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Catherine McGuire
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Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: **File No. SR-NASD-2003-176 – Response to Comments and Amendment No. 1**

Dear Ms. McGuire:

This letter responds to comments received by the Securities and Exchange Commission ("SEC" or "Commission") to the above-referenced rule filing, a proposal to require the Chief Executive Officer ("CEO") and Chief Compliance Officer ("CCO") to certify annually that a member has in place processes to establish, maintain, review, modify and test policies and procedures reasonably designed to achieve compliance with applicable securities laws, rules and regulations. The proposed rule change was published for comment in the Federal Register on December 31, 2003.[1]

The SEC received four comment letters in response to the proposed rule change.[2] All of the commenters support the requirement that each member designate a CCO and further support the goal of increased interaction between senior management and compliance personnel. Ultimately, however, each of the commenters opposes the proposed rule change, contending generally that it is either duplicative of existing requirements or does not achieve its objectives by the most effective and least burdensome means. For the reasons set forth below, NASD disagrees with the commenters. In addition, based on conversations with the Commission staff, NASD is amending the proposed rule change to require that the mandated meetings between the CEO and CCO include discussion of compliance system deficiencies, risks and resources. NASD is also making certain non-substantive amendments to the proposal.

At the outset, NASD notes that the four comment letters received to the proposed rule change represent a marked decline from the 160 unfavorable comments received in response to

[1] Exchange Act Release No. 48961 (December 23, 2003), 68 FR 75704 (December 31, 2003).

[2] Letter from 1st Global Capital Corp. to Secretary, SEC, dated January 21, 2004 ("Global"); letter from Empire Corporate FCU to Jonathan G. Katz, dated January 27, 2004 ("Empire"); letter from the National Society of Compliance Professionals, Inc. to Jonathan G. Katz, dated February 5, 2004 ("NSCP"); and letter from Securities Industry Association and The Bond Market Association to Jonathan G. Katz, dated February 6, 2004 ("SIA/BMA").

an earlier proposal with similar objectives. That proposal, which appeared in Notice to Members 03-29 (June 2003), would have required each member to designate a CCO and further required that the CCO and CEO certify annually to the *adequacy* of the member's compliance and supervisory systems at the time of execution. By comparison, the current proposal requires the CEO and CCO to certify to having in place *processes* to establish, maintain, review, modify and test policies and procedures reasonably designed to achieve compliance with applicable laws, rules and regulations. NASD believes the current proposal more efficiently and pragmatically achieves the same goal of enhanced compliance. Indeed, as discussed in more detail below, even the SIA/BMA letter essentially embraces all of the current proposal's requirements, save the act of certifying itself.

Commenters raise three general objections to the proposal. First, commenters contend that the proposal is either duplicative or unnecessary in light of existing rules that require members to establish and maintain supervisory systems and a proposal pending with the Commission to strengthen internal controls.[3] In fact, the proposed rule change would complement the closely related obligations imposed by Rule 3010 and proposed Rule 3012. The former sets forth the fundamental requirement to establish and maintain supervisory systems and procedures reasonably designed to achieve compliance with applicable laws, rules and regulations. The latter addresses the execution and efficacy of those systems and procedures. The current proposal would effectively serve as a prequel to Rule 3010 that would compel substantial and purposeful interaction between senior management and compliance personnel at the entry point of compliance policy development, thereby enhancing the quality of those compliance and supervisory systems that are required under Rule 3010 to be established, maintained and upgraded. Thus, the proposal is not duplicative of existing (or proposed) regulatory obligations and would not merely add a "second potential rule violation for the same underlying transgression," as Global contends.

Second, commenters express concern that the proposal could require a CCO to certify to processes in areas that are not within the CCO's responsibility or control, thereby potentially weakening compliance in those areas where the CCO may not have expertise. For example, SIA/BMA suggests that in some firms responsibility for compliance with financial operations or the clearance and settlement process rests with individuals outside the compliance department. In a related comment, NSCP asserts that the proposal would lead compliance officers to limit the scope of their own responsibility and provide a disincentive for novel approaches to business and regulatory challenges.

