

# NASD Notice to Members 99-45

## NASD Provides Guidance On Supervisory Responsibilities

### Suggested Routing

- ☒ Senior Management
- ☐ Advertising
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### Background

The National Association of Securities Dealers, Inc. (NASD®) is issuing this *Notice to Members* as part of its continuing effort to provide members, particularly smaller member firms, with guidance on complying with the rules that govern their conduct. This *Notice* will focus on those sections of NASD Conduct Rule 3010 (the Rule) that require members to establish a supervisory system and develop and maintain written supervisory procedures. The NASD recently published a related *Notice to Members* that provides guidance on supervisory responsibilities for trade reporting and market-making activities.<sup>1</sup> In addition, the NASD intends to publish subsequent *Notices* that will focus on written supervisory procedures relating to a particular topic area (e.g., opening and maintaining customer accounts). Members are encouraged to contact Stephanie M. Dumont, Assistant General Counsel, NASD Regulation, Inc. (NASD Regulation®) at (202) 728-8176; or Daniel M. Sibears, Vice President, Member Regulation, NASD Regulation, at (202) 728-6911 with questions or comments on this *Notice* or to suggest topics for future *Notices to Members*.

In order to assist members in developing their own supervisory systems, this *Notice* will provide an explanation of the purposes underlying the different sections of Rule 3010.<sup>2</sup> It is important for members to understand that while this *Notice* provides an explanation of the Rule and guidelines on the basic elements of supervisory procedures, it is *not* to be construed as a checklist of steps guaranteed to constitute adequate written supervisory procedures or a substitute for the development of supervisory procedures that are tailored to the needs and circumstances of individual member firms. ***Members retain the responsibility to design and implement supervisory procedures that are appropriate for their specific businesses and structures.***

### Compliance Procedures Versus Supervisory Procedures

It is important that members recognize the distinction between written compliance guidelines and written supervisory procedures. Compliance guidelines generally set forth the applicable rules and policies that must be adhered to and describe specific practices that are prohibited. In contrast, written supervisory procedures document the supervisory system that has been established to ensure that compliance guidelines are being followed and to prevent and detect prohibited practices. For example, a compliance guideline might discuss NASD Rule 2860(b)(19) regarding the suitability of options transactions for customers by describing the elements of the rule and the types of information the firm believes its associated persons must gather about the customer before recommending an options transaction. In comparison, the written supervisory procedures would instruct the supervisor on the steps necessary to determine whether the associated person gathered the requisite information before recommending the options transactions and whether the transaction was suitable for the customer (e.g., the supervisor should examine the customer account forms that describe the customer's net worth, annual income, options trading experience, etc.). In addition, the written supervisory procedures would describe the activities the supervisor will conduct, if he or she determines a transaction is not suitable for a customer.

### Supervisory System Versus Written Supervisory Procedures

Another important concept for members to understand is the distinction between a supervisory system and written supervisory procedures. The Rule sets forth members' obligations to establish both a supervisory system and

written supervisory procedures. Written supervisory procedures are a critical part of an overall supervisory system. The written supervisory procedures document the supervisory system that the firm has established. For example, a supervisory system may include elements such as automated exception reports and surveillance programs that monitor for unusual trading activity in customer accounts. The written supervisory procedures would instruct the supervisor on which reports produced by the surveillance system the supervisor is to review as part of his or her supervisory responsibilities, including a description of how often these reports should be reviewed, the steps to be taken if suspicious activity is discovered, and how to document the supervisor's oversight activities.

### **Supervisory System And Written Procedures - Rule 3010(a) And (b)**

Regardless of its size or complexity, each member must adopt and implement a supervisory system that is ***tailored specifically to the member's business*** and must address the activities of all its registered representatives and associated persons. ***Supervisory procedures must be in writing and must be reasonably designed to achieve compliance*** with applicable securities laws and rules and the rules of the NASD (hereinafter "securities laws"). ***Ultimate responsibility for supervision rests with the member.***

#### ***Tailored To The Member's Business***

To fulfill its obligations to establish and maintain a supervisory system, a member must determine the types of business it conducts, how the firm is organized and operated, and the current regulatory requirements. This analysis will enable the member to design a supervisory system that is current and appropriately tailored to

its specific attributes and structure. Factors that should be considered in this analysis include, among other things, a review of the member's:

- product lines and customer base (e.g., institutional vs. retail);
- number and geographic location of offices and personnel;
- existing reporting systems, operating units, and organizational structures;
- experience of personnel, including whether the firm employs persons who should be subject to heightened supervisory procedures due to a history of customer complaints, disciplinary actions, or arbitration proceedings; and
- applicable regulatory requirements, including specific activities required (e.g., principal approval of transactions) and specific records required to be created and maintained (e.g., new account documentation) in each product or operational area.

