

NASD Notice to Members 98-96

NASD Elaborates On Member Firms' Supervision Responsibilities For Trade Reporting And Market-Making Activities

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Executive Summary

During the last two years, NASD Regulation, Inc. (NASD RegulationSM) has imposed numerous and significant disciplinary actions against member firms for supervisory deficiencies, particularly in the areas of trade reporting and market-making activities. Indeed, much of the recent focus in the area of written supervisory procedures has been in the context of NASD Regulation's Trading and Market Maker Surveillance (TMMS) examination process. Accordingly, the purpose of this *Notice* is to reiterate for members in the context of trading and market-making activities the requirements of National Association of Securities Dealers, Inc. (NASD[®]) Rule 3010, the supervision rule, concerning a member firm's obligation to establish, maintain, and enforce a supervisory system and written supervisory procedures which reflect that system.¹

Establishing, maintaining, and enforcing written supervisory procedures is a cornerstone of self-regulation within the securities industry. Supervisory procedures reasonably designed to achieve compliance with applicable rules, and to detect and deter rule violations by a member firm and its associated persons, enable the firm to identify and respond to regulatory concerns in a manner that can reduce the risk of disciplinary action by NASD Regulation.² Moreover, appropriately designed and implemented supervisory systems and written supervisory procedures serve as a "frontline" defense to protect investors from fraudulent trading practices and help to ensure that members are complying with rules designed to promote the transparency and integrity of the market. As a result, effective supervisory systems within member firms enhance investor confidence and, in turn, promote the fairness, liquidity, and efficiency of the market for all market participants.

As markets evolve and become more complex, it is essential that firms have in place effective supervisory systems and written supervisory procedures. At most member firms front-line supervisors have responsibilities for firm revenues in addition to their supervisory responsibilities with regard to applicable laws, rules, and regulations. Appreciating both the significance and the compatibility of these dual responsibilities, NASD Regulation believes that an effective supervisory system contemplated by Rule 3010 includes a strong overall commitment on the part of supervisors to establish and maintain clearly defined procedures for compliance with applicable laws, rules, and regulations, and a climate of intolerance for lax compliance by the persons they supervise.

NASD Rule 3010 requires each member to establish, maintain, and enforce written supervisory procedures with respect to the types of business in which it engages, which "are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules . . ."³ Because many of the failure to supervise charges recently imposed on members have been for inadequacies revealed in the TMMS examination process, in the trade reporting, market making, and equity order handling areas, this *Notice* focuses on elements of adequate supervisory procedures and systems in these areas. Given the differences among member firms in terms of their business mixes, and the fact that compliance with NASD Rule 3010 can be achieved through a variety of procedures and systems, this *Notice* only addresses some of the general elements that member firms should consider in assessing their supervisory systems and written procedures. NASD Regulation is not mandating any particular type or method of supervision. Nor is the *Notice* designed to provide a checklist of

steps guaranteed to constitute adequate written supervisory procedures. NASD Regulation will continue to examine closely member firms' supervisory systems and written procedures and, where appropriate, initiate disciplinary action against both firms and their supervisory personnel for failure to adopt, implement, and enforce appropriate supervisory procedures.

If you have any questions about this *Notice*, please call the Legal Section of the Market Regulation Department, NASD Regulation, at (301) 590-6410.

Discussion

Requirements Of NASD Rule 3010

NASD Rule 3010 provides that each NASD member must "establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the rules of this Association."⁴ In addition to the creation of supervisory systems, Rule 3010 also requires member firms to establish, maintain, and enforce companion written supervisory procedures.⁵ Thus, a member and/or individual can violate NASD Rule 3010 in several different ways. Specifically, it is a violation if the member and/or individual *fails to establish and maintain* a supervisory system and/or fails to describe the operation of that system in written supervisory procedures. In addition, it is a violation if the member and/or individual *fails to enforce* a supervisory system and/or written supervisory procedures. Either type of violation can occur in the absence of an underlying rule violation.

There is an important distinction between written guidelines for com-

pliance and written supervisory procedures. Guidelines for compliance generally set forth the applicable rules and describe prohibited practices.⁶ While such compliance guidelines certainly serve a valuable regulatory purpose, and can represent an important element of an effective supervisory system, compliance guidelines in and of themselves do not constitute an adequate supervisory system or procedures. Beyond compliance guidelines, member firms must also adopt written *supervisory* procedures that describe the actual supervisory system established by the firm to achieve compliance with applicable rules and regulations. Specifically, the firm's written supervisory procedures should include a description of the controls and procedures used by the firm to deter and detect misconduct and improper activity. The written supervisory procedures should also identify the specific personnel who perform the various supervisory functions.