NASD believes these comments overlook the express language of the proposal, which provides substantial flexibility for members to rely on others with primary compliance responsibility to discharge the proposal's obligations. For example, the proposed interpretive material permits co-certifications by officers other than the CCO who have primary compliance authority over a segment of a member's business operations. Similarly, the interpretive material

[3] *See* Amendment No. 2 to SR-NASD-2002-162, Exchange Act Release No. 48298 (August 7, 2003), 68 FR 48421 (August 13, 2003).

contemplates that the report evidencing a member's processes may be reviewed by such other officers as the member deems necessary to make the certification.

More fundamentally, the basis for having the CCO certify does not rest on the premise that the CCO has either responsibility for the execution of compliance policies or expertise pertaining to each function, product or service. The CCO is the primary advisor to the member on its overall compliance scheme and the particularized rules, policies and procedures that the firm adopts. In such capacity, the CCO is often faced with products and services in which he or she does not have specialized knowledge or experience. But even in those circumstances, the CCO should nevertheless have an expertise in the process of (1) gaining an understanding of the product, service, or line function in question, (2) identifying the relevant rules, regulations, laws and standards of conduct pertaining to such products or services based on experience and/or consultation with those persons who have a technical expertise in the product or service in question, (3) developing or advising other business persons charged with the development of policies and procedures reasonably designed to comport with such standards, and evidencing the supervision by the line managers who are responsible for the execution of compliance, and (4) developing programs to test compliance with the identified standards. It is that expertise in the process of compliance that makes the CCO an indispensable party to the certification.

Moreover, the ambit of the certification proposal is coextensive with that of current Rule 3010(a)(8) and proposed Rule 3012(a)(1). As such, the certification of processes relates only to those specific areas for which there already exists an obligation for a member to establish compliance policies and procedures. NASD believes it follows that the CCO – a designation supported by commenters – should reasonably assume responsibility to discharge the certification requirement in those compliance areas, with reliance as necessary on those other accountable individuals within a member's unique compliance structure.

Since the certification of processes applies only to those areas for which existing rules require compliance systems, the proposal cannot, as NSCP suggests, encourage CCOs to "narrowly define both their own roles and the reach of the various compliance regulations they seek to have their firms address." The scope of compliance regulations that a member must address is not a matter of discretion for the CCO; rather, it is determined by a member's business lines and the attendant laws, rules and regulations. The proposal also would not inhibit a CCO from implementing novel approaches to compliance challenges. Instead, the proposal merely would require the CCO and CEO to certify to the existence of those approaches and document them in a report reviewed by the CEO, CCO and other appropriate officers.

Finally, commenters assert that, to the extent that sufficient attention to compliance is not already encouraged by the existing regulatory framework, the goals of the proposal can be achieved without the certification requirement. To that end, SIA/BMA suggests a modified proposal that, in addition to designation of a CCO, would require (1) preparation of an annual compliance report to be presented to a member's Board of Directors (or equivalent governing body) and Audit Committee that details supervisory processes and significant compliance

initiatives, issues and requirements[4] and (2) mandatory meetings between the CEO and CCO to assess the structure and strength of a member's compliance and supervisory systems and documentation to evidence those discussions.

The SIA/BMA modified proposal essentially incorporates – and in some ways goes beyond – the substantive requirements of the NASD proposal, save the certification requirement. In so doing, SIA/BMA necessarily acknowledge that the meeting and reporting requirements of the proposal are not overly burdensome and will not divert compliance resources away from "critical day-to-day functions" – a concern also raised by Empire. Thus, the concerns expressed by SIA/BMA are reduced to these: the act of certification itself is unduly burdensome and will subject CEOs and CCOs to additional liability and meritless litigation. These remaining concerns also are shared by the other commenters.

