



CRITICAL ELEMENTS OF AN EFFECTIVE SUPERVISORY STRUCTURE

Rules Adopted by the NASD and the NYSE in the Past Year Have Heightened the Supervisory Requirements for Securities Firms. Among the More Significant Changes Are a Certification Requirement by the Chief Executive Officer and Mandatory Compliance Inspections.

By Paul B. Uhlenhop*

The purpose of this article is to focus on the critical elements of an effective supervisory structure. To create such a structure, it is necessary to understand the supervisory responsibilities. Part I of this article discusses the law and rules that define supervisory responsibilities. Part II discusses the regulatory liability of compliance officers. Finally, Part III discusses the design of a supervisory structure.

I. SUPERVISORY RESPONSIBILITIES IN GENERAL

Current Rules

The supervisory responsibility of broker-dealers and persons who may be supervisors is spelled out in the Securities Exchange Act of 1934 ("34 Act") in Sections 15(b)(4)(E) and 15(b)(6), New York Stock Exchange ("NYSE") Rule 342 and National Association of Securi-

ties Dealers Regulation, Inc. ("NASD") Conduct Rules 3010, 3012 and 3013.

The 34 Act indirectly mandates a supervisory requirement. Under the Act, a broker-dealer and its supervisory personnel are strictly liable for a violation by a subordinate that they supervise unless the broker-dealer has adequate written supervisory procedures that have been reasonably implemented. Section 15(b)(4)(E) of the Act provides for liability of a broker-dealer or an associated person who has violated the securities laws or who "has failed reasonably to supervise, with a view to preventing violations of the provision of such statutes, rules and regulations, another person who commits such a violation if such person is subject to his supervision." Subsection (E) further provides that no person shall be deemed to have failed reasonably to supervise any other person if:

- (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect,

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insofar as practicable, any such violation by such person, and

- (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and systems without reasonable cause to believe that such procedures and systems were not being complied with. (emphasis added)¹

NASD Rule 3010 is similar to Section 15 of the Act in structuring its requirements around the concept of reasonable supervision. Rule 3010(a) requires that

Each member shall 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 applicable NASD Rules. Final responsibility for proper supervision shall rest with the member.

In particular, each member firm shall establish and maintain a system of supervision and enforce it to supervise the types of business in which it engages and to supervise the activities of its registered representatives and asso-

ciated persons in a manner reasonably designed to achieve compliance with the securities laws and regulations and with the applicable rules of the NASD. Rule 3010 establishes a number of requirements including, but not limited to, the following:

- (1) written supervisory procedures;
- (2) designation of registered principals with authority to carry out the supervisory responsibilities for the type of business that the member is authorized to conduct;
- (3) designation of an Office of Supervisory Jurisdiction for each location where business is conducted;
- (4) designation of one or more registered principals at each OSJ, including the main office, and one or more registered representatives or principals at each non-OSJ branch office, with authority to carry out supervisory responsibilities assigned to that office;
- (5) the assignment of each registered person to an appropriately registered representative or principal;
- (6) qualified supervisory personnel;
- (7) annual compliance review; and

1. 34 Act, Section 15(b)(4)(E) ; 15 U.S.C. 78(o)(b)(4)(E).

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- (8) designation of one or more principals who shall review the supervisory systems and inspections and take or make recommendations to senior management of appropriate action reasonably designed to comply with applicable laws and regulations.

Rule 3010(b) requires that the written supervisory procedures set forth the titles, registration status and location of the supervisory personnel and *the specific responsibilities* of each supervisory person. A member must maintain internal records regarding all such persons and the date when their responsibilities become effective. Last, but not least, each member must maintain written supervisory procedures at each OSJ and each location where supervisory activities are conducted. In addition to the annual review of supervisory procedures required by Rule 3010(a), Rule 3010(b) requires further that these procedures be changed *any time* there is a material change in the business of the member. The recent amendments to Rule 3013 require specific review of procedures as business regulatory and legislative changes and events dictate. This in essence means that a broker-dealer should review its procedures on a regular and consistent basis. As discussed below, the NASD has recently amended Rule 3010 to add significant new requirements with respect to procedures.

In addition, a new Rule 3012 concerning the supervisory control system was recently adopted as discussed below. Also, the certification requirements for the chief executive officer and responsibilities of the chief compliance officer were adopted by NASD Rule 3013. Similar rules were adopted by the NYSE. These rules are discussed below. It should also be noted that the NASD has filed with the SEC a proposed amendment to NASD Rule 3010(a)(3) and 3010(b)(1) that extends those rules to both registered representatives, registered principles as well as other associated persons.

Rule 3012 - Supervisory Control System

When the NASD adopted recent amendments to Rule 3010, it also adopted Rule 3012 effective January 31, 2005. In addition, on January 30, 2005, the NASD published Notice to Members ("NTM") 05-08 providing advice with respect to specific matters covered by Rule 3012. Recently, the NASD published further guidance in Notice to Members 05-29 with respect to Rule 3012(a)(1). Rule 3012 requires members to designate a

principal who shall be responsible for monitoring the supervisory control policies and procedures, including testing them to verify that they are reasonably designed to achieve compliance, and to create and amend the supervisory procedures where needed. The designated principal must submit to senior management no less than annually a report detailing the system, a summary of the tests, significant deficiencies, and procedures to remedy the deficiencies. Procedures are designed to review and supervise customer activity by persons performing supervisory functions. The supervisory control system rule states in part as follows:

- (1) Each member shall designate and specifically identify to NASD one or more principals who shall establish, maintain, and enforce a system of supervisory control policies and procedures that (A) test and verify that the 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 with applicable NASD rules and (B) create additional or amend supervisory procedures where the need is identified by such testing and verification. The designated principal or principals must submit to the member's senior management no less than annually, a report detailing each member's system of supervisory controls, the summary of the test results and significant identified exceptions, and any additional or amended supervisory procedures created in response to the test results.
- (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) 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.

