

January 8, 2002

Mr. Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549-0609

RE: **SR-NASD-2002-162 – Proposed Supervisory Controls Amendments**

Dear Mr. Katz:

This comment letter, in response to the above-referenced NASD rule filing, is submitted on behalf of the National Society of Compliance Professionals (“NSCP”).

The NSCP is the largest organization of securities industry professionals devoted exclusively to compliance. Since its founding in 1987, it has grown to over 1,250 members. The constituency from which its membership is drawn is unique. While compliance and legal personnel from the largest brokerage and investment management firms are counted among its ranks, the membership is more diverse than those of other similar non-profit organizations. NSCP’s membership is drawn from traditional broker-dealers, investment advisers, bank and insurance affiliated firms, as well as the Law, Accounting and Consulting firms that serve them.

**General Comments**

NSCP members share NASD’s concerns about the proper workings of member firms’ supervisory systems. In instances where controls are lacking or not followed, investors may be put at risk.

NASD’s impetus for proposing these rule changes is stated to be the *Gruttadauria* case. This case involved an elaborate scheme to misappropriate millions of dollars in customer funds over a period of years. Gruttadauria’s scheme involved, among other things, deceiving customers regarding the value and contents of their accounts, creating false account statements, false customers’ account addresses, and fraudulent withdrawal of funds from customers’ accounts. He also had assistance in the scheme from other individuals, and used entities, which he controlled, to advance his scheme.

While it is possible that Gruttadauria’s activities might have been detected had proper supervisory procedures been in place, even with the tightest controls possible, someone who wishes to go to such lengths to steal customer funds will be able to find a way to elude controls. NSCP does not believe that the actions of one individual should be the occasion to create significant remedial restrictions upon an entire industry, as though it were a single firm whose procedures had been found woefully and regularly inadequate.

The rules, as proposed, swing the regulatory pendulum too far, as they impose significant burdens upon member firms. The high costs of implementing the controls proposed by the rules, as well as the administrative burden, and potential regulatory and civil liability placed on the compliance profession will be excessive for what the rules are purportedly attempting to address.

The rule proposal states, “NASD rules contain extensive supervisory requirements.” We agree. As will be discussed below, some of the proposals are merely putting in writing what is already required in the NASD rules, while others go beyond a “belts and suspenders” approach to monitoring supervisory procedures.

The proposed amendments, and their NYSE counterparts, are intended to address broker-dealer practices and supervisory procedures that potentially accommodate certain misconduct of rogue brokers, most recently Frank Gruttadauria. That misconduct has led to significant customer losses and mistreatment, and we support the effort to prevent any recurrence. However, the proposed amendments related to trade and price discretion are in many instances over broad and will harm existing business practices far more than is necessary. In other instances, the proposed amendments, specifically those in Rule 3012 (a), do not meaningfully add to the existing regulatory framework, and are likely to create confusion or needless duplication of effort without contributing to the goal.

## **Discussion**

### **Rule 2510(d): One day limit on TPD and NH orders**

We believe proposed NYSE Rule 408(d) and NASD Rule 2510(d) are reasonably consistent. The proposal for Rule 2510(d) requires that all orders marked TPD (time and price discretion) or NH (not held), which are not executed in whole or in part on the business day entered, must be marked as expired at the end of the business day and purged from open order files like a common “day limit order.”

The proposed amendment limits price and time discretion to one day without written authorization from the customer. It would also require trade tickets, for trades using price and time discretion, to reflect the trade as such on the trade ticket.

While proper authorization of such trades and the documentation of same are important safeguards, as well as prudent business practice, limiting time and price discretion to one day would severely harm the way orders are worked for broker dealers. In addition, we wish to emphasize that, unlike routine retail customer orders, many institutional orders are frequently “worked” over several days, and on any given day, the executions may only be partial fills, thus the written authorization from the customer to permit multi-day TPD should not be individualized to the trade where an institutional client is concerned.