SIA/BMA state that it "may be difficult to overstate the time and effort required to administer this process" and suggest that it would misdirect compliance efforts away from preventing and detecting violation of applicable laws, rules and regulations. NASD does not believe the certification requirement and basic compliance obligations are a zero sum game. If members already discharge their compliance obligations satisfactorily and have processes in place to establish, maintain, review, test and modify their policies and procedures, the act of certification will serve to engage the CEO in compliance matters and impose only a minimal additional burden beyond the meeting and reporting requirements to which SIA/BMA have no burden objections. If, however, members do not already have such processes in place, then the certification requirement appropriately will spur a necessary expenditure of compliance resources. Stated another way, the certification is nothing more than a confirmation by a member that it has in place a process that is an indispensable predicate to determining the laws, regulations and rules pertaining to its business and adopting the associated policies and procedures required under Rule 3010. As such, the processes would be necessary to undertake irrespective of this rule proposal, and so it cannot be reasonably argued that the certification imposes any substantive incremental obligation.

Even assuming that the certification process itself imposes some measurable burden on members, NASD believes the investor protection benefits of the proposal outweigh that burden. NASD believes the requirement to execute a certification will result in appreciably greater attention to these important processes and foster more meaningful interaction between compliance and senior management than in the absence of such certification.

Commenters also question the need for the additional potential liability associated with the proposal. As with any effective rule, there must be a potential penalty for failure to comply. Here, the potential liability exists if a CEO or CCO makes a false certification, just as there would be potential liability if either the CEO or CCO failed to comply with enumerated requirements under the kind of modified proposal put forth by SIA/BMA.

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[4] SIA/BMA envision a compliance report similar in nature to that mandated by New York Stock Exchange ("NYSE") Rule 342.30, which requires each member annually to submit to its CEO or managing partner a report on the member's supervision and compliance efforts during the preceding year.

Commenters express further concern that the certification requirement will expose CEOs and CCOs to additional liability beyond a false certification. In particular, commenters predict that the proposal will engender baseless litigation against CEOs and CCOs for compliance and supervisory failures. In response, NASD notes that the interpretive material makes explicit that the certification relates only to processes and that supervisors with business line responsibility are accountable for the discharge of a member's compliance policies and written supervisory procedures. It further states that execution of the certification does not by itself establish business line supervisory responsibility. Therefore, the proposal clearly circumscribes the scope of potential liability for a CEO or CCO in the event of a supervisory shortfall. NASD does not think it appropriate to base its regulatory policy decisions on the assumption that future litigants might propound claims directly at odds with the explicit limitations of its rules.

Amendments

Based on conversations with the Commission staff, NASD is amending the proposal to augment the substance of compliance discussions that must take place at least annually between the CEO and CCO. Currently, the interpretive material requires that the CEO and CCO must hold one or more meetings each year to discuss and review the processes that are the subject of the certification.

NASD believes that those mandated meetings present a practical and important opportunity to discuss more broadly the quality of compliance, including such areas as resources, risk and deficiencies. Accordingly, NASD is amending the proposal to require that the CEO and CCO also discuss during their meetings the member's compliance efforts to date and that they further identify and address significant compliance problems and plans for emerging businesses areas. These enumerated topics in the amendment closely parallel the requirements in NYSE Rule 342.30, the substance of which drew favorable comment from SIA/BMA. NASD notes that the amendment to include an expanded discussion of compliance matters during meetings between the CEO and CCO would not require the CEO and CCO to certify to the adequacy of its compliance program or that all compliance deficiencies have been identified and addressed. Rather, it requires only that the CEO and CCO address those subjects during their meetings, which are part of the processes to which the certification extends.

For the foregoing reasons, and to make certain non-substantive changes to the rule text, NASD is hereby amending the proposed interpretive material as follows [Proposed new language is underlined; proposed deletions are in brackets]:

IM-3013. Annual Compliance And Supervision Certification

The NASD Board of Governors is issuing this interpretation to the requirement under Rule 3013(b), which requires that the member's chief executive officer (or equivalent officer) and chief compliance officer execute annually[1] a certification that the member has in place processes to establish, maintain, review, test and modify written compliance policies and written supervisory procedures reasonably designed to achieve compliance with

applicable NASD rules, MSRB rules and federal securities laws and regulations. The certification shall state the following:

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 3013[ ](b), the undersigned make the following certification:

1. The Member has in place processes to:

(a) establish, [and] maintain and review policies and procedures reasonably designed to achieve compliance with applicable NASD rules, MSRB rules and federal securities laws and regulations;

