



Securities Industry Association

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October 17, 2003

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

Re: NASD Notice to Members 03-49 -- Proposed Amendments to Rule 3010 to
Require Heightened Supervision Plans for Associated Persons with a
Specified Threshold of Industry/Regulatory-Related Events

Dear Ms. Sweeney:

The Self-Regulation and Supervisory Practices Committee of the Securities Industry Association¹ is pleased to respond to NASD Notice to Members 03-49 ("Notice"), which seeks comments on proposed amendments to NASD Rule 3010 to require firms to adopt heightened supervision plans for associated persons who meet or exceed threshold numbers of industry or regulatory-related incidents (such as customer complaints, arbitration proceedings, terminations for cause, and disciplinary actions) within a fixed time period. As proposed, the rule contemplates a triggering threshold of three events within a five-year period.

As detailed below, we strongly support uniform guidance for imposition of closer supervision of associated persons who demonstrate a pattern of misconduct. Such guidance serves the interests of investor protection and would enhance both market integrity and investor confidence. While clearly well-intentioned, the proposed amendments raise a number of difficulties in their current form and may not necessarily be the most effective means of achieving the stated objectives. As such, we urge the NASD to consider the following modifications to the proposed rule change:

¹ The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker's Association, brings together the shared interests of more than 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2002, the industry generated \$222 billion in domestic revenue and \$356 billion in global revenues. (More information about SIA is available on its home page: www.sia.com)

- Limit the scope of the rule to sales practice abuses, as reported on Uniform Forms U-4 and U-5;
- Build into the rule a safe harbor based on certain delineated facts and circumstances that should not be counted toward the triggering threshold for heightened supervision;
- Replace the proposed threshold of three events within five years with a threshold of five events within a three-year period; and
- Afford firms 90 days, rather than 30 days, to establish and implement the required supervisory procedures, with such time frame to begin running from the time NASD notifies the firm that it is subject to these provisions.

I. Executive Summary

Currently, Rule 3010 generally requires NASD members to establish and maintain supervisory systems for each of their associated persons that are reasonably designed to achieve compliance with applicable securities laws and NASD rules. Rule 3010, however, does not specifically address supervision of associated persons with a history of industry or regulatory-related events. As stated in the Notice, the proposed rule change is intended to bolster investor protection by promoting earlier and more effective detection, and thus prevention, of future sales practice and other regulatory abuses by the associated person(s) requiring heightened supervision. In connection with the heightened supervision requirement, NASD seeks comment on the types and frequency of incidents that should be considered in requiring that persons be subject to heightened supervision plans.

Notably, and in recognition of the fact that a quantitative threshold alone may be inadequate, the proposed amendments seek to provide member firms with flexibility not to impose heightened supervision based upon a qualitative review of the activities of that particular individual. In such cases, firms must document a clear, well-reasoned rationale supporting its determination. The proposal also would require member firms to establish and implement a supervisory plan within 30 days of the date the firm is notified by the NASD or from the time that a firm obtains knowledge that the threshold has been met by a particular registered representative.

The Committee supports NASD's efforts to provide firms with uniform standards that will further assist firms in their efforts to identify and supervise those individuals whose activities may require heightened scrutiny. We believe, however, that the criteria set forth in the Notice are unnecessarily expansive and will inadvertently capture many associated persons who hardly qualify as having a "history" of misconduct.

II. The Threshold Criteria

NASD proposes that members be required to impose heightened supervision plans on their associated persons who, within the previous five years, were subject to (i) three or more pending, adjudicated, or settled regulatory actions or investigations; or (ii) two or more terminations relating to regulatory or compliance issues or internal reviews initiated by an employing member firm to examine whether an individual engaged in misconduct. NASD suggests that these categories of “industry/regulatory-related incidents” should include “customer complaints, arbitration proceedings, terminations for cause and disciplinary actions”.

A. The Scope of the Rule Should Include Only Sales Practice Complaints as Reported on Forms U-4 and U-5 and Contain a Safe Harbor

1. Sales Practice Complaints

Among the most problematic aspects of the proposal is the inclusion of all customer complaints within the three-event triggering threshold, regardless of merit, dollar amount alleged, or whether the complaint was adjudicated, dismissed or settled in the registered person’s favor. Indeed, in its current form, the rule proposal appears to include verbal, operational and service-related complaints, as well as “stale” complaints currently archived under the NASD’s Public Disclosure Program for lack of any activity.

A more effective approach, we believe, is one that would subject registered persons to heightened supervision for *sales practice* abuses as reported on Forms U-4 and U-5. Not only is this approach more germane to the stated objectives of identifying those individuals whose regulatory records warrant heightened oversight, it strikes a better balance between the interests of investor protection and fundamental fairness considerations to registered persons. Thus, we strongly recommend that NASD limit the scope of the proposed amendments only to reportable sales practice abuses.