Rule 3012 in subsection (2)(A) provides a limited exemption for small firms as follows:

- (ii) 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.

To qualify for the limited exemption, the member must document in its supervisory control procedures the factors it has relied upon to obtain an exemption by reason of its size and resources and why it has no other alternative. The NTM accompanying the rules states the exemption will be "narrowly construed." It should also be noted that the accompanying release states that the NASD will propose a rule requiring members using the limited exemption to notify the NASD of such use.

As noted in subsection (2)(A)(i) above, the person who does the review must be senior to or "otherwise independent" of the producing manager. The definition of "otherwise independent" precludes reporting directly or indirectly to the producing manager under review and must not be situated in the same office as the producing manager or have supervisory responsibility over the activity being reviewed, including not being *directly* compensated based in whole or in part from revenues accruing from those activities. Furthermore, there is a two-year requirement for alternating the reviewer. Does the "otherwise independent" requirement apply to a person who is senior? The NTM accompanying the rule appears to state that these requirements apply notwithstanding the word "or." This means that a senior person who receives part

of his compensation based upon a formula involving the revenues of the supervised persons unit may not serve as the senior or independent reviewer unless the small firm exception applies. *See also* discussion of subsection (C) of Rule 3012(b)(2) below which requires specialized procedures under certain circumstances for producing managers who supervise certain activities. Under subsection (C), it appears that a senior manager may receive some compensation based on the revenues of the producing manager's unit or the producing manager although specialized procedures are necessary if he receives more than 20% of his compensation from supervised producing manager units. *See also* Rule 3010(c)(3) below which discusses independence in connection with inspection of offices. It is likely that these two provisions will be interpreted in concert, although they are somewhat different in their wording.

NTM 05-08 provides advice with respect to the scope of the term "producing manager." The NTM advises that a producing manager would include a branch office manager, sales manager, regional or district sales manager or any person who performs similar functions and services customer accounts in a capacity requiring registration. The NTM also makes clear that institutional accounts are included and that there is no de minimus exception. However, there is an exception for accommodation accounts where due to vacation, travel, illness, or similar circumstances, an account executive is out and orders must be entered for customers. The NTM warns that such status is a facts and circumstances question and cannot be a regular occurrence. Importantly, the NTM also states that stock lending and certain prime brokerage activities, specifically clearing, financing and custody functions relating to prime brokerage, would not be considered to be within rule 3012(b)(2) although they are subject to the general supervisory requirements. Other customer activity with respect to prime brokerage would appear to be covered and not excluded.

Rule 3012(a)(2)(B) requires that procedures be reasonably designed for review and monitoring of the following activities:

- (i) all transmittals of funds (e.g., wires or checks, etc.) or securities from customers to third party accounts (i.e., a transmittal that would result in a change of beneficial ownership); from customer accounts to outside entities (e.g., banks, investment companies, etc.); from customer accounts

to locations other than a customer's primary residence (e.g., post office box, "in care of" accounts, alternative address, etc.); and between customers and registered representatives, including the hand-delivery of checks;

- (ii) customer changes of address and the validation of such changes of address; and
- (iii) customer changes of investment objectives and the validation of such changes of investment objectives.

The policies and procedures established pursuant to paragraph (a)(2)(B) must include a means or method of customer confirmation, notification, or follow-up that can be documented.

If a member is not engaged in all or any of the activities above, the member must specify in its procedures those activities in which it does not engage and also document that such procedures must be in place before a member engages in them.

NTM 05-08 further discusses what would be considered sufficient to demonstrate compliance with the required notification of clients with respect to changes of address, changes of investment objectives, and transmittal of funds or securities. Any type of notification or confirmation is permitted as long as it can be documented. However, based on many years of experience defending cases, direct confirmation to the address of the client is by far the preferable means. Telephone conversations are inherently suspect, although NTM appears to allow them. NTM 05-08 also carves out that the customer notification does not apply to ACATS transfers, but any ex-ACTS transfer is covered, such as letters of authorization for transfers to charitable organizations, another broker-dealer or similar circumstances where less than the whole account is transferred. NTM 05-08 specifically provides that the following types of changes would not require prior approval by the firm:

1. allocations from a parent holding account to sub-accounts by an entity registered under Section 8 of the Investment Company Act of 1940;
2. allocations among sub-accounts by investment advisers registered under Section 203 of the Investment

Advisers Act of 1940 ('Advisers Act') or registered with the appropriate state authority, as required by Section 203A of the Advisers Act; or

3. allocations in the context of a prime brokerage arrangement.

Subsection C of Rule 3012(a)(2) requires:

Procedures that are reasonably designed to provide *heightened supervision over the activities of each producing manager who is responsible for generating 20% or more of the revenue of the business units supervised by the producing manager's supervisor*. For the purposes of this subsection only, the term "heightened supervision" shall mean those supervisory procedures that evidence supervisory activities that are designed to avoid conflicts of interest that serve to undermine complete and effective supervision because of the economic, commercial, or financial interests that the supervisor holds in the associated persons and businesses being supervised. In addition, for the purpose of this section only, when calculating the 20% threshold, all of the revenue generated by or credited to the producing manager or the producing manager's office shall be attributed as revenue generated by the business units supervised by the producing manager's supervisor irrespective of a member's internal allocation of such revenue. A member must calculate the 20% threshold on a rolling, twelve-month basis. (Emphasis added.)