(b) modify such policies and procedures as business, regulatory and legislative changes and events dictate; and

(c) test the effectiveness of such policies and procedures on a periodic basis, the timing and extent of which is reasonably designed to ensure continuing compliance with NASD rules, MSRB rules and federal securities laws and regulations;

2. The Member's processes, with respect to item 1 above, are evidenced in a report reviewed by the chief executive officer (or equivalent officer), chief compliance officer and such other officers as the Member may deem necessary to make this certification. These processes at a minimum must include:

(a) one or more meetings between the chief executive officer (or equivalent officer) and the chief compliance officer to:

(i) discuss and review the matters that are the subject of this certification[,];

(ii) discuss and review the member's compliance efforts to date; and

(iii) identify and address significant compliance problems and plans for emerging businesses areas. [and]

(b) review of the report by the Member's board of directors and audit committee; and

3. The undersigned chief executive officer (or equivalent officer), chief compliance officer and other officers as applicable (referenced in item 2 above) have consulted with or otherwise relied on those employees, officers, outside consultants, lawyers and accountants, to the extent they deem appropriate, in order to attest to the statements made in this certification.

It is critical that each NASD member understand the importance of employing comprehensive and effective compliance policies and written supervisory procedures. Compliance with applicable NASD rules, MSRB rules and federal securities laws and [rules]regulations is the foundation of ensuring investor protection and market integrity and is essential to the efficacy of self-regulation. Consequently, the certification requirement is intended to require processes by each member to establish, maintain, review, test and modify its compliance policies and written supervisory procedures in light of the nature of its businesses and the laws and rules that are applicable thereto, and to evidence such processes in a report reviewed by those executing the certification.

The execution of the certification by the chief compliance officer (and other designated officers with primary compliance responsibility) is intended to ensure that the person(s) charged with managing the member's compliance program has regular and significant interaction with senior management concerning the subject matter of the certification. The rule permits co-certifications by other compliance officers that report to the chief compliance officer. However, the NASD Board of Governors expects that any such co-certifications will be executed only by senior compliance officers that have primary compliance responsibility over a segment of a member's business operations.

The NASD Board of Governors recognizes that supervisors with business line responsibility are accountable for the discharge of a member's compliance policies and written supervisory procedures. The signatories to the certification are certifying only as to having processes in place to establish, maintain, review, test and modify the member's written compliance and supervisory policies and procedures and the execution of this certification does not by itself establish business line responsibility.

The requirement to designate a chief compliance officer does not preclude such person from holding any other position within the member, including the position of chief executive officer, provided that such person can discharge the duties of a chief compliance officer in light of his or her other additional responsibilities. The requirement that a member's processes include a review of the report (required by item 2 of the certification) by the board of directors and audit committee does not apply to members that do not utilize these types of governing bodies and committees in the conduct of their business.[2]

The report required in item 2 of the certification must document the member's processes for establishing, maintaining, reviewing, testing and modifying compliance policies. The report must be produced prior to execution of the certification and be reviewed by the chief executive officer (or equivalent officer), chief compliance officer and any other officers the member deems necessary to make the certification. The report should include the manner and frequency in which the processes are administered, as well as the identification of officers and supervisors that have responsibility for such administration. The report need not contain any conclusions produced as a result of following the processes set forth therein. The report may be combined with any other compliance report or other similar report required by any other self-regulatory organization provided that (1) such report is clearly titled in a manner indicating that it is responsive to the requirements of the certification and this Interpretive Material; (2) a member that submits a report for review in response to an NASD request must submit the report in its entirety; and (3) the member makes such report in a timely manner, i.e., annually.

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[1] Members must ensure that each ensuing annual certification is effected no later than on the anniversary date of the previous year's certification.

[2] Members, as a part of their process, must have the report reviewed by their governing bodies and committees that serve a similar functions in lieu of a board of directors and audit committee.

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We hope this response to comments is helpful and that the amendments adequately address the issues discussed with the Commission staff. Please feel free to contact me at (202) 728-8451 if you wish to discuss this matter further.

Sincerely,

Philip A. Shaikun
Associate General Counsel