2. The Rule Should Include a Safe Harbor in Addition to a Qualitative Opt-Out

The Committee also recommends that the proposed amendments contain a safe harbor that specifically excludes certain types of immaterial or duplicative events from the three-event test. While the current proposal seeks to afford firms the flexibility not to impose a heightened supervision plan in certain situations based upon a qualitative assessment of a particular registered person’s activities, we think this provision alone is not sufficient. Notwithstanding the proposed opt-out provision, firms will be hard pressed to decline imposing heightened supervision for individuals who meet a straight-forward three-events in five years test for fear of being second guessed by both examiners and aggressive plaintiff’s counsel. No matter how well documented the firm’s rationale for its determination, absent a safe-harbor, such determinations could be the subject of hindsight second-guessing, as well as potentially burdensome information requests. To avoid such an outcome, we urge the NASD to provide for a safe-harbor that specifically identifies certain types of generic events that should not be counted toward the three-event threshold, including, for example:

- Joint or related account holders filing separate complaints based on the same set of facts and circumstances;
- Operational complaints or complaints alleging primarily a product failure or poor performance, even if the registered person is named in the related litigation or arbitration;
- Complaints where the registered person prevailed in a final, adjudicatory proceeding;
- Regulatory actions or criminal proceedings that are dismissed or withdrawn against the subject registered person; and
- Any event that was reported in error by the reporting regulator or firm.

We provide the foregoing as examples of some of the types of events that we believe should be expressly excluded from the heightened supervision trigger-events, not as an all-inclusive list. We welcome the opportunity to explore this issue further with the NASD staff.

C. NASD Should Modify the Proposed Triggering Threshold to Five Events Within a Three-Year Period

The Committee also believes that in determining which registered persons are likely to engage in a *pattern* of sales practice violations, the appropriate threshold should be five *reportable* events within three years, instead of the proposed three events within five years. Not only does this more closely parallel existing SRO examination practices, using the universe of reportable events under Uniform Form U-4 and U-5 also streamlines the process of identifying and reviewing potentially relevant activity.

Currently, SRO Examination Guidance,² based on the 1997 report, use a three-year look back period to achieve the objective of assessing a registered person's "recent history of final disciplinary actions...." In this regard, member firms have already developed internal controls and systems that effectively monitor the complaints under this standard.

Moreover, we believe a look-back period in excess of three years would be difficult to administer and would not add to the efficacy of the program to detect at an early stage registered persons with a recent history of sales practice abuses. Specifically, potential patterns of misconduct are likely to become evident within a period of time far shorter than five years. Furthermore, the longer the period for aggregating complaints and other qualifying events, the more difficult the task of sorting through and reconstructing the information leading to the triggering event. Indeed, since complaints frequently lag behind the events giving rise to the complaint, sometimes by several years,

² In a 1997 report issued by staff of the SEC, NASD, NYSE and NASAA, "A Review of the Sales Practice Activities of Selected Registered Representatives and the Hiring, Retention, and Supervisory Practices of the Brokerage Firms Employing Them," a recommendation was made to have member firms enhance their supervision of registered representatives with a recent history of final disciplinary actions involving sales practice abuse or other customer harm.

a three-year window actually involves review of information that occurred significantly earlier. In light of the forgoing, we respectfully request that the NASD amend its proposal as suggested above.

III. The 30-day Implementation is Too Short to be Effective

The proposed amendments to Rule 3010 would require member firms to establish and implement the required supervisory procedures within 30 days of receiving notice from NASD or obtaining actual knowledge that it is subject to these provisions. The Committee understands the need to have member firms act promptly to impose heightened supervision on brokers who meet the threshold. However, as a practical matter, firms will have great difficulty in acting to impose effective procedures for heightened supervision in less than 90 days. Many firms employ a committee review process to evaluate the various events that may be deemed to trigger an internal threshold, and these events are evaluated for evidence that they suggest a pattern or practice of sales practice violations or regulatory abuses.

For example, upon receiving a complaint, a firm typically conducts due diligence, which may include, among other things: (i) reviewing the alleged misconduct, (ii) compiling a thorough record of contact and transaction information, (iii) sifting through the material in a thoughtful and coherent manner; (iv) having a committee act on the information by making a determination as to whether heightened supervision is required; and (v) determining what form heightened supervision will take, if at all. While taking in excess of thirty days, such a process is important, and, more significantly, has proven effective in isolating registered persons in need of heightened supervision.

In addition, we strongly urge NASD to (i) implement a formal process that informs member firms when the thresholds are triggered, much like the notification process for NASD's Continuing Education Notice Program, and (ii) to make such notification the exclusive action that implicates the heightened supervision rules. This ensures that firms and registered person are on a level playing field, as well as avoids later assertions by a firm that it did not possess the relevant information and therefore did not implement timely a program of heightened supervision.

IV. Conclusion

As detailed above, we strongly support uniform guidance for imposition of heightened supervision of associated persons who demonstrate a pattern of misconduct. Such guidance would serve the interests of investor protection and market integrity and enhance investor confidence in our markets. As such, we urge the NASD to reconsider the current proposal and give thorough consideration to the alternatives we recommend herein.

Finally, because the quality of investor protection should not depend on the particular marketplace, we think that the area of heightened supervision in particular calls

for consistency in application among SROs, as well as the State securities laws. Therefore, we urge the NASD to coordinate with the SEC, SROs and State Securities Administrators to ensure that any rule changes flowing from this initiative represent a joint effort resulting in a consistent standard. We would welcome the opportunity to discuss these ideas with the NASD staff, and we look forward to working with the NASD in this regard. If you have any questions or require further information, please call the undersigned or Amal Aly, Vice President and Associate General Counsel at (212) 618-0568.

Sincerely,

John Polanin Jr.
Chairman
SIA Self-Regulation and
Supervisory Practices Committee

cc: Mary Schapiro, Vice Chairman & President, Regulatory Policy & Oversight, NASD
Elisse Walter, EVP, Regulatory Policy & Programs, NASD
Robert C. Errico, EVP, Member Regulation and Qualifications & Testing, NASD
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