In addition, it will require substantial re-training in the field, as well as the wholesale modification of electronic databases to accommodate this sort of change. In order to detect violations, it will be necessary to somehow record which orders are day – discretionary and then track if an order is placed beyond the end of business for that day. For larger firms relying on central trading desks, the only reasonable means of enforcement would be automation, which will then require substantial software modification and expense.

We believe that two matters are somewhat unclear in the proposal. First, we believe that “standing” written instructions as opposed to trade-by-trade written instructions should be permitted with respect to the granting of limited time and price discretion lasting more than one day. Second, we believe that it should be made clear that the receipt of written instructions from a customer is exclusively a recordkeeping requirement and does not affect the longstanding exemption from heightened review requirements associated with full discretion over a customer account.

We recommend that the NASD consider the following two suggestions for implementing a rule change in this area. First, limit the rule to retail customers, who are most likely to both lose track of their instructions to the broker, and most likely to be harmed by unscrupulous brokers.

Second, for institutional (or all) customers, extend the limitation to five business days, instead of one. In the ERISA context, a broker who takes more than five days to work an order may be deemed a fiduciary. This is precisely the cross-over that the proposed rule seems to be addressing, but it does not need to occur in one day. Without a longer period, the fundamental operation of the business would be compromised.

### **Rules 3010 (c) (2) & (3): Annual audits by “independent” persons**

The rule proposal would require Offices of Supervisory Jurisdiction (OSJ’s) and Branch office annual audits to be conducted by persons “independent” from activities performed at the office and from those individuals providing supervision to that office. Results must be reported to senior management and must be kept for three years. Further, specific items are required to be tested: a) safeguarding of funds/securities; b) books and records; c) supervision of customer accounts serviced by branch managers; d) transmittal of funds between customers, representatives and/or third parties; e) validation of address changes; and f) validation of changes in customer account information.

The changes would not apply to NASD member firms that do not conduct a public business, have net capital requirements of \$5,000 or less, or have fewer than ten registered representatives.

The changes appear to apply only to OSJ and Branch locations. The proposal says nothing about detached locations that are not registered. The assumption could be made, however, that the proposal would require ALL offices to have on-site inspections – a costly burden to many firms. This assumption is based upon the new record retention rules recently adopted by the SEC and our understanding that the NASD may be considering a modification of the definition of “branch office” in the NASD manual to conform more closely to the SEC books and records definition of office.

Under the new SEC books and records rules, virtually every detached location will be deemed a “branch.” In many firms, such branch inspections are currently carried out by sales managers, regional managers, and various product specialists who are involved in sales activity or supervising sales activity at these detached locations. Under the proposed rule, these persons would not be deemed “independent.” Only the compliance officer (or Internal Auditor, or hired consultant) would be “independent.” The burden of inspections will fall onto the compliance officer, or would require firms to greatly increase their compliance staff. Further, costs may have to be incurred to hire outside auditors or consultants to perform these inspections.

We suggest that such detached inspections still be permitted to be carried out by regional management under the direction of the regional compliance officer, with possibly a quality assurance check by the regional compliance officer.

In addition, the “independence” requirement seems a bit ambiguous. It requires that the inspector be “independent from the activities being performed at the office and those persons providing supervision to that office.” In many compliance departments, it might be said that the home office compliance personnel are both a part of the activities performed at the office and may be interpreted as providing supervision to the location. The sorts of items that could cause concern would include practices where the home office personnel approve sales material generated by the locality, approve outside business activities, or may be consulted by local personnel in matters of supervision. It should also be noted that the special supervisory actions regarding supervision of managers’ client accounts required by the proposed rule related to branch/OSJ managers would probably take place in the home office and constitute a further participation in local activities by home office personnel. In this case, it may well be compliance areas that are called on to perform this supervision.

The purest form of compliance with the proposal would be either the creation of separate inspection unit with no line duties, or the passing of inspections duties to another area such as law or internal audit. Absent that, many compliance departments may be deemed, to a greater or lesser degree, to be involved in the activities performed at the locality. Consequently, this would violate the independence requirement.