Once a thorough review and analysis of these factors has been conducted, the firm can then establish the framework of its supervisory system, taking into consideration, among other things:

- the availability, location, and qualifications of registered principals and, where appropriate, representatives to be assigned supervisory responsibilities;
- the importance of clear lines of authority, accountability, and responsibility;
- the maintenance of records and other documentation that will permit both the firm and regulators to determine how and by whom supervisory obligations are being discharged;

• the technological environment in which the firm operates; and

- the need to provide for the periodic evaluation of the firm's system and procedures such that both will continue to accurately reflect the firm's business and current regulatory requirements.

### ***Written Procedures***

Once a member has designed its supervisory system, Rule 3010(b) requires the member to memorialize this system in writing and implement and enforce these written procedures. It is important that supervisory procedures be set forth in writing for several reasons. Written procedures provide the personnel subject to the supervisory system, as well as those responsible for implementing it, a document that explains the supervisory system and their specific responsibilities. Written procedures also provide stability and continuity as personnel take on different responsibilities or leave the firm. In addition, senior management can use the written procedures to determine whether personnel are complying with the supervisory system by auditing compliance with the written procedures. Accordingly, the Rule requires that a copy of the member's written supervisory procedures, or the relevant parts, be maintained at each office of supervisory jurisdiction and any other location where supervision occurs.

It is equally important that the written supervisory procedures clearly identify who has supervisory responsibilities. A member must keep a record of each associated person who has supervisory responsibilities and the date each person was assigned those responsibilities. This must include the titles, registration status, and locations of the supervisory personnel. The written procedures also must include the business line and applicable securities laws for which each supervisor is responsible. When developing its written procedures to include this

information, a member should keep in mind that the purpose of this rule is to allow for personnel at the firm, as well as regulators, to easily determine who is responsible for supervising a particular area and the time period for which the person was assigned the supervisory responsibility.

Written supervisory procedures are not static documents that can be used for an indefinite period of time without modification. A firm's existing supervisory system may become outdated or ineffective as a result of changes in the firm's business lines, products, practices, or new or amended securities laws. In such instances, the written supervisory procedures must be updated to properly reflect any necessary changes to the supervisory system. Rule 3010(b) does provide a member with a reasonable amount of time after changes occur to amend its written supervisory procedures. Reasonableness, however, is determined in light of the relevant facts and circumstances. For example, an amendment to rules pertaining to a type of business that a member conducts daily (e.g., market making) should be incorporated into the supervisory system and written procedures prior to the effective date of the rule change. Changes in a title or other administrative matters, on the other hand, may not warrant an immediate change and could be updated on a periodic basis.

It is crucial that all persons associated with a member be informed of any changes in the supervisory system and applicable written procedures. The Rule, therefore, requires members to inform all associated persons of such changes. This can be accomplished, for example, by distributing updates to the relevant sections of the written supervisory procedures.

### ***Reasonably Designed To Achieve Compliance***

The Rule requires that a member's supervisory system be reasonably designed to achieve compliance with applicable laws and regulations. This standard recognizes that a supervisory system cannot guarantee firm-wide compliance with all laws and regulations. However, this standard does require that the system be a product of sound thinking and within the bounds of common sense, taking into consideration the factors that are unique to a member's business described above.