It should be noted that the New York Stock Exchange rule uses a 10% threshold rather than the NASD's 20% threshold. If a dual member follows the NYSE rule, it will be in compliance. The above subsection, while seemingly clear on its face, in actual operation raises numerous problems that have been unanswered. As noted above, the question and answer NTM 05-08 makes it clear that a producing manager includes both retail and institutional. The threshold amount, however, is determined based upon any override or other income derived by the senior supervisor from the producing manager's customer activity. This raises numerous questions. NTM 05-08 states

that if there is *no link* between the supervisor's salary and the producing manager's production, there would be no conflict. The NTM did not indicate whether the link has to be direct or whether it may be indirect. In cases of discretionary bonuses, it remains unclear. It would seem that if a factor in a discretionary bonus program included activity by a producing manager's unit, there would be the conflict and one would have to look at the threshold percentage on a revenue basis. It also appears that all revenue generated or credited to the producing manager or the producing manager's office is attributed as revenue generated by the business units supervised by the producing manager's supervisor.

Any member in compliance with substantially similar requirements of the New York Stock Exchange is deemed to be in compliance with the provisions of Rule 3012.

Required Inspections

In addition to the review and testing required by Rule 3012, Rule 3010(c) was recently amended, effective December 31, 2005 to require member inspection of its operations to evaluate its system of supervision. The inspection team must be "independent" as explained below. Rule 3010(c), in part, provides as follows:

1. Each member shall conduct a review, at least annually, of the businesses in which it engages, which review shall be reasonably designed to assist in detecting and preventing violations of, and achieving compliance with, applicable securities laws and regulations, and with applicable NASD rules. *Each member shall review the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or abuses.*
 - (A) Each member shall inspect *at least annually every office of supervisory jurisdiction and any branch office* that supervises one or more non-branch locations.
 - (B) Each member shall inspect *at least every three years every branch office that does not supervise one or more non-branch locations*. In establishing how often to inspect each non-supervisory branch office, the firm shall consider whether the nature and complexity of the securities activities for which the location is responsible, the volume

of business done, and the number of associated persons assigned to the location require the non-supervisory branch office to be inspected more frequently than every three years. If a member establishes a more frequent inspection cycle, the member must ensure that at least every three years, the inspection requirements enumerated in paragraph (c)(2) have been met. The non-supervisory branch office examination cycle, an explanation of the factors the member used in determining the frequency of the examinations in the cycle, and the manner in which a member will comply with paragraph (c)(2) if using more frequent inspections than every three years shall be set forth in the member's written supervisory and inspection procedures.

- (C) *Each member shall inspect on a regular periodic schedule every non-branch location*. In establishing such schedule, the firm shall consider the nature and complexity of the securities activities for which the location is responsible and the nature and extent of contact with customers. The schedule and an explanation regarding how the member determined the frequency of the examination schedule shall be set forth in the member's written supervisory and inspection procedures.

Each member shall retain a written record of the dates upon which each review and inspection is conducted. (Emphasis added.)

The above new rule requirement is fairly clear with respect to inspections of retail type offices. However, subsection (C) seems to also require the inspection of all other operations of a broker-dealer, such as proprietary trading, trading execution, research, corporate finance, market making, and floor exchange activities. While this is certainly desirable, if the NASD intended to do so, it could and should clarify that all offices and all operations are to be inspected with some frequency based on the nature of the business. The SEC staff of the Division of Market Regulation has on its web site Staff Legal Bulletin No. 17 entitled "Remote Office Supervision March 19, 2004." This is an outstanding discussion and checklist of items that should be covered in supervisory procedures and compliance policies for branch and other remote offices.

Rule 3010(c)(2) requires that a member must make a written report and keep on file for a minimum of three years the record of each office inspection and review conducted pursuant to paragraph (c)(1)(C), quoted above, if the regular periodic schedule is longer than the three year cycle. In such case, the report must be maintained until completion of the next inspection report.

Each report is required to include testing and verification of the firm's policies and procedures, including supervisory policies and procedures in the following areas:

- (A) safeguarding of customer funds and securities;
- (B) maintaining books and records;
- (C) supervision of customer accounts serviced by branch office managers;
- (D) transmittal of funds between customers and registered representatives and between customers and third parties;
- (E) validation of customer address changes; and
- (F) validation of changes in customer account information.

If a member does not engage in all of the activities set forth above, the report must note that the firm does not engage in those activities and that before engaging in them a supervisory policy and procedure needs to be in place.

In addition, Rule 3010(c)(3) requires independence in connection with any inspection. Specifically, the rule requires the following:

- (3) *An office inspection by a member pursuant to paragraph (c)(1) may not be conducted by the branch office manager or any person within that office who has supervisory responsibilities or by any individual who is supervised by such person(s). However, if a member is so limited in size and resources that it cannot comply with this limitation (e.g., a member with only one office or a member has a business model where small or single-person offices report directly to an office of supervisory jurisdiction manager who is also considered the offices' branch office*

manager), the member may have a principal who has the requisite knowledge to conduct an office inspection perform the inspections. The member, however, must document in the office inspection reports the factors it has relied upon in determining that it is so limited in size and resources that it has no other alternative than to comply in this manner.

A member must have in place procedures that are reasonably designed to provide heightened office inspections if the person conducting the inspection reports to the branch office manager's supervisor or works in an office supervised by the branch manager's supervisor and the branch office manager generates 20% or more of the revenue of the business units supervised by the branch office manager's supervisor. For the purposes of this subsection only, the term "heightened inspection" shall mean those inspection procedures that are designed to avoid conflicts of interest that serve to undermine complete and effective inspection because of the economic, commercial, or financial interests that the branch manager's supervisor holds in the associated persons and businesses being inspected. In addition, for the purpose of this section only, when calculating the 20% threshold, all of the revenue generated by or credited to the branch office or branch office manager shall be attributed as revenue generated by the business units supervised by the branch office manager's supervisor irrespective of a member's internal allocation of such revenue. A member must calculate the 20% threshold on a rolling, twelve-month basis. (Emphasis added.)