A firm's supervisory system may include a range of techniques and controls in addition to formal reviews and examinations of exception reports, which always should be included. For example, an effective supervisory system can include the maintenance of a comprehensive training and continuing education program that promotes a thorough understanding by associated persons of the applicable laws, rules, and regulations. In addition, elements of an effective supervisory system can include internal and external audits, and periodic reviews by "audit committees" or similar bodies constituted to evaluate a firm's controls. It can also include less formal monitoring and oversight by a qualified supervisor, or designee, actively involved in the business. Ultimately, an effective supervisory system may be comprised of many different elements, both objective—

such as regular reviews of specific areas of activity—and subjective, including placing competent, qualified, and experienced individuals in supervisory roles. In addition, a tone should be set from the top of the firm that lax compliance with – and deliberate violation of – laws, rules, and regulations will not be tolerated.

The supervisory system should be designed to ensure that delegated responsibilities are diligently exercised. Policies and procedures are not sufficient if there are no auditing systems to determine whether they are being followed as described.

Accordingly, written supervisory procedures should describe the following:

a) specific identification of the individual(s) responsible for supervision – either by name or by title and position;

b) the supervisory steps and reviews to be taken by the appropriate supervisor – this need not be a detailed description, but it should identify any exception reports and/or other documents being reviewed and the substantive area being reviewed (*e.g.*, Limit Order Protection, trade reporting, etc.). If a member firm employs automated systems as part of its supervisory system, those systems should also be generally described.

c) the frequency of such reviews – this should be more specific than simply providing for "a review" or "a review from time to time." The frequency of reviews should be described, *e.g.*, daily, weekly, monthly, quarterly, or annually (how frequently a firm conducts any such reviews will depend upon the nature, type, or level of firm activity in that particular area); and

d) how such reviews shall be documented – the firm should describe how the review will be documented, for example, initialing order tickets, initialing blotters, or filling out review logs. The procedures should also provide for the documentation of steps taken as a result of supervisory reviews (*e.g.*, trades broken, restitution for best execution violations, etc.). The staff recognizes that there are a variety of ways, in addition to those noted, that reviews can be documented as having been conducted, particularly where the review is conducted on-line. Firms should document reviews in a manner sufficient to demonstrate to firm management and regulators that a review has been conducted.

Subject Areas Typically Addressed In The Written Supervisory Procedures Of Firms Engaged In Market-Making Activity

As the staff has pointed out during the course of TMMS examinations, the written supervisory procedures and supervisory systems of firms engaged in market-making activities must address, at a minimum, trading practice rules (*i.e.*, passive market making, best execution, firm quote rule compliance, limit order protection, short-sale rules, markups and markdowns, and the Securities and Exchange Commission's [SEC] Order Handling Rules), trading systems such as Small Order Execution SystemSM (SOESSM) and SelectNetSM, trade reporting, Automated Confirmation Transaction SystemSM (ACTSM) Rules compliance, and any other material aspect of the firm's market-making business.

In August 1996, the SEC issued a Report of Investigation that detailed deficiencies in the NASD's performance of its duty to oversee The Nasdaq Stock Market® (Section 21(a) Report). As a result, NASD

Regulation has been examining carefully member firm policies, practices, and procedures that encompass all of the areas referenced in the Section 21(a) Report. In particular, NASD Regulation has been looking closely at whether a firm's written supervisory procedures address the following subject areas:

- pricing conventions;
- size conventions;
- coordination of quotations, trades, and trade reports;
- exchange of proprietary and customer information;
- improper collaboration and coordination of Market Maker activities;
- failure to honor quotations;
- harassment;
- late and inaccurate trade reporting; and
- other trading rules and regulations that relate to market-making activities.

In addition, both the NASD and the SEC have recently emphasized the importance of a broker/dealer's best execution obligations. Whether a firm has fulfilled these obligations depends upon the different facts and circumstances present at each member firm. Nevertheless, as the SEC has repeatedly stated, to comply with the supervisory obligations that flow from best execution, a supervisory system must provide a mechanism for regularly and rigorously comparing execution quality likely to be obtained from different markets or Market Makers, and for determining that such analyses are performed.

Obligation To Update And Amend Written Supervisory Procedures And Supervisory Systems Upon The Implementation Of Rule Changes; Awareness Of Market Practices

Members must keep abreast of changes in laws, rules and regulations, market practices, and indicated patterns of non-compliance and must modify their supervisory procedures and systems as necessary. In this connection, NASD Rule 3010(b)(3) provides that "each member shall amend its written supervisory procedures as appropriate within a reasonable time after changes occur in applicable securities laws and regulations, including the Rules of this Association." What constitutes a "reasonable time" depends on, among other things, the complexity of the rule change and the changes (if any) required to be made in the supervisory system, the magnitude of any such changes, the extent to which the rule change imposes new requirements or modifies pre-existing requirements, and the amount of advance notice provided about the effective date of the rule change. In this connection, NASD Regulation believes that significant rule changes generally are promulgated and approved in a manner that affords members sufficient time to prepare for implementation of the rule change.