Because reasonableness is determined in light of the particular facts and circumstances surrounding a situation, it is difficult to articulate with any specificity a standard that would be applicable in all circumstances. As practical, the NASD will identify certain procedures it believes are reasonable, as well as those practices that it finds are not reasonable. For example, in *Notice to Members 98-96*, the NASD noted that written supervisory procedures that instruct a supervisor to initial order tickets and blotters or to fill out review logs to document a review are reasonable, while procedures that merely recite the applicable rules or fail to describe the steps the firm will take when potential deficiencies are identified are not reasonable.<sup>3</sup>

### ***Members Are Responsible For Supervision***

The ultimate responsibility for supervision lies with the member. This responsibility, however, does not preclude a member from implementing a supervisory system designed by another party, which could include, for example, a computer software program that detects excessive trading in customers' accounts. If a member chooses to implement such a system, though, it must make its own determination that the system implemented is current and reasonably designed to achieve

compliance with the securities laws. This may include, for example, monitoring the system to ensure that it functions as designed.

### **Minimum Requirements Of A Supervisory System - Rule 3010(a)**

Although a supervisory system must be tailored to meet the member's specific structure, the NASD has identified certain elements that must be included in every member's supervisory system. While each element will be discussed individually, members should keep in mind that each of these elements must be incorporated into an overall supervisory system that is reasonably designed to achieve compliance with the securities laws and rules. Members must be cognizant of how these elements affect and are affected by other requirements in the Rule and other rules and statutory provisions. ***Furthermore, a member is not relieved of its supervisory obligations by merely incorporating each of these minimum elements into its supervisory system.***

### ***Designating Principals Responsible For Supervision - Rule 3010(a)(2)***

Rule 3010(a)(2) requires that a member assign responsibility for each type of business that the member conducts to one or more principals. This requirement is limited to those types of business that require registration as a broker/dealer. If a member also conducts a type of business that does not require broker/dealer registration, this requirement would not apply to that particular type of business, however, other regulatory requirements, including, for example, state insurance laws, may apply.

The Rule requires that principals be appropriately registered and vested with the authority to carry out the supervision for which they are

responsible. Persons responsible for supervising a particular type of business, therefore, must be registered as principals for that type of business. They must also have the authority to implement the written supervisory procedures and take any other action necessary to fulfill their responsibilities.

This provision seeks to achieve several regulatory objectives:

- to ensure that there is an identifiable individual who has ultimate responsibility for implementing the member's supervisory system and written procedures for each type of business the member conducts;
- to ensure that the individual responsible for a particular type of business possesses the knowledge and experience necessary to supervise the business; and
- to ensure that the person responsible for supervision actually has the authority to supervise.

A member would not be in compliance with the Rule, for example, if a person registered solely as a general securities principal was responsible for supervising the preparation of financial reports that are filed with regulators. In addition, a member would not be in compliance with the Rule if a general securities principal was responsible for supervising general securities activities, but was not given the requisite authority to fulfill the supervisory obligations. This could occur, for example, if the principal was not granted access to those documents necessary to determine whether a registered representative was complying with the NASD's suitability rules, or if the principal was not permitted to take action against or place under closer supervision a person that failed to follow the firm's compliance guidelines. Having the requisite authority to fulfill supervisory

responsibilities generally means that the person charged with the responsibilities can exercise power to affect the conduct of a person whose behavior is at issue. This, however, does not necessarily mean that the supervisor must have the ability to terminate a person whose conduct is at issue.<sup>4</sup>

#### ***Designating Offices Of Supervisory Jurisdiction - Rule 3010(a)(3)***

Certain types of activities (e.g., order execution) are sufficiently vested with regulatory significance that the locations where members conduct these types of activities require special recognition and attention. Such locations or offices are known as offices of supervisory jurisdiction (OSJ). Paragraph (g)(1) of the Rule lists the types of activities that have been identified by the NASD as requiring significant supervisory attention and defines the term "office of supervisory jurisdiction" as any office of a member where one or more of the delineated activities occur.

A member must designate as an OSJ any office that conducts any of the functions listed in that section. A member also must designate any other office as an OSJ, if such designation is necessary to enable the member to fulfill its supervisory obligations. In making this determination, members must consider several factors that are listed in the Rule. These factors include whether the activities conducted at the office involve regular contact with public customers, the distance of the office from another OSJ, and whether the activities conducted at the office are diverse or complex.

In summary, in order to design a supervisory system that is in compliance with this paragraph of the Rule, a member must:

- review the types of activities that occur at each of its offices;

- determine for each office whether any of the activities listed in paragraph (g)(1) of Rule 3010 are conducted at the office; if one or more of the activities listed are conducted, then the member must designate that office as an OSJ; and

- determine, after considering the factors listed in paragraph (a)(3), if it is necessary, in order to fulfill its supervisory obligations, to designate any other offices as OSJ.

