

Notice to Members

JANUARY 2006

SUGGESTED ROUTING

Legal & Compliance
Operations
Registered Representatives
Senior Management
Trading

KEY TOPICS

Rule 3012 (Supervisory Control Systems)

GUIDANCE

Supervisory Controls

SEC Approves Amendments to NASD Rule 3012 to Require Members Relying on Rule 3012's "Limited Size and Resources" Exception to Notify NASD of their Reliance; **Effective Date: February 14, 2006**

Executive Summary

On November 18, 2005, the Securities and Exchange Commission (SEC) approved amendments to NASD 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.

NASD is issuing this *Notice to Members (NTM)* to advise members of the rule change and to introduce the electronic reporting system that members will need to use to notify NASD of their reliance on Rule 3012's "limited size and resources" exception. Questions and answers relating to the rule change and the reporting system are included. The new rule text is in Attachment A and is effective on February 14, 2006. A sample screen shot of the electronic notification system Web page is in Attachment B.

Questions/Further Information

Questions concerning this *Notice* may be directed to Patricia Albrecht, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8026.

Background

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 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"¹ of a producing manager may conduct the producing manager's day-to-day supervisory reviews. However, Rule 3012 provides an exception for any member firm that is so limited in size and resources (the "limited size and resources" exception) that the member does not have sufficient senior or "otherwise independent" persons who can conduct the required supervisory reviews. In such situations, a principal who is sufficiently knowledgeable of the member's supervisory control procedures may conduct the required supervisory reviews.²

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.³ In *NTM 04-71* (October 2004), the *Notice* announcing the SEC's approval of Rule 3012, NASD advised its members that it intended to file a rule change that would enable NASD to identify those firms relying on the exception. On June 23, 2005, NASD filed such a proposed rule change, which the SEC approved on November 18, 2005.⁴

Discussion

Pursuant to the approved amendments to Rule 3012, which become effective on February 14, 2006, any member that elects to rely on the "limited size and resources" exception to Rule 3012 to conduct any of its producing managers' supervisory reviews must 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. If the member has been relying on the "limited size and resource" exception prior to February 14, 2006, the member must notify NASD of such reliance by March 16, 2006 (*i.e.*, within 30 days of February 14, 2006).

Once a member has provided its initial notification of reliance on Rule 3012's "limited size and resources" exception, the member will need to notify NASD of its continued reliance on the exception on an annual basis.⁵ Each ensuing annual notification by the member must be effected no later than on the anniversary date of the previous year's notification.⁶ 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.⁷

Rule 3012 Exception Notification System

To facilitate members' compliance with these notification requirements, NASD has created the Rule 3012 Exception Notification System. The system can be accessed directly at www.nasd.com/RegNotes 3012. In addition, members can access the form by going to NASD's Web site home page (www.nasd.com), selecting the tab at the top of the page entitled "Regulatory Systems" and the following links: Regulation Filing Applications > Regulatory Notifications > NASD Rule 3012 Exception.

Members will use the user ID and password they have received from the NASD Entitlement Program (www.nasd.com/entitlement)⁸ to log onto the Rule 3012 Exception Notification System. Once logged into the system, a Web page with the notification form will appear (see Attachment B). Members should then complete the appropriate fields and select the notification option that is most appropriate for the members' individual notification requirements. Members should be aware that some information fields will pre-populate automatically based on previously provided information in NASD records. For example, if a firm is using the Rule 3012 Exception Notification System to provide the required annual notification of its continued reliance on the exception, the system will pre-populate the information field entitled "Prior Notification Date" with the date of the firm's previous notification.

After completing the notification form, members should click on the word "review." A page will then be displayed permitting members to review the notification form. After completing the review, members should click on the word "submit" displayed on that page. After the form has been submitted, the notification system will display a confirmation page that members should print for their records.

Questions and Answers Regarding the New Requirement for Members to Notify NASD of their Reliance on Rule 3012's "Limited Size and Resources" Exception

To help members relying on Rule 3012's "limited size and resources" exception, NASD is publishing the following questions and answers relating to the notification requirement and the Rule 3012 Exception Notification System.

Q1: When can my firm start using the Rule 3012 Exception Notification System to notify NASD of the firm's reliance on Rule 3012's "limited size and resources" exception?

A: The Rule 3012 Exception Notification System will be online February 14, 2006, the rule amendments' effective date.

Q2: My firm started relying on Rule 3012's "limited size and resources" exception before the February 14, 2006 effective date of the notification requirement and is continuing to rely on the exception. When does the firm have to notify NASD of its reliance on the exception? How will my firm use the Rule 3012 Exception Notification System to make that notification?

A: The firm will need to notify NASD of the firm's reliance on the exception no later than March 16, 2006 (*i.e.*, within 30 days of February 14, 2006). The firm would choose the notification option that states that the firm has determined to rely on the exception and provide the date the firm began relying on the exception.

Q3: My firm started relying on Rule 3012's "limited size and resources" exception in March 2005 but determined in December 2005 that it no longer needed to rely on the exception. What are the firm's notification obligations under those circumstances?

A: Prior to the recent amendments to Rule 3012 discussed in this *NTM*, which become effective on February 14, 2006, members were not required to notify NASD of their reliance on Rule 3012's "limited size and resource" exception or any subsequent cessation of reliance on the exception. Accordingly, a firm that relied on the exception prior to February 14, 2006, but also ceased relying on the exception prior to that date, does not have any notification obligation. However, if the firm determines on or after February 14, 2006 to rely on the exception, the firm must comply with Rule 3012's notification provisions.