It should be noted that the independence requirement of Rule 3010(c)(3) for inspections is slightly different than the independence provisions in Rule 3012. The heightened supervision requirements of Rule 3010 and 3012 have similarities but are different. The requirement for 3012(a)(2)(C) applies to heightened supervision of the activities of each producing manager whereas the requirement in 3010 quoted above applies to heightened inspections of offices. Under Rule 3010, (i) if the person conducting the inspection reports to the supervisor of the branch manager or works in the office supervised by the supervisor of the branch manager and (ii) the branch

office generates 20% or more of the revenue of the business unit supervised by the supervisor, heightened supervision of the office applies. This latter 3010 requirement would apply in situations where there is a proprietary trading branch office that is supervised, even though the manager of the branch office is not a producing manager in the sense of Rule 3012. This is a subtle but key difference that must be taken into consideration in inspection of offices where the manager is not a producing manager.

Rule 3010 has a broader exemption than Rule 3012. The 3010 exemption is not limited only to small firms, but may be used by larger firms. The adopting release says "A member firm may use the exception, regardless of its size and resources, if the firm has a business model where single or small offices report directly to an OSJ manager who is considered the office's branch office manager (also referred to as the 'independent dealer' or 'independent contractor model')." The OSJ, however, would be subject to the inspection requirements. From a practical standpoint in this model of business, a firm would do well to do inspections of the single or small person offices as a routine course and many broker-dealers do.

Rule 3010(g) defines Office of Supervisory Jurisdiction and Branch Office, which is discussed further below.

Employee Investigation

Rule 3010(e) requires the investigation of the background business qualifications and experience of each registered person. The SEC Books and Records Rule 17a-3(a)(12) also requires a full history of each person who is employed by a firm or associated with handling funds, securities or soliciting customers. Rule 3010(f) also provides as follows:

Any applicant for registration who receives a request for a copy of his or her Form U-5 from a member pursuant to this Rule shall provide such copy to the member within two (2) business days of the request if the Form U-5 has been provided to such person by his or her former employer. If a former employer has failed to provide the Form U-5 to the applicant for registration, such person shall promptly request the Form U-5, and shall provide it to the requesting member within two (2) business days of receipt

thereof. The applicant shall promptly provide any subsequent amendments to a Form U-5 he or she receives to the requesting member.

Review of Transactions and Correspondence

NASD Rule 3010(d) has a number of requirements regarding review of transactions and correspondence. Rule 3010(d)(1) requires a member's procedures to include review and notation by the registered principal in writing of all transactions and of all incoming and outgoing written and electronic correspondence of registered representatives relating to its investment banking or securities business. These procedures must be in writing, maintained and designed to reasonably supervise each registered representative.

Rule 3010(d)(2) requires each member to have written procedures to review incoming and outgoing written and electronic correspondence with the public relating to its business. The procedures need to be able to identify customer complaints to ensure that customer funds and securities are handled in accordance with the firm's policies. Although 3010(d)(2) permits review of correspondence after distribution or after receipt, procedures in such case require special provisions with respect to education and training of associated persons with documentation of such education.

Rule 3010(d)(3) requires members to retain correspondence relating to its business with details regarding the person's prepared outgoing correspondence and who reviewed incoming and outgoing correspondence.

Tape Recording of Conversations

Rule 3010(b) also requires tape recording of conversations and other special procedures with respect to certain registered persons at a disciplined firm as defined in the rule. A "disciplined" firm is determined based on the disciplinary history of registered representatives and the size of the firm.

Proposed Rule Change — Heightened Procedures for Problem Employees

In September 2003, the NASD 03-49 proposing amendments requiring heightened supervision procedures for

associated persons with a specified threshold of industry or regulatory related events. Although this rule is not effective, we understand that the NASD is examining firms to determine if they have heightened supervision plans in as part of their written supervisory procedures even though the rule is not in place. The NASD staff believes that even though the rule is not in place, written supervisory procedures require heightened supervision of certain employees who have a history of customer complaints, arbitrations, litigations or regulatory actions. Under the proposed rule, special supervisory procedures would have to be adopted over the activities of the associated persons who have:

- (1) three or more customer complaints or arbitrations in the previous five years;
- (2) subject to three or more pending, adjudicated or settled regulatory actions or investigations;
- (3) subject to two or more terminations for cause or internal reviews for alleged investment-related misconduct in the previous five years.

The special supervisory procedures currently are required for most persons who have been permitted to return to the business after they have been subject to a disqualification. Under the proposed rule, the firm must have written supervisory procedures for heightened supervision with registered persons falling within its definition. However, the firm may decide for reasons set forth not to impose the heightened supervisory restrictions. For example, if there have been three or more customer complaints and arbitrations and the associated person has won the arbitrations and the complaints are baseless, the firm has the option not to impose heightened supervisory procedures but must document the reasons for excepting any person from the procedures. It is expected that this proposed rule will be in effect shortly.

Rule 3013 — CEO Certification

The NASD has adopted Rule 3013² which requires every member to designate a Chief Compliance Officer ("CCO"). In addition, the rule requires that there be an annual certification from the Chief Executive Officer ("CEO") 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, and that the chief executive officer has conducted one or more meetings with the chief compliance officer in the preceding 12 months to discuss such processes.

The accompanying interpretation IM-3013 requires the CEO to certify the following:

1. The Member has in place processes to:
 - (a) Establish, 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 undersigned chief executive officer (or equivalent officer) has conducted one or more meetings with the chief compliance officer in the preceding 12 months, the subject to which satisfy the obligations set forth in IM-3013.
3. The Member's processes, with respect to paragraph 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, and submitted to the Member's board of directors and audit committee.
4. The undersigned chief executive officer (or equivalent officer) has consulted with the chief compliance officer and other officers as applicable (referenced in paragraph 3 above) and such other employees, outside

2. See NTM 04-79 (November 2004).

consultants, lawyers and accountants, to the extent deemed appropriate, in order to attest to the statements made in this certification. (emphasis added)

The explanatory material in IM-3013 states that if the member does not have a Board of Directors or Audit Committee or equivalent, there need not be a report submitted to them.

The Interpretation specifically states that if a CEO has concluded that there is inadequate basis for making the certification, and does not make it, that refusal would constitute conduct "inconsistent with the observance of high standards of commercial honor and just and equitable principals of trade in violation of NASD Rule 2110."

The interpretive material recognizes that supervisors with business line responsibility are accountable for discharge of a member's compliance policies and supervisory policies. IM-3013 also states that the NASD recognizes that the required consultation between the CEO and the CCO without more would not establish business line responsibility by the CCO for supervision.

Written Procedures Practice

Establishment of written supervisory procedures is a complex and continuing task. Appropriate procedures cannot be taken from a book or downloaded from the internet. Boilerplate alone is not adequate. While "canned" procedures may provide a useful starting point, supervisory procedures have to be tailored to each broker-dealer and its business. NASD NTM 99-45 and NTM 98-96 provide an excellent statement of what the NASD expects in this regard. The recent NTM 05-29 discusses steps to be taken in designing supervisory procedures. While the summary is relatively short, it does provide a worthwhile checklist of broad procedures to be followed. One needs to consider the customer base, product lines, and geographic locations of offices and personnel. Further, the broker-dealer's current systems, operating units and organizational structures need to be considered. Likewise, experience of personnel and their background are important in developing procedures. The applicable regulatory requirements are constantly changing and business is constantly changing, so it is a never-ending chase to keep written supervisory procedures current. Most important, supervisory procedures must be practical and

tailored to the business. Procedures that are too complex are generally not followed. If they are not followed, there is almost automatic liability. Complex procedures that are not followed are, in many cases, worse than no procedures at all. NTM 05-29 specifies the following that should be considered in designing procedures:

- The first step a member should consider taking when designing its supervisory control system is to conduct an inventory of all of the member's businesses and of the securities laws, regulations, and NASD rules relevant to those businesses.
- The member should then analyze the requirements of those applicable laws, regulations and NASD rules by asking, "what questions do the requirements raise that must be answered?" For example, what conduct is prohibited, compelled, limited, or conditioned? How will the member assure compliance with those requirements? Who at the member firm will be responsible for supervising such conduct, and what are the method and parameters of such supervision?
- The member should then analyze its own supplementary internal requirements, if any. Will the member's internal business policies further restrict conduct?
- The member should next compare the answers that result from the analysis conducted above to its current supervisory procedures and use that comparison to determine if any gaps or deficiencies in those procedures are evident.
- The member should then analyze how to address any identified gaps or deficiencies. To do this, the member should first use the same type of question-based approach outlined above. For example, if the member has entered into one or more new businesses or aspects of an existing business, does that call into question other laws or rules or a different application of such laws and rules? Have laws or rules changed in a manner that renders existing procedures inaccurate, obsolete, or incomplete? Has the member's history with respect to customer complaints, litigations/arbitrations, regulatory inquiries or actions, internal surveillance history and experience, branch office examinations, internal audits, or other reported matters in the media or by the regulators with respect to other broker-dealers raised questions as to the sufficiency of the mem-

ber's procedures?

- The answers resulting from this analysis can be distilled into new or amended supervisory procedures that resolve the identified gaps or deficiencies in the member's supervisory procedures.

While these procedures are certainly a summary and general in nature, they do provide a helpful checklist. More detail with respect to designing procedures is set forth in the section of this article entitled "Designing the Supervisory Structure."

OSJs and Branch Offices

NASD Rule 3010(g)(1) defines an Office of Supervisory Jurisdiction (OSJ) as follows:

"Office of Supervisory Jurisdiction" means any office of a member at which any one or more of the following functions take place:

- (A) order execution and/or market making;
- (B) structuring of public offerings or private placements;
- (C) maintaining custody of customers' funds and/or securities;
- (D) final acceptance (approval) of new accounts on behalf of the member;
- (E) review and endorsement of customer orders, pursuant to paragraph (d) above;
- (F) final approval of advertising or sales literature for use by persons associated with the member, pursuant to Rule 2210(b)(1); or
- (G) responsibility for supervising the activities of persons associated with the member at one or more other branch offices of the member.

The NASD is reviewing the definition of OSJ in light of the recent changes in the business, particularly with respect to trading firms. The NASD has granted limited

relief in this area for offsite proprietary trading locations where the trading system has real time monitoring capability at an office of an OSJ or the electronic trading system at the OSJ has approval control or limits on executions. This relief has been granted only in connection with proprietary trading transactions. The NASD has not permitted such relief in the case of any type of customer transactions where the office is held out to the public as an office of the firm.

Rule 3010(g)(2)(A) defines the term Branch Office as "any location identified by any means to the public or customers as a location at which the member conducts an investment banking or securities business." However, the following are excluded from the definition of branch office:

- (a) any location identified in a telephone directory line listing or on a business card or letterhead, which listing, card, or letterhead also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch locations are directly supervised;
- (b) any location referred to in a member advertisement, as this term is defined in Rule 2210, by its local telephone number and/or local post office box provided that such reference may not contain the address of the non-branch location and, further, that such reference also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch location are directly supervised; ...
- (c) any location identified by address in a member's sales literature, as this term is defined in Rule 2210, provided that the sales literature also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch locations are directly supervised; [or]
- (d) any location where a person conducts business on behalf of the member occasionally and exclusively by appointment for the convenience of customers, so long as each customer is provided with the address and telephone number of the

branch office or OSJ of the firm from which the person conducting business at the non-branch location is directly supervised.

Rule 3010(g)(3) provides that:

- (3) A member may substitute a central office address and telephone number for the supervisory branch office or OSJ locations referred to in paragraph (g)(2) above provided it can demonstrate to the Association's District Office having jurisdiction over the member that it has in place a significant and geographically dispersed supervisory system appropriate to its business and that any investor complaint received at the central site is provided to and resolved in conjunction with the office or offices with responsibility over the non-branch business location involved in the complaint.

It is important to remember that the terms "Branch Office" and "OSJ" are not synonymous. Because the differences in supervisory requirements between Branch Office and OSJ can be confusing, the terms need to be reviewed carefully when, for example, determining whether an office really is an OSJ or whether a Branch Office falls within the subparagraph (g)(2) definition. The branch office exclusions of Rule 3010(g)(2) offer a variety of helpful relief for remote offices and representatives. Further relief may be found in subsection (g)(3) of Rule 3010, which permits a member to substitute a central office address and telephone number for the supervisory branch office or OSJ under certain conditions, the most important of which is that a supervisory program exists to review complaints and to see that they are followed up with the local office.

The NASD has proposed revision of the definition of "Branch Office" in NASD Rule 3010(g)(2) designed to allow registration of branch offices through the central registration depository system. The proposed definition has gone through several amendments as a result of comments from the public and National Association of Securities Administrators. The current definition of a branch office as set forth above applies to any location identified to the public as a location in which the member conducts an investment banking or securities business. The proposed definition is any location other than the main office where one or more associated persons or members regu-

larly conduct the business of effecting any transactions in or inducing or attempting to induce the purchase or sale of any security or that is held out as such, excluding:

- (A) a customer service or back office type function where there are no sales activities;
- (B) certain associated persons' primary residences subject to certain limitations and restrictions;
- (C) temporary locations used for securities business less than 30 days a year (i.e., secondary residence or summer home);
- (D) an office of convenience to meet with customers where they are located, which is not held out to the public as a branch office;
- (E) any location that is primarily engaged in non-securities activities and from which there are less than 25 securities transactions effected in any one year, provided there is information concerning the address, telephone number, location from which the associated person regularly conducts business;
- (F) activities on the floor of a registered national exchange; and
- (G) a temporary location in connection with a business continuity plan.

Unfortunately, the change in the rule will sweep in a number of locations that were previously not branch offices, primarily trading offices where firms conduct proprietary trading on electronic markets. Electronic markets were not excluded from the national securities exchange definition. Thus, a broker-dealer that trades on eSpeed or similar upstairs electronic securities markets and does not hold the office out to the public and does not deal with any customers but conducts only proprietary trading will fall within the proposed definition. The proposal has been pending for some time and there is still controversy; it is unclear whether the new definition will be adopted.

New York Stock Exchange Rule 342

The SEC recently approved the amendment to NYSE Rule 342 and certain other rules of the NYSE so that such

rules are similar to the amended NASD Rules 3010 and 3012. The effective date of Rule 342 and other recent NYSE rules adopted at the same time was January 31, 2005, the same effective date as the new NASD rules. The NYSE amended Rule 401 with respect to transmitting funds from customer accounts, customer changes of address and customer changes of investment objectives, requiring new procedures with respect to all of those areas. Also, Rule 408 was amended to be parallel to the NASD rule changes discussed previously. Rule 410 was changed with respect to maintenance of orders received from customers and changes in account name or designation. While Rule 342 does not define a branch office, it does require prior NYSE consent for each office "other than a main office." Thus, under the literal wording of the rule, when a registered representative operates from home or a remote location, each such location is considered an office. However, the NYSE has supplemented Rule 342 so that the rule is similar in concept, if not wording, to the NASD rule. For that reason, NYSE Rule 342 is not discussed at length in this paper.

II. COMPLIANCE OFFICERS

The SEC Position

Over the past 10 years, the SEC enforcement staff and various self-regulatory organizations have brought proceedings against compliance officers for failure to supervise. The SEC has clearly stated that legal and compliance personnel are not automatically supervisors for purposes of the 34 Act. The SEC and other regulators, when determining whether a compliance officer has supervisory responsibility, will focus on the degree of responsibility, ability, or authority to affect the conduct of the broker whose behavior is at issue. See *In re Gutfreund*.³ A more basic test is whether the compliance officer has the ability to hire or fire an employee. See *In re Arthur James Huff*.⁴ However, since *Gutfreund*, this later test is not definitive. Under *Gutfreund*, a compliance officer will be deemed to be a supervisor if it is shown that he or she was in a unique position in relationship to the wrongful conduct such that he or she has the ability to stop it and that the employer has authorized the particular compliance personnel to go beyond his usual compliance and legal duties to supervise a particular employee or operation.

In the 21(a) Report accompanying the *Gutfreund* consent order, then-Commissioner Mary L. Schapiro (now President of the NASD) stated as follows:

There are three critical messages in this report concerning who may be deemed to be a 'supervisor.' First, employees who have legal or compliance responsibilities do not become 'supervisors' solely because of their positions. In other words, the Commission will analyze each case on the basis of its unique facts and circumstances, taking into account the managerial structure of the particular firm and the devolution of responsibility within the firm. Second, the determination of whether a particular person is a supervisor depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employees whose behavior is at issue. Again, the facts and circumstances are crucial, as is an analysis of responsibility and control, to making the determination. And third, it is possible, to *become* a supervisor under a particular set of facts and circumstances, even if formerly you did not have 'direct supervisory responsibility for any of the activities of the employee.'

* * * * *

In my view, the facts and circumstances which may make you 'become' a supervisor vis-à-vis a particular employee, when formerly you were not, are (1) your knowledge and awareness of allegedly improper conduct, and (2) being so situated within a firm that you have some ability to affect the conduct at issue.⁵

Most large wirehouses consider their compliance officers to be staff personnel, not line supervisors, and their procedures make it clear that the compliance officers do not supervise specific registered representatives or princi-

3. 52 S.E.C. 2849, 1992 SEC Lexis 293 (Dec. 3, 1992).

4. 50 S.E.C. 524, 1991 WL 296561 (Mar. 28, 1991).

5. Remarks of Commissioner Mary L. Schapiro, *Broker-Dealer Failure to Supervise: Determining Who is a "Supervisor,"* at 14-15, SIA Compliance and Legal Seminar (Mar. 24, 1993).

pals. Compliance staff provide compliance advice to line supervisors but the decision as to whether to hire, fire, discipline or carry out the advice remains with the line supervisors. However, if the written supervisory procedures, particularly the designations of supervisors, are not clear regarding who has responsibility for supervision of a particular person, the compliance officer may be charged as a supervisor. *The SEC and the self-regulatory organizations' basic principle seems to be that if the written supervisory procedures do not clearly delineate the line of supervision, all persons dealing with a violator will be charged for failure to supervise.* It appears that the SEC is reaching in some cases beyond its past acknowledged standard to name compliance personnel if (1) they are very senior persons; (2) they can, by reason of their influence within the firm, cause a person to be terminated or stop the violative conduct. This could create troublesome precedent due to its fact-intensive nature and the difficulty of application. If continued, ultimately, the courts and the SEC are going to have a difficult time dealing with the potentially arbitrary nature of this standard.

It is critically important that compliance officers establish a supervisory chain of command which does not include compliance personnel. Supervisory procedures should *not* specifically assign supervisory responsibilities to compliance professionals. If they do, then the compliance personnel may have supervisory responsibilities. Of course, the fact that compliance personnel review actions or activities of others will not necessarily amount to direct supervision.

The NASD and NYSE

Notwithstanding some comments to the contrary, the recent amendments to NASD Rule 3010 and the adoption of Rules 3012 and 3013 and the companion NYSE rules increase the risk of disciplinary action for compliance officers. It is interesting to note, however, that the NASD in promulgating Rule 3013 departed from its proposed rule which also required certification by the chief compliance officer. The NASD staff recently stated that the rule should not increase the risk for compliance officers. However, because of the responsibility for evaluating the compliance system, for reporting to the chief executive officer and a variety of other issues that are raised, the chief compliance officer and compliance personnel will be the subject of complaints by claimants in arbitration and by plaintiffs in litigation. In arbitration,

the tribunal generally lets claimants argue any position and often treats violations of NASD and NYSE rules as actionable even though they may not be a legal cause of action. In litigation, it is unlikely that the mere violation of a supervision rule itself will constitute a legal cause of action. However, from an evidentiary standpoint, it may be offered to prove either intent or evidence of lack of supervisory control resulting in vicarious liability of a broker-dealer for violation by employees. With respect to NASD and NYSE disciplinary proceedings, the rules create a significant number of responsibilities for compliance personnel and officers, all of which could involve disciplinary action in the event of a violation of the intricate rules established by NASD rules 3010, 3012, 3013 and the NYSE companion rules.

III. DESIGNING THE SUPERVISORY STRUCTURE

In large part, an efficient, effective supervisory structure is no more than an efficient management structure. Supervisory controls from a regulatory standpoint are in most cases good management controls. An efficient, effective supervisory structure should have adequate supervisory controls giving reasonable assurances of (1) reliability of reporting and effecting transactions; (2) compliance with applicable rules and laws; and (3) reliability of financial reporting. To achieve this, the elements discussed below need to be considered.

The Control Environment

A control environment requires a number of things, including (1) a general philosophy of high ethics throughout the firm; (2) an organizational structure providing for control; (3) human resource department participation; and (4) compliance Department participation.

The SEC and the NASD have often talked about the tone at the top. That means that the top executives, in their day-to-day business dealings with their subordinates, demonstrate a philosophy of ethics and integrity. All firms should have a code of ethical conduct. The mission statement of the firm should also clearly reflect the tone at the top. There should be adequate training regarding the code of conduct, ethics, legal and regulatory requirements for all personnel. Performance and incentive compensation should be designed to avoid unrealistic performance goals that undermine ethics and create inherent conflicts resulting in violations of law and regulatory requirements.

The control environment should have a procedure to resolve close ethical and legal calls with appropriate documentation. It should also encourage careful and realistic risk assessment as explained below.

Risk Assessment

Risk assessment is a very important element of an appropriate supervisory structure. In the first instance, identification of risk is a significant job. Each significant organizational, structural and business risk needs to be identified. Business risk includes conflicts and ethical issues as well as legal and regulatory issues. Risks need to be continually assessed as changes are made in the business of the entity, the activities of its competitors, the technology available and the business climate. Risk must be assessed but the assessment obviously has to be reasonable because every business is threatened with enumerable risks, not all of which can be identified. Therefore, reasonable risk assessment is the key - the ones that are a real threat or a possibility. Another key element is management of risk with internal controls. Although risk control is a management task, the compliance department must work with management to control risk. In all steps of risk assessment, the compliance department must be a key participant. The identification of the risk, the assessment of risk and the development of controls for management of the risk should involve the compliance department in almost all phases.

Control Activities

Control activities are another important element in structuring an efficient supervisory structure. As part of the structure, it must be clear as to who is accountable to whom and for what. This needs to be articulated not only in an organizational chart, but in specific job descriptions for each supervisor. This requires the active participation of the compliance department as well as supervisory managers. Most importantly, the job descriptions must be realistic and must conform to reality of the business. In addition, job descriptions must be certain to cover all of the areas of responsibility, including the person's supervisory compliance duties. Compliance procedures need to specifically instruct supervisors as to how supervision should be documented. The control activities must be changed on a regular basis as there are changes in the business, competitors and in technology and business practices. To accomplish this, it is necessary to periodically

review and test all of the procedures and policies and the supervisory structure control activities.

Information and Communication

Information and communication is another critical element. The supervisory structure must be designed so that there is a free flow of information at all times to and between management supervisors at all levels. Information must also simultaneously flow to the compliance department. As the information goes up the line of supervisors, it must be condensed so that it is truly usable by senior managers. The flow of information must be designed to be usable by not only management but by the compliance department. Importantly, the information and communication system will rely to a large extent on computer systems, testing and exception reports. However, exception reports must be realistic. There must not be too many false positives.

Notwithstanding the developments in software and computer compliance systems today, there is no substitute for individual review. The key is communication with the individuals being supervised as to what they are doing, how they are doing it and why they are doing it. The ability to review, ask questions and understand why supervised persons are engaging in specific activity requires training of the supervisor in communications, a healthy skepticism and how to follow up when things that seem out of place or too good to be true.

Monitoring

The last key element of a supervisory structure is a program for monitoring. Day-to-day monitoring by supervisors and the compliance department is critical. This involves systems, exception reports and most importantly knowing how supervised personnel are carrying out their business functions. Day-to-day monitoring must also include the compliance department's review of exception reports and communications from supervisors seeking advice.

Important elements of monitoring are inspections and audits. Regular inspections are required by the NASD and NYSE rules. Routine inspections in most cases should be on a surprise basis. The supervisory procedures should also envision for-cause inspections. There should be parameters determining when to conduct a surprise

inspection for cause, but the procedures should provide for judgment calls as to whether or not to proceed with a for-cause surprise inspection. In all cases, there should be an audit or inspection program, which may need to be expanded or contracted, depending upon the particular issues and nature of the audit. A report should always be prepared. The firm's procedures should provide for use of either employees who are independent from the function being inspected, or outside independent auditors, such as law firms or other firms that conduct regulatory inspections. There should be procedures to evaluate the inspection report by both management and the compliance department. Significant deficiencies should be brought to the attention of the highest level of the firm. The procedure should detail how deficiencies should be brought to senior executives or the audit committee in the case of public companies. The procedures should include a process for evaluating remedies for the deficiencies, implementation of the remedies, and most importantly, after a period of time, testing the remedies to provide reasonable assurances that they are functional.

The Overall Structure

Creating a supervisory structure today is a challenge. In the past, broker-dealers were smaller and simpler and tended to be more specialized. Today, some firms engage in retail sales, institutional sales, corporate finance, research, proprietary trading, making markets on and off exchanges and other diverse activities. In the traditional organization, a chief executive officer has three or four other key executives reporting to him: normally the chief financial officer, the chief legal officer and the head of sales. In large firms, the head of corporate finance and research and sometimes a head of market activity, including proprietary trading, report to the chief executive officer as well. Today, many of those functions need to be segregated at least at two levels below the chief executive officer so that there are separate executives heading each of retail sales, institutional sales, research, corporate finance, proprietary trading and market making. In many cases, protective walls are required between research and corporate finance, between corporate finance, research and proprietary trading, and between market making and proprietary trading. In addition, because of the wide range of activities, a large firm has a significantly complex job in structuring its compliance structure. Smaller or specialized firms also may have conflicts that need to be carefully reviewed, but in general it is simpler. For the

large firm, there are obviously many structures.

Each of the line departments should have a relationship with the chief compliance officer at the senior executive level, but also at each level down the line. For example, each branch office should report up the line to the head of retail. However, each branch office manager should have a liaison directly with the compliance department. There should be a liaison between the compliance department and each lowest level supervisor and a liaison between each supervisor from the lowest level, such as the branch manager, and each district manager, regional manager and national retail sales manager.

The Compliance Department Within the Firm Structure

Today it is recommended for most firms that the chief compliance officer report directly to the chief executive officer. The chief compliance officer is normally a staff function and is not a line function with a right-to-hire or fire, although the compliance function needs to be part of the decision-making process with respect to retention of employees that may have had violations of either firm policy or the law. Based on my personal experience, it is a mistake for the chief compliance officer to report to the general counsel because in such cases the general counsel becomes a de facto chief compliance officer in many cases. I believe that it is better to separate the legal function from the compliance function for a variety of reasons. Obviously the law department will be involved with the compliance department, but their role is significantly different than the role of the compliance department.

The compliance department may or may not have an internal audit function. Internal audit department in many firms may perform such functions as part of the compliance department because of efficiency. However, the internal audit department may be completely independent from the compliance department and carry out the Rules 3010 and 3012 inspections. However, my experience is that most firms are placing the inspection function within the internal audit department, whether it is under the compliance department or completely independent of the compliance department. If the firm is big enough this may work well. It is possible to outsource the inspection or audit function to law firms or compliance organizations. However, the compliance department must be in a position to assist in structuring the inspections, reviewing the reports and from time to time getting into detail

behind the report, including workpapers of the internal auditors. Structure of the compliance department will vary enormously depending upon the size of the firm and its activities. In a large firm, there will be specialists in the compliance department for retail sales, institutional sales, research issues, corporate finance issues, proprietary trading issues and market making. If the firm engages in international operations, there will be compliance specialists in those areas.

Another important element of the compliance department is its systems, primarily today electronic systems which will enable the department to review a wide range of transactions and to sample them as need be. The systems need to be designed so that they can be easily changed to review different types of activities as the markets change and business methods change. Exception reports are an important part of the review system. ■