When rule changes necessitate a modification of a member firm's supervisory system and written supervisory procedures, a firm can comply with NASD Rule 3010(b)(3) by preparing and distributing a supplemental memorandum or other similar document describing the modification or amendment being made and updating in some manner relevant supervisory materials.

Supervisory Responsibilities Of Firms That Enter Into Give-up Or Other Arrangements

Many member firms enter into give-up or other arrangements that allow another firm to report trades on their behalf. Although a firm may allow another firm to perform its trade reporting responsibilities, the firm has the ultimate obligation to report trades in compliance with the rules and to supervise its activities to detect and deter violations of the trade reporting and ACT rules. These obligations cannot be contracted away. Thus, any firm that agrees to allow another firm to report trades on its behalf must establish, maintain, and enforce supervisory procedures which allow it to determine that the other firm is reporting those transactions in compliance with the rules. In this connection, NASD Regulation notes that executing "Attachment 2" to the ACT agreement does not relieve a member firm of any of its obligations in this area.

Use Of Automation As Part Of A Firm's Supervisory System

Written supervisory procedures may incorporate the use of automated systems to assist in determining compliance with applicable rules. As part of its supervisory system, a firm must test and monitor such systems periodically to determine that they are operating properly. In addition, personnel using the systems should be trained so that they understand how the systems work. For example, programmers should be advised of the regulatory requirements the system is being designed to address. Supervisory and compliance personnel should understand the system's capabilities and limitations. These principles apply whether or not the system software is designed by the firm or purchased from an

outside source. Additionally, when purchasing or designing a system, the firm should determine that such a system can reasonably assist the member firm in meeting its supervisory obligations. A system programming error or the failure of software need not result in a charge of failure to supervise if the firm has in place an effective supervisory procedure reasonably designed to detect such errors or failures. Indeed, the existence of an appropriate supervisory system that detects a particular error or failure and permits the firm to take appropriate remedial action may in certain instances be a mitigating factor in determining the necessity and severity of disciplinary action. Despite the means or procedures to detect system errors or failures, however, repeated system failures or errors without corrective action would weigh heavily against any mitigation that such procedures may provide.

Automated Assistance From NASD Regulation And Nasdaq

In a number of areas, resources are provided by NASD Regulation and Nasdaq to assist member firms in meeting their supervisory responsibilities. For example, NASD Regulation presently seeks to contact member firms engaged in underwriting activities on a real-time basis if it detects trading or quotation activity that may be inconsistent with the SEC's "passive market-making" rule, Rule 103 under Regulation M.

Additionally, NASD Regulation and Nasdaq provide the membership with transaction and market data that may be accessed through the Nasdaq TraderSM Web Site (www.nasdaqtrader.com) on the Proprietary Trading Data Web page. Information currently available includes monthly "report cards" that compare a firm's level of late trade reporting to industry-wide averages

and the member's direct peers. The "report card" also provides similar information with respect to the firm's compliance with the firm quote rule and the best execution rule. Through this Web Site, members also have access to daily share volume reports for a broker/dealer, daily share volume reports for a security, monthly summaries, and historical research reports such as Market Maker Price Movement Reports and Equity Trade Journals.

The provision of such reports and trade information by NASD Regulation and Nasdaq do not obviate the need for member firm supervision. Nevertheless, member firms may appropriately incorporate such resources into the overall design and implementation of their written supervisory procedures and systems.

Common Supervisory Deficiencies Noted During TMMS Examinations

To assist the membership in developing adequate written supervisory procedures, the following are examples of supervisory procedures most frequently found to be deficient by the staff during the course of TMMS examinations. Merely avoiding these bad practices in no way ensures that a firm's written procedures will be found to be adequate. Avoiding these particular practices, however, could assist member firms significantly in developing adequate written supervisory procedures.

1. The Written Supervisory Procedures Merely Recite the Applicable Rules: The staff has observed many instances where the written supervisory procedures merely recite applicable NASD and SEC rules without any description of a procedure that will achieve compliance with those rules. While

such documents can be an important component of a member firm's supervisory system, duplicating or restating the rules and identifying prohibited activities, without describing a procedure to determine whether there is compliance with those rules, is not sufficient to serve as the firm's written supervisory procedures.

2. Failure to Designate Responsible Supervisory Personnel in the Procedures: The staff has observed instances where firms have failed to designate the person or persons responsible for conducting supervision in each type of business. The specific person charged with conducting a particular review or procedure should be identified – either by name or by title.⁷ Merely stating that the "Compliance Department," "Trading Department," or a "principal" will conduct the review is not sufficient. The procedures should state, for example, that "John Doe will review" or "the Head Trader will review." Additionally, the person designated to carry out the review should be adequately experienced and qualified to do so.

3. Failure to Describe the Review Process Adequately: As stated above, the supervisory steps and reviews do not necessarily have to be set forth in a detailed description. Nevertheless, the staff has observed instances where the description of the supervisory procedure or review has been so vague that firm management, firm supervisory personnel, and regulators cannot determine what the review entails. For example, it is not sufficient to provide that "John Doe will review for compliance with all NASD trade reporting rules, limit order protection, etc."

4. Failure to Document Reviews: The staff has observed instances where firms have failed to preserve

and maintain the documentation that reflects the fact that particular supervisory reviews have been conducted.

5. Failure to Denote Specifically the Frequency of Reviews: The staff has observed instances where firms have failed to designate the frequency with which particular supervisory reviews are conducted.⁸

6. Failure to Monitor Adequately the Performance of Automated Compliance Systems: The staff has observed instances where firms have failed to test periodically the performance of automated trade execution, reporting, and other automated compliance systems that assist the firm in complying with applicable rules.

7. Failure to Monitor Adequately the Performance of Service Bureaus and Other Members to Which the Firm has Delegated its Trade Reporting Responsibility: The staff has observed instances where firms have failed to implement procedures to review periodically the accuracy and timeliness of trade reporting conducted by another member or service bureau on the firm's behalf.

8. Failure to Reflect Supervisory Systems in the Firm's Written Supervisory Procedures: The staff has observed instances where firms that in fact have effective supervisory systems in place fail to describe them in the firm's written supervisory procedures. It has also been the staff's experience that firms which conduct effective supervisory reviews sometimes fail to describe them in their written supervisory procedures. This is particularly true for firms that use automated systems to ensure compliance with applicable rules. Such systems should be generally described in the firm's written supervisory procedures.

9. Failure to Describe the Steps the Firm Will Take when Potential Deficiencies are Identified: The staff has reviewed written supervisory procedures that fail to describe the steps a supervisor should take when deficiencies are found. Because each situation may have aggravating or mitigating factors, general procedures, versus specific steps to be taken, will be adequate for purposes of the written supervisory procedures. For example, the procedures may indicate that the supervisor will discuss the matter with the compliance, audit, or legal department and the supervisor and/or representatives from one or more of these other areas will follow up with the registered person or persons involved to determine the reason for a deficiency, the possible need for further training, etc.

10. Failure to Update Procedures Within a Reasonable Period to Reflect New Regulatory Requirements or Firm Procedures: The staff has observed numerous instances where members have failed to establish and maintain written supervisory procedures by the effective date of a new rule.

11. Failure to Preserve and Maintain Written Supervisory Procedures That Were in Effect During Past Time Periods in Accordance with SEC Rules 17a-3 and 17a-4: The staff has reviewed instances where members allege that written supervisory procedures were in effect for a specified business line during a specified time period, but were unable to document that the procedures actually existed at that time.

Firms should review their existing supervisory systems and written supervisory procedures in light of the guidance provided in this *Notice*. Deficiencies in supervisory systems should be addressed immediately.

Endnotes

¹For additional guidance concerning NASD Rule 3010, see *Notices to Members 88-84* and *89-34*.

²Self-imposed disciplinary action at the firm level is an integral part of the self-regulatory process – one that often constitutes a mitigating factor with respect to sanctions. However, self-imposed disciplinary action does not necessarily preclude the imposition of appropriate sanctions by NASD Regulation where it is deemed warranted after review of the facts and circumstances regarding a particular matter.

³NASD Rule 3010(b)(1).

⁴NASD Rule 3010(a).

⁵See NASD Rule 3010(b) (1) and (2).

⁶See *In Re Bryant*, Securities Exchange Act Release No. 32357, 54 SEC Docket 345.

⁷It should be noted that NASD Rule 3010(b)(2) provides that a member firm shall maintain on an internal record the names of all persons who are designated as supervisory personnel and the dates for which such designation is or was effective.

⁸NASD Rule 3010 clearly does not require, however, that a member firm must review *all* of its trading activity for compliance with

applicable rules. In these instances, the following have been found insufficient:

- a) reviews will be conducted as warranted or as needed;
- b) reviews will be conducted from time to time;
- c) reviews will be conducted regularly; and
- d) reviews will be conducted on a "spot check" basis.

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