Q4: What are my firm's notification obligations if the firm decides after February 14, 2006 to cease relying on Rule 3012's "limited size and resources" exception and notifies NASD through the Rule 3012 Exception Notification System but then subsequently determines that it needs to rely on the exception once again?

A: If a firm that has previously used the Rule 3012 Exception Notification System to notify NASD that it has ceased relying on the exception subsequently determines that it needs to rely on the exception once again, the firm will have to notify NASD of its renewed reliance on the exception. The firm will notify NASD by using the notification option that states that the firm has determined to rely on the exception and providing the date the firm began relying on the exception. The firm will have to provide this notification within 30 days of its renewed reliance on the exception.

Q5: I understand that Rule 3010 (Supervision) also has a "limited size and resources" exception. Is this exception the same as Rule 3012's "limited size and resources" exception? Also, should my firm use the NASD Exception Reporting System to notify NASD if the firm is relying on Rule 3010's exception?

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- A: Rule 3010's "limited size and resources" exception is different from Rule 3012's "limited size and resources" exception. As noted earlier, Rule 3012's exception addresses who may conduct a producing manager's supervisory reviews if the firm cannot meet the general supervisory requirement that someone who is either senior to or "otherwise independent" of the producing manager conduct the producing manager's day-to-day supervisory reviews. Rule 3010's "limited size and resources" exception addresses who may conduct an office inspection if a firm cannot meet the general inspection requirement that someone other than a branch office manager, any person within that office who has supervisory responsibilities, or any individual who is directly or indirectly supervised by such persons conduct the office inspection.

Rule 3012's notification requirement only applies when a firm is relying on Rule 3012's "limited size and resources" exception. There is no similar notification requirement with respect to a firm's reliance on Rule 3010's "limited size and resources" exception. However, Rule 3010 does require that a firm relying on the "limited size and resources" exception document in its office inspection reports the factors it has used to determine that the firm has no other alternative than to comply in this manner.

Endnotes

- 1 For purposes of Rule 3012, "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." Rule 3012(a)(2)(A)(i).
- 2 Rule 3012(a)(2)(A)(ii).
- 3 See Exchange Act Release No. 50477 (Sept. 30, 2004), 69 FR 59972 (Oct. 6, 2004) (SR-NASD-2004-116).
- 4 See Exchange Act Release No. 52799 (Nov. 18, 2005), 70 FR 71573 (Nov. 29, 2005) (SR-NASD-2005-084).
- 5 See Rule 3012(a)(2)(A)(iii) and n.2.
- 6 See Rule 3012(a)(2)(A)(iii), n.2.
- 7 See Rule 3012(a)(2)(A)(iii).
- 8 The NASD Entitlement Program is an initiative that replaced the security component of participating, Web-based systems with a shared entitlement service. This service provides authorized users the ability to access these systems with a single NASD user ID and password. Currently, there are nearly 20 NASD applications available via this shared entitlement platform, and more applications will be added in the future. If a member does not have an NASD entitlement account, account set-up instructions can be found at www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=1166. Questions regarding the Entitlement forms or process should be directed to the NASD Gateway Call Center at (301) 869-6699 (broker-dealer firms) or (240) 386-4848 (investment adviser firms).

ATTACHMENT A

Text of approved rule changes

New text is underlined; deleted text is bracketed.

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,¹ and annually thereafter.² 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 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.

* * * * *

- 1 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.
- 2 Members must ensure that each ensuing annual notification is effected no later than on the anniversary date of the previous year’s notification.

Attachment B:

Sample screen shot of the Rule 3012 Exception Notification System

Investor protection. Market integrity. **NASD**

Home Regulation Investor Education Dispute Resolution Professional Development

ack NASD

Firm Notification to Rely on the Limited Size and Resources Exception in NASD Rule 3012

Firm Information

Name

CRD#

City

State/Province

Phone

Chief Compliance Officer

Executive Representative

NASD Information for Member

NASD District Office

NASD District Phone #

NASD District Examiner

NASD District Supervisor

Notice Information

Name of Person Filing Notice

CRD #

Today's Date
mm/dd/yyyy

E-Mail Address

Phone Number

Pursuant to Rule 3012(a)(2)(iii) members electing to rely on the "limited size and resources" exception to conduct any of its producing managers' supervisory reviews must fulfill certain notifications requirements. Specifically, members must notify NASD electronically (or through any other process prescribed by NASD) within 30 days of the date on which the member relies on the exception. If, however, the member has been relying on the exception prior to February 14, 2006, the effective date of this notification requirement, the member must notify NASD by March 16, 2006. Afterwards, the member will need to notify NASD of its continued reliance on the exception on an annual basis. If the member determines that it no longer needs to rely on the exception, the member must provide a one-time notification to NASD within 30 days of ceasing to rely on the exception. Please be aware that NASD is required to notify the SEC of this information.

Please select the section that best fulfills your firm's notification obligations and provide the requested dates. Please note that you may choose only one section.

☐ If your firm has determined to rely on Rule 3012's "limited size and resources" exception, please provide the date on which the firm began to rely on the exception.

Date of Firm's Reliance

☐ If your firm has previously notified NASD of its reliance on Rule 3012's "limited size and resources" exception and intends to continue to rely upon the exception, please provide an annual notification of continued reliance. Please note that each ensuing annual notification must be effected no later than on the one-year anniversary date of the previous year's notification.

Annual Notification Date

Prior Notification Date

☐ If your firm has determined that it no longer needs to rely on Rule 3012's "limited size and resources" exception, please provide the date on which the firm ceased relying on the exception. Please note that your firm must provide this information within 30 days of ceasing to rely on the exception. This is a one-time notification requirement. Firms are not required to provide this information on an annual basis.

Date Firm Ceased its Reliance

Review