If the member firm cannot achieve, internally, the level of “independence” sought by the rule proposal, members would be required to incur the additional cost of hiring an outside consulting firm to perform the obligations set out in the proposal. Even if the apparent segregation of duties required is achieved internally, there may well be additional costs for new personnel and their associated costs. These additional costs could severely impact a smaller firm’s net capital computation, as well as its overall profitability.

The NASD should clarify what “activities” means or elucidate what sorts of routine compliance activities would not violate the independence requirement of the proposed rule.

Concerning the six enumerated inspection items, many OSJ or Branch offices conduct only a few (possibly none) of the listed items at the location. For example, in many broker-dealers, validation of address changes takes place from the home office rather than from a local OSJ or Branch; there would not be any materials or records to inspect on-site, other than client correspondence or requests to make the changes. This is also true for client requests for transmittal of funds; many firms prohibit such activity at remote locations.

Similarly, in many broker-dealers, the local branch has no authority but to forward funds into the home office, and literally could not, from a local OSJ or Branch, effect the transfer of funds to anyone else, other than by placing a request with the Home Office which would have to be acted upon by the Home Office. These offices have no independent accounts at the local level.

We recommend that the language be modified somewhat to indicate that the list is illustrative of the types of concerns that need to be reviewed, and is not a mandate for compliance. Another alternative may be to require that the actual detached location be reviewed in conjunction with such records of address changes, account transfers, etc., pertaining to that location at the Home Office level. If the latter alternative is selected, however, Home Office compliance personnel may face a challenge to its resources because software systems that may be used for system-wide exception reports may not be easily altered to review transactions for a single OSJ or Branch. Further, one must ask what is gained if the firm is validating address changes and account changes from a Home Office perspective by requiring a redundant layer of double-checking at the OSJ or Branch level.

In sum, the list of inspection items is poorly suited to many firms, and unless intended to be done in conjunction with central processes (which is not stated in the proposal), will lead to meaningless, and more importantly, costly, inspection routines. The broad needs of the membership would be better served by making this list guidance, where applicable, rather than a mandated routine, or by mandating that validation of these items be conducted at the Home Office, OSJ or Branch level, wherever is applicable to particular firms.

We believe that offering a method of obtaining an exemption from Rule 3010(c) (2), pursuant to Rule 9600 is commendable. However, what the proposal fails to recognize is that even the actual filing of such requests is burdensome. Firms may need to incur the costs of employing outside counsel for such requests. It is also not clear if the exemption pertains to a single office location or to a class of offices. If the former, the filing burden could be very large for some firms.

### **Rule 3012(a): Supervisory procedures subject to “independent” control review process**

This new proposed rule appears to codify in yet another rule the requirements already in place in Rule 3010, as clarified in various NASD *Notices To Members* (NTM's). The proposed language first requires that there be a system of supervisory control policies and procedures. Assuming the language is used as explained in the NYSE counterpart proposal, such a system would provide for a process by which to evaluate existing supervisory procedures, including sampling. Given the number and scope of supervisory procedures already required by Rule 3010, and various NTMs and interpretive memoranda, this is a very broad task. To some extent, it is captured in the yearly compliance review that all members currently perform under Rule 3010(c). Some larger firms may supplement this process with internal or external auditors. Requiring all of the supervisory procedures to be subject explicitly to a control review process will not target rogue broker misconduct.

Further, the proposed rule, if implemented, should be limited to retail accounts. Institutional accounts are far less vulnerable to the misconduct intended to be addressed in the release.

It is clear that compliance officers make up a vital part of any control or supervision system. We are concerned that the independence requirement will have the unintentional result of forcing compliance personnel out of their vital functions they perform, or cause a whole new layer of controls to be established.

With regard to the required independence for those who implement the controls, the language should clarify that compliance officers who do not supervise personnel in these areas should be deemed independent, and further, that where compliance officers are a regular feature of certain functions, such as countersigning a new account form, they do not, by those actions, