

Special Notice to Members

JUNE 2003

SUGGESTED ROUTING

Executive Representative
Legal & Compliance
Senior Management

REQUEST FOR COMMENT

ACTION REQUESTED BY JULY 11, 2003

Certification by Chief Executive Officer and Chief Compliance Officer

NASD Requests Comment on Proposal to Amend Rule 3010 and Adopt Interpretive Material 3010-1. **Comment Period Expires on July 11, 2003**

KEY TOPICS

Compliance
Supervision

Executive Summary

NASD is proposing to amend Rule 3010 and adopt related interpretive material to require each member to designate a Chief Compliance Officer who, jointly with a member's Chief Executive Officer,¹ must certify annually that the member has in place adequate compliance and supervisory policies and procedures. The proposed rule changes are intended to enhance investor protection by encouraging senior management to focus increased attention to a member's compliance and supervisory systems and by fostering regular interaction between business and compliance officers. The proposal also would promote joint consideration by the Chief Compliance Officer and senior management of specific compliance problems or initiatives. This proposal is intended to foster greater investor protection by providing a strong consultative voice to Chief Compliance Officers in their dealings with other supervisors, managers, and officers of the member. The accompanying interpretive material makes it clear that the obligation of the Chief Executive Officer and Chief Compliance Officer is limited to executing the certification upon a reasonable basis that comports with the high standards of commercial honor and just and equitable principles of trade. Provided that the signatories execute upon such a basis, neither would incur any greater liability for the adequacy of supervisory and compliance policies and procedures than would otherwise be the case in the absence of this certification.

The text of the certification and proposed interpretive material are attached.

Questions or comments concerning this *Notice* may be directed to Philip Shaikun, Assistant General Counsel, Regulatory Policy and Oversight, at 202-728-8451.

03-29

Request for Comment

NASD is proposing an amendment and interpretive material to NASD Rule 3010 to require a member's Chief Executive Officer and Chief Compliance Officer to certify to the adequacy of the member's compliance and supervisory policies and procedures. Members wishing to comment must make a submission that is received by July 11, 2003. Members and interested persons can submit their comments using the following methods:

- ♦ mailing in written comments, or
- ♦ e-mailing written comments to pubcom@nasd.com.

Written comments submitted via hard copy should be mailed to:

Barbara Z. Sweeney
NASD
Office of the Corporate Secretary
1735 K Street, NW
Washington, DC 20006-1500

Important Note: The only comments that will be considered are those submitted in writing by mail or by e-mail.

Before becoming effective, any rule change must be approved by the NASD Board of Governors and the Securities and Exchange Commission.

Background and Discussion

Comprehensive compliance and supervisory systems constitute the bedrock of effective securities industry self-regulation and the primary strata of investor protection. As such, NASD believes that a member's senior management should regard the adequacy of its compliance and supervisory policies and procedures with the same seriousness

accorded to such fundamental operational prerequisites as, for example, net capital requirements. To develop this ethos, NASD further believes it is essential that regular and significant interaction occur between senior business and compliance officers. Moreover, those compliance officers must be empowered with sufficient leverage to oblige senior management to give meaningful consideration to the caliber of a member's compliance and supervisory systems.

To that end, NASD has developed a proposal to ensure that compliance – and by extension, investor protection – is given the highest priority by a member's senior executive officers. Specifically, the proposal would amend Rule 3010 to require each member to designate a Chief Compliance Officer and would further require that individual and a member's Chief Executive Officer jointly to certify annually that the member has in place compliance and supervisory policies and procedures reasonably designed to comport with applicable NASD rules, MSRB rules, and federal securities laws and rules. NASD recognizes that in certain instances the compliance function is undertaken by associated persons who have multiple areas of responsibility within the member, including the role of Chief Executive Officer. Consequently, it is possible that, at times, a single associated person would be executing the certification only once in the joint capacity of Chief Compliance Officer and Chief Executive Officer.

NASD further has proposed an accompanying interpretive material, IM-3010-1, that both articulates the philosophy behind the proposed rule amendment and delineates important limitations to the obligations and

liabilities associated with the certification requirement. In particular, proposed IM-3010-1 makes three noteworthy interpretations.

First, the interpretive material limits the scope of the certification to the adequacy of compliance and supervisory policies and procedures commensurate with the nature of the member's business segments and its activities related thereto. Notably, although the rule proposal would require certification annually, it would not relieve a member of its current and ongoing obligation to periodically review the adequacy of its policies and procedures in light of business and regulatory developments.