Members' obligations under this paragraph of the Rule, as well as their obligations under other paragraphs of the Rule, are ongoing. Thus, as events occur that change the structure of the firm, such as changing the types of business that are conducted in different locations, adding registered personnel, or opening, moving or closing offices, members must consider the effects that these events will have on OSJ designation requirements. In this regard, members must have systems and procedures in place to determine the effects of such events or changes.

#### ***Assigning Supervisors For Registered Representatives And Designating OSJ/Non-OSJ Branch Supervisors - Rule 3010(a)(5) And (a)(4)***

Paragraph (a)(5) of the Rule requires that **each registered person** be assigned to at least one supervisor. Thus, it is irrelevant whether the person to be supervised is a registered representative or a registered principal, or that the registered person is part of the senior management of the member.

When designating supervisory personnel, it is important to remember that a supervisor can only be responsible for supervising those activities for which they are qualified. For example, a supervisor with a qualification limited to investment company products and variable contracts cannot supervise a

registered person conducting general securities activities. In such a situation, the supervisor could supervise the registered person's activity in investment company products and variable contracts, but an appropriately qualified supervisor would have to supervise the registered person's other activities.

The requirement that every registered person be assigned at least one supervisor serves several functions. It provides the person being supervised with a clear line of authority and specifically identifies for the supervisor the persons for which he or she has responsibility. In addition, this requirement recognizes the obvious fact that a supervisory system reasonably designed to achieve compliance with the securities laws does not permit persons to supervise themselves.

In summary, in order to design a supervisory system that is in compliance with this paragraph of the Rule, a member must:

- determine the number of registered persons associated with it;
- determine the type(s) of activity each registered person conducts;
- determine the qualifications of each person assigned supervisory responsibility;
- assign each registered person to one or more supervisors that are qualified to supervise the activities of the registered person; and
- continue to monitor the activities of registered persons and the qualifications of their assigned supervisors to ensure that the supervisors are properly qualified.

Paragraph (a)(4) of the Rule requires members to assign each OSJ at least one principal with the authority to carry out the supervisory responsibilities conducted at the

OSJ. Each branch office that is not designated as an OSJ also must have at least one supervisor assigned to it. In this situation, certain supervisory **tasks** may be delegated to a registered representative. However, in all cases, ultimate supervisory **responsibility** for every registered and unregistered branch office must be assigned to one or more appropriately registered principals.

Having one or more identifiable registered principals assigned to supervise each OSJ provides clarity as to who is responsible for all of the supervisory obligations assigned to each OSJ. For example, it provides persons working in an OSJ or being supervised from an OSJ with a clear line of authority and specifically identifies for the supervisor the areas and persons for which the supervisor has responsibility.

Paragraph (a)(4) of the Rule also requires that the person or persons assigned responsibility for supervising an OSJ or a branch office be **appropriately** registered to fulfill the supervisory obligations assigned to the office. Therefore, those individuals with ultimate responsibility for supervising each type of business conducted at the office or supervised from the office must be registered as a principal for that type of business. Thus, a member must ensure that the supervisor(s) assigned to an OSJ are appropriately qualified to supervise the activities conducted or supervised from that OSJ. For example, a principal with limited qualifications could not be assigned as the sole supervisor of an OSJ that conducted activities for which the principal was not qualified. In such a situation, another principal, whose qualifications correspond to the other types activities, must be assigned to the OSJ. In addition, these persons must have the authority to implement the written supervisory procedures and take any other action required to fulfill the supervisory obligations assigned to the office.

In summary, in order to design a supervisory system that is in compliance with this paragraph of the Rule, a member must:

- determine which of its offices are designated as OSJ;
- determine the type of activity conducted at or supervised from each OSJ;
- determine the qualifications of the person assigned supervisory responsibility;
- assign to each OSJ or non-OSJ branch one or more supervisors that are qualified to supervise the activities of the office;
- provide supervisors with the authority to fulfill the supervisory obligations assigned to them; and
- continue to monitor the activities of registered persons and the qualifications of their assigned supervisors to ensure that the supervisors are qualified to supervise.

#### ***Determining Qualifications Of Supervisory Personnel - Rule 3010(a)(6)***

Paragraph (a)(6) of the Rule sets the standard for determining the qualifications of supervisors. The Rule requires that members make reasonable efforts to determine that all supervisory personnel are qualified to fulfill their assigned responsibilities. At a minimum, the supervisor must be properly licensed to conduct the assigned responsibilities. However, passing the appropriate licensing examination does not, in and of itself, qualify a supervisor. Members should determine that supervisors understand and can effectively conduct their requisite responsibilities. In this regard, members should consider the experience the supervisor possesses or the training the supervisor has received.

Determining whether reasonable efforts have been made by a member to ascertain a supervisor's qualifications depends on the facts and circumstances surrounding the situation. For example, if a firm failed to determine whether a supervisor is properly registered for the type of activity the supervisor is responsible for overseeing, the firm would not be considered to have made a reasonable effort, given that a person's registration status is readily available. In addition, merely relying on the representations made by a person about his or her qualifications may not be sufficient if the member can confirm the representations without having to undertake extreme or excessive efforts. A member can contact the person's current or former supervisors, especially when the supervisors are associated with the member.

A member's obligation to determine whether a supervisor is properly qualified to fulfill his or her supervisory duties is an ongoing obligation. Thus, a member that receives indications that a supervisor is having difficulty performing his or her supervisory functions would have an obligation to investigate to determine whether such person can continue in a supervisory role.<sup>5</sup>

A member's written supervisory procedures should identify those qualifications it has deemed important in determining whether a supervisor can fulfill his or her assigned responsibilities, the procedures for determining whether the supervisor possesses such qualifications and the methods for monitoring the supervisor's performance.

#### ***Annual Compliance Meeting - Rule 3010(a)(7)***

Paragraph (a)(7) of the Rule requires that each registered representative participate, at least once each year, in an interview or meeting at which compliance matters relevant to the particular representative are discussed. This requirement gives

registered representatives the opportunity to regularly discuss compliance issues and assists the firm in ensuring that representatives remain current on changing compliance requirements or changes in the firm. These meetings can be held with representatives individually or with a group of representatives, and can be held at a central or regional location or at the member's place of business. Matters other than compliance may also be discussed at the meeting. The member can designate other persons to conduct the meeting, however, ***members remain ultimately responsible for fulfilling the obligations under the Rule.*** Thus, at a minimum, members must review the presentation prepared by a third party to determine that all the necessary topics will be discussed at the meeting.

The Rule provides members with substantial flexibility in implementing the compliance meeting. Depending on the method chosen, however, certain precautions must be taken to comply with the Rule. For example, if a meeting is held with a group of registered representatives, the meeting must cover compliance matters that relate to the different types of activities that each of the representatives attending the meeting conduct. Relevant matters not addressed at the group meeting must be covered at an individual meeting or at another group session. Whether the meeting is conducted with each representative individually or through group meetings, each individual representative must be provided the opportunity to discuss compliance matters that relate to the types of activities he or she conducts.

With respect to delivery mediums, the meeting can be conducted by video conference, interactive classroom setting, telephone, or other electronic means, provided that certain safeguards are in place. Members choosing to conduct compliance conferences other than in person must ensure that the

communication forum used allows for interactive communication with the representative. This means, at a minimum, that attendees are able to hear presenters live and, in an interactive environment, ask questions and engage in dialogue with the presenters. This does permit presenters to use supplemental learning and communications tools, such as video tapes or computer programs that include informational or instructional materials.

In addition to ensuring an interactive environment for all compliance conferences, members conducting such conferences through electronic means or aids may bear a heightened responsibility associated with such electronic communications. As with all compliance conferences, members must ensure that representatives scheduled to appear at a particular location in fact arrive at and are in attendance for the entire conference.

A member's written supervisory procedures should document the procedures for developing a meeting that discusses relevant compliance matters, determining when a representative must attend and confirming a representative's attendance at a required compliance meeting.

In summary, in order to design a supervisory system that is in compliance with this paragraph of the Rule, a member must:

- confirm that each registered representative attended a compliance meeting within one year from the last compliance meeting attended;
- identify those representatives that have not attended a compliance meeting at least once in the last year;
- determine for each registered representative the types of activities that the representative conducts;

- develop a meeting, whether held on an individual basis or as a group, that discusses compliance matters relevant to each type of activity conducted by the representative or representatives; and

- determine what, if any, special safeguards must be in place depending on how the meeting is conducted (e.g., video conferencing or contracting with a third party to conduct the meeting).

### ***Review Of Supervisory System - Rule 3010(a)(8)***

Rule 3010(a)(8) requires that at least one principal be designated to review the firm's supervisory system, procedures, and internal inspections. If more than one principal is so designated, it must be clear which areas of the supervisory system each has been assigned to review. The purpose of this review is to determine the effects of changes such as hiring additional registered persons, the departure of registered persons, commencing a new line of business (e.g., market making), a change in ownership, or changes in the securities laws, on the member's existing supervisory systems and procedures. A supervisory system and/or written procedures that are not current with regulatory requirements or the structure and business activities of the member would not be reasonably designed to achieve compliance with the securities laws.

The Rule requires that one or more registered principals be specifically assigned this responsibility. In this way, there is at least one person at each member who is responsible for reviewing and analyzing the effect of such changes on the member's supervisory system and procedures as a whole. However, the utility of such a review is undermined if the problems or deficiencies discovered as a result are not addressed and corrected. The principal assigned to conduct the review, therefore, also

has the obligation to take action reasonably designed to achieve compliance with the securities laws or to recommend such action to senior management. Thus, for example, if a principal assigned this responsibility discovers that the written supervisory procedures do not address all the types of businesses that the firm conducts, the principal must take action or recommend such action to senior management to correct this deficiency.

### **Internal Inspections - Rule 3010(c)**

It is important that members not only review their supervisory systems and procedures to ensure that they are current and adequate, but also conduct inspections to determine whether the systems and procedures are being followed. Paragraph (c) of the Rule, therefore, requires members to annually review the businesses they conduct, and sets forth the standard for this review.

The mandatory annual review must be reasonably designed to assist members in detecting and preventing violations of the securities laws. The "reasonably" designed standard means, for example, that indications of problems, or "red flags," must be investigated. When a member receives an indication of irregularities in a customer's account (e.g., a compliance program indicates or a supervisor discovers a frequency of trading in a customer's account that exceeds the customer's normal level of trading), it must require that the account be examined to determine whether churning or some other violative conduct has occurred. If it does not, then that member's examination procedures would not be reasonably designed to detect or prevent irregularities or abuses.

The Rule also requires that each office of a member be reviewed. The frequency of this review will depend on several factors, including whether an office is designated as an OSJ. At

a minimum, an OSJ must be reviewed every year, whereas branch offices are required to be reviewed in accordance with a stated cycle. In determining the inspection cycle for a branch office, a member must consider the nature and complexity of the securities activity for which the branch office is responsible, as well as the volume of business conducted at the office and the number of associated persons assigned to the office. Once a member determines its inspection cycle, it must document the cycle in its written supervisory and inspection procedures.

Some NASD members employ associated persons at offices that are not designated as OSJs and are not registered as branch offices. For purposes of this *Notice*, such offices are referred to as "unregistered offices" and include any location at which a member is conducting a securities business that does not fall within the definition of OSJ or branch office. Some associated persons working in these unregistered offices may be involved in other business enterprises, such as insurance, real estate sales, accounting, tax planning, or investment advisory services, and consequently may be classified for compensation purposes as part-time employees or independent contractors. Some unregistered offices also operate as separate business entities under names other than those of the members. While the NASD does not encourage or discourage such arrangements, a large number of geographically diverse offices presents the potential that sales practice problems will not be as quickly identified as in larger, centralized branch offices. This increased potential must be taken into account when drafting supervisory procedures.

Members employing associated persons in unregistered offices are responsible for establishing and carrying out procedures that will subject these persons to effective supervision. To be effective, the

supervision must be designed to monitor securities-related activities and to detect and prevent regulatory and compliance problems of associated persons working at unregistered offices. In this regard, a member's supervisory responsibility would include, but not be limited to:

- maintaining a record of the locations of all unregistered offices, which must be made available to regulators upon request;
- educating associated persons working from an unregistered office as to their obligations to the firm and to the public, including prohibited sales practices;
- maintaining regular and frequent professional contact with such individuals; and
- implementing appropriate supervisory practices, such as records inspections and compliance audits at the associated persons' places of employment, to ensure that their methods of business and day-to-day operations comply with applicable rules and requirements.

To fulfill these obligations, a firm should consider whether the number and location of its registered principals are adequate to properly supervise its unregistered office personnel effectively.

The Rule does not specify the frequency of inspections for unregistered offices, but in order to fulfill the general obligation to supervise, such inspections should be conducted according to a regular schedule. The frequency and scope of inspections should be determined based on factors such as the nature and volume of business conducted at the office and the nature and extent of contact with customers. A non-OSJ office that supervises one or more unregistered offices should be inspected at least annually.

Inspections of unregistered offices should include, among other things, a review of any on-site customer account documentation and other books and records, meetings with individual registered representatives to discuss the products they are selling and their sales methods, and an examination of correspondence and sales literature.

Unannounced visits may be appropriate, particularly where there are indications of misconduct or potential misconduct, such as the receipt of a significant number of customer complaints, personnel with disciplinary records, or excessive trade corrections, extensions, liquidations, or variable contract replacements. Each firm should determine the types of "red flags" that would trigger an unannounced inspection. Members should note that in *In re Royal Alliance Associates, Inc.*,<sup>6</sup> the SEC stated that it harbored grave doubts that a practice of conducting a pre-announced compliance examination only once a year would necessarily discharge the supervisory obligations of any firm that incorporates a structure in which smaller offices are operated by only one or two representatives. In addition, the SEC recently reaffirmed its belief in the importance of unannounced examinations in *In re NYLIFE Securities, Inc.*<sup>7</sup> In this case, the SEC found that NYLIFE Securities' failure to conduct an unannounced examination of a registered representative during a seven-year period was inadequate to satisfy its supervisory obligations, especially in light of the fact that approximately one-half of NYLIFE Securities' approximately 6,300 registered representatives work in off-site offices with fewer than five people.

*Royal Alliance* and *NYLIFE Securities* emphasize the need for close attention to supervision of small, dispersed offices. Members are encouraged to read both the *Royal Alliance* and *NYLIFE Securities* decisions in their entirety,

as well as *Notice to Members 98-38, NASD Reminds Members of Supervisory and Inspection Obligations*.

## Conclusion

With a better understanding of the reasons for some of the requirements contained in Rule 3010, members can more effectively develop a supervisory system that is tailored to their specific structure. Supervisory systems and written procedures must address changes in regulatory requirements, the types of business the member conducts, and the structure of the member. A member must determine the effects firm-wide of such changes. For example, the decision to begin maintaining customers' funds at a branch office would require that the office be designated as an OSJ, which would in turn require that the office be supervised by an appropriately registered principal and that the office be inspected annually. One change can have multiple effects.

To keep their supervisory systems and written procedures current, members should regularly read *NASD Notices to Members*, *NASD* interpretive letters, and *NASD Regulatory and Compliance Alerts*, all of which are available on *NASD Regulation's Web Site* ([www.nasdr.com](http://www.nasdr.com)). In addition, it is important that each member carefully consider any obligations or requirements imposed by state securities laws, federal laws and rules, and other self-regulatory organization rules. Supervisory obligations of firms and the standards against which their conduct will be measured, may be affected by SEC decisions and interpretations, as well as by judicial determinations.



## Endnotes

<sup>1</sup>*NASD Notice to Members 98-96* (December 1998).

<sup>2</sup>Members should read this *Notice* in conjunction with Rule 3010. The NASD's rules are available on the NASD Regulation's Web Site at [www.nasdr.com](http://www.nasdr.com).

<sup>3</sup>*Supra* note 1. *Notice to Member 98-96* describes additional types of practices the

NASD believes are reasonable and others that it has cited as deficient.

<sup>4</sup>*See In Re Christopher J. Benz*, Securities Exchange Act Release No. 38440.

<sup>5</sup>*See In Re Charles L. Campbell*, Securities Exchange Act Release No. 26510, 42 SEC Docket 1095.

<sup>6</sup>SEC Release No. 34-38174 (January 15, 1997)

<sup>7</sup>SEC Release No. 34-40459 (September 23, 1998)

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