

## SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-52195; File No. SR-NASD-2005-084]

### Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of 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

August 3, 2005.

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> notice is hereby given that on June 23, 2005, the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in items I, II, and III below, which items have been prepared by NASD. On July 8, 2005, NASD filed amendment No. 1 to the proposed rule.<sup>3</sup> On July 27, 2005, NASD filed amendment No. 2 to the proposed rule.<sup>4</sup> The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

#### I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

NASD is proposing to amend 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. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

\* \* \* \* \*

Rule 3012 Supervisory Control System

(a) No Change.

(1) No Change.

(2) The establishment, maintenance, and enforcement of written supervisory control policies and procedures pursuant to paragraph (a) shall include:

(A) Procedures that are reasonably designed to review and supervise the

customer account activity conducted by the member's branch office managers, sales managers, regional or district sales managers, or any person performing a similar supervisory function.

(i) *General Supervisory Requirement.* A person who is either senior to, or otherwise independent of, the producing manager must perform such supervisory reviews. For purposes of this Rule, an "otherwise independent" person: May not report either directly or indirectly to the producing manager under review; must be situated in an office other than the office of the producing manager; must not otherwise have supervisory responsibility over the activity being reviewed (including not being directly compensated based in whole or in part on the revenues accruing for those activities); and must alternate such review responsibility with another qualified person every two years or less.

(ii) *"Limited Size and Resources" Exception.* If a member is so limited in size and resources that there is no qualified person senior to, or otherwise independent of, the producing manager to conduct the reviews pursuant to (i) above (e.g., a member has only one office or an insufficient number of qualified personnel who can conduct reviews on a two-year rotation), the reviews may be conducted by a principal who is sufficiently knowledgeable of the member's supervisory control procedures, provided that the reviews are in compliance with (i) to the extent practicable.

(iii) *Notification Requirement.* *If a member determines that it must rely on the "limited size and resources" exception set forth in (ii) above to conduct any of its producing managers' supervisory reviews, the member must notify NASD through an electronic process (or any other process prescribed by NASD) within 30 days of the date on which the member first relies on the exception,<sup>5</sup> and annually thereafter.<sup>6</sup> If a member subsequently determines that it no longer needs to rely on the exception to conduct any of its producing managers' supervisory reviews, the member must, within 30*

<sup>5</sup> The "limited size and resources" exception became effective on January 31, 2005, prior to the effective date of the notification requirement set forth in this subparagraph (iii). In the event a member is already relying on the "limited size and resources" exception (or determines to rely on the exception prior to the effective date of the notification requirement), the member must notify NASD of such reliance within 30 days of the effective date of the notification requirement.

<sup>6</sup> Members must ensure that each ensuing annual notification is effected no later than on the anniversary date of the previous year's notification.

days of ceasing to rely on the exception, notify NASD by using the electronic process or any other process prescribed by NASD.

[(iii)](iv) *Documentation Requirement.* A member relying on (ii) above must document in its supervisory control procedures the factors used to determine that complete compliance with all of the provisions of (i) is not possible and that the required supervisory systems and procedures in place with respect to any producing manager comply with the provisions of (i) above to the extent practicable.

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#### II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in item IV below. NASD has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

##### (A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

###### 1. Purpose

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

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

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

<sup>3</sup> The amendment 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.

does not have associated persons who can conduct the required supervisory reviews. In such situations, a member may have the reviews conducted by a principal who is sufficiently knowledgeable of the member's supervisory control procedures.

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>7</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 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>8</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

<sup>7</sup> See Exchange Act Release No. 50477 (Sept. 30, 2004), 69 FR 59972 (Oct. 6, 2004) (SR-NASD-2004-116).

<sup>8</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 requires the member to notify NASD within thirty (30) days of the rule change's effective date.

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.

## 2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD rules must 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. NASD believes this notification requirement will help ensure that NASD members have in place supervisory controls policies and procedures that are reasonably designed to prevent fraudulent and manipulative acts, thereby protecting investors and the public interest.

### (B) Self-Regulatory Organization's Statement on Burden on Competition

NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

### (C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

Written comments were neither solicited nor received.

## III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) By order approve such proposed rule change, or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

## IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule

change, as amended, is consistent with the Act. Comments may be submitted by any of the following methods:

### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2005-084 on the subject line.

### Paper Comments

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-9303.

All submissions should refer to File Number SR-NASD-2005-084. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principal office of NASD.

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to the File Number SR-NASD-2005-084 and should be submitted on or before August 30, 2005.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>9</sup>

**Jill M. Peterson,**

*Assistant Secretary.*

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<sup>9</sup> 17 CFR 200.30-3(a)(12).