Second, the interpretive material clarifies that the Chief Executive Officer and Chief Compliance Officer only must certify to the adequacy of the compliance and supervisory system – but not generally to the implementation or execution of that system. Nonetheless, the interpretive material notes that certification carries an implicit representation that implementation of the system has at least been audited and tested for efficacy.

Third, the interpretive material explains that no liability under the proposed rule or other NASD rule will attach to the signatories of the certification, provided there was a reasonable basis to certify at the time of execution. The touchstone of reasonableness would be whether the act of certification was consistent with high standards of commercial honor and just and equitable principles of trade. Provided that the signatories execute upon such a basis, neither would incur any greater liability for the adequacy of supervisory and compliance policies and procedures than would otherwise be the case in the absence of this certification.

Thus, it is not NASD's intent with this proposal to make the Chief Executive Officer and Chief Compliance Officer personally liable for every compliance or supervisory failure a firm might experience. Rather, the proposal seeks to facilitate development of an ethical culture of compliance within firms by elevating the status of the Chief Compliance Officer and by compelling periodic and significant consultation between senior business and compliance personnel.

In this respect, the proposed rule is analogous to the recently enacted provisions of the Sarbanes-Oxley Act of 2002 that require a company's principal executive and financial officers to certify the accuracy of financial reports and the existence of internal controls designed to ensure that accuracy. In addition, the SEC recently enacted Regulation AC, another certification-based regulation that requires research analysts to affirm that their research reports reflect their true opinions. NASD supports the rationale behind those initiatives and believes its certification proposal similarly will promote corporate ethics and public trust and also will enhance investor protection and bolster the integrity of our members and markets.

Endnote

- 1 As used in this *Notice to Members*, the term "Chief Executive Officer" includes any other title utilized by the member connoting equivalent management status and seniority.

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EXHIBIT A

Annual Compliance And Supervision Certification

The undersigned are respectively the chief executive officer (or equivalent officer) and chief compliance officer of [name of member corporation/partnership/sole proprietorship] (the "Member"). As required by NASD Rule 3010 (c) [to be amended to include requirement] the undersigned makes the following certification:

1. The Member, based on the types of businesses in which it engages and the nature of its activities in connection with these types of businesses, 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.
2. The undersigned senior executive officer/managing partner and chief compliance officer have consulted with or otherwise relied on those employees, officers, outside consultants, lawyers and accountants as they consider appropriate, in order to attest to the statements made in this certification.
3. Notwithstanding the requirement to make this certification annually, the Member has reviewed and will continue to review the adequacy of its compliance and supervisory policies and procedures on a periodic basis as necessitated by the types of businesses in which it engages and the nature of its activities in connection with these types of businesses, any changes or modification in such businesses and activities, or the promulgation of new laws or rules or any amendments to existing laws or rules.

EXHIBIT B

IM-3010-1 Annual Compliance And Supervision Certification

The Board of Governors is issuing this interpretation to the requirement under Rule 3010(c) to have the member's chief executive officer (or equivalent officer) and the chief compliance officer execute a certification that the member has compliance and supervisory policies and procedures reasonably designed to comport with applicable NASD rules, MSRB rules and federal securities laws and rules.

The Board of Governors is concerned that each member understands the importance of employing adequate compliance and supervisory policies and procedures. Compliance with applicable NASD rules, MSRB rules, and federal securities laws and rules is the foundation of ensuring investor protection and market integrity, and is essential in promoting the efficacy of self-regulation. Consequently, the certification requirement is intended to require a regular review by each member of its compliance and supervisory policies and procedures in light of the nature of its businesses and the laws and rules that are applicable and to take such action as may be appropriate with respect thereto.

The execution of the certification by the chief compliance officer is intended to ensure that the person charged with managing the member's compliance program has regular and significant interaction with senior management concerning the subject matter of the certification. Furthermore, the Board of Governors understands that the chief compliance officer is not necessarily responsible for the execution of each compliance and supervisory policy and procedure and that the signatories to the certification are certifying as to adequacy, but not necessarily as to the implementation, of the member's compliance and supervisory policies and procedures. However, necessary components to ensure the adequacy of these policies and procedures are the auditing and testing of the implementation of the compliance and supervisory policies and procedures.

The scope of the requirement to have adequate compliance and supervisory policies and procedures for the business lines in which the member engages is defined by the nature and extent of regulation attendant to each line of business.

No liability will accrue to the signatories to the certification under this or any other NASD rule or interpretation as a consequence of their certification provided that at the time they execute the certification they have a reasonable basis for doing so and do so in a manner that comports with high standards of commercial honor and just and equitable principles of trade.