountability of designated supervisors.

Particularly in the current environment of heightened sensitivity to internal control structures and reputational risk, these changes will consequently raise management awareness and causes supervisors to become even more engaged in supervisory issues. Accountability is placed clearly with management, where it belongs, and the quality of self-regulation will be further improved. Attestations as to the existence of firm processes, on the other hand, provide illusory protections or benefits at best, and indeed, as we suggest below, may negatively impact the effectiveness of the balance of the proposed changes.

B. Certification Fails To Support Compliance Officers in Their Traditional Roles And May Detract From the Actual Practice of Compliance

A primary concern with the proposed certification is that the CCO in many cases would be required to certify as to "processes" that are not within the CCO's responsibility or control. Depending upon firm size, organizational structure and nature of business, both Compliance Department reporting lines and the allocation of Compliance-type functions can vary. Consequently, it is not uncommon for professionals outside a Compliance Department, both non-business line and business line, to have responsibility for some or all the processes to which the certification refers.[15]

For example, as a matter of practice, oversight of a firm activities relating to the firm's financial controls usually reside with the broker-dealer's Controller, Chief Financial Officer, Internal Audit Department or Treasurer. Similarly, a member firm's systems and procedures for assuring compliance with margin regulations and the clearance and settlement process is typically the responsibility of the firm's Chief Operations Officer. SRO rules recognize these distinctions and establish regulatory responsibilities and a qualification examination for a member firm's Financial and Operations Principal that are separate from those prescribed for Chief Compliance Officers.[16] By placing the certification responsibility exclusively with the

[15] Internal Audit, Legal or Operations professionals may perform one or many of the responsibilities performed by the Compliance Departments. Business unit managers also may have responsibility for supervisory policies and procedures specific to their business line.

[16] NASD Financial & Operations Principal - Series 27.

firm's Compliance officers,[17] NASD's current proposal could have the unintended consequence of obliging a CCO to attest to the soundness of firm compliance processes that fall outside of his or her responsibility, and indeed in some cases within the purview of another senior officer of the firm.

Equally problematic is that certification will require firms to devote considerable time and resources simply to manage the certification process. Even though the certification now refers to firms' "processes," the act of certification will likely necessitate long chains of sub-certifications. It may be difficult to overstate the time and effort that will be required to administer this process. This would amount to a serious misdirection of Compliance efforts away from detecting, preventing and deterring violations or abusive conduct and instead toward fulfillment of a bureaucratic certification requirement.

C. Certification Will Result in Increased CEO and CCO Exposure to Unjustified Actions

Notwithstanding NASD's assurances to the contrary, the Associations continue to believe that the potential for additional liability, actual or perceived, stemming from the certification is real. Certifications in hand, aggressive plaintiffs' counsel will be armed with a fact to support and prolong otherwise baseless litigations and arbitrations against CEOs and CCOs, irrespective of the general absence of a private right of action for violations of SRO rules. Particularly within the context of failure to supervise claims or issues relating to the adequacy of the firm's policies and procedures, the mere fact that the CEO and CCO made a written attestation about the firm's supervisory and compliance processes significantly increases the possibility that such claims could survive a motion to dismiss. Regardless of the ability or likelihood of ultimately prevailing on the merits, firms and Compliance officers could be faced with the Hobson's choice of protracted litigation, or settlement of claims at substantial cost to avoid expensive and protracted discovery and/or the expected business distraction.

III. Conclusion

Given the widely publicized cases of malfeasance over the last several years, it would be hard to imagine senior management of any firm not focusing increased attention on compliance and supervisory matters. These events have led to new regulations that will enhance the role of Compliance personnel and underscore the accountability of senior management. While well intentioned, the proposed certification is not necessary and runs a significant risk of unintentionally diverting Compliance attention from actual compliance efforts to a sterile exercise of fulfilling the certification process. Open and constructive dialogue between Compliance personnel and senior business management can be assured through other requirements in the proposed rule change. We strongly believe that mandatory meetings concerning specific issues of compliance combined with annual reports to the firm's governing body will best accomplish the goals of the proposal.

Indeed, despite the significant regulatory lapses uncovered in the mutual fund industry over the last year, the Commission nevertheless found that substantive rules governing funds' internal controls, policies and procedures, together with mandatory communication, sufficiently

[17] While the proposal contemplates and permits reliance upon sub-certifications, it limits co-certifications to "other senior *compliance* officers" with primary responsibility over particular business area.

promote the interests of investor protection without need for certification.[18] As with our recommended approach, these rules focus on characteristics of successful supervisory and compliance programs that, unlike certification, directly promote an effective compliance regime. Accordingly, the Associations respectfully recommend that the Commission only approve those substantive portions of the rule proposal we have described above and defer consideration of a certification at this time.

We thank you for your consideration and would welcome the opportunity to meet with the Commission staff to discuss the issues raised in this letter. If you have any question, please feel free to contact any of the undersigned or SIA Vice President and Associate General Counsel, Amal Aly at (212) 618-0568.

Sincerely,

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[18] Release Nos. IA-2204; IC-26299; File No. S7-03-03. (December 17, 2003), 68 FR 74714. While we understand that mutual fund rule considerations are not identical to those involved in the immediate rule proposal, we believe them to be sufficiently analogous to require reexamination of a certification for the broker-dealer industry. We also note that the Commission currently has equitable power to impose conditions on behavior of registered broker-dealers through its cease and desist authority. Section 21C of the Exchange Act empowers the Commission, on appropriate facts, to order "future compliance or steps to effect future compliance … as the Commission may specify." In the event egregious facts were to be presented in a case before the Commission that indicated a pattern of disregard for supervisory or compliance principles, the Commission could conceivably seek a remedy that could include certification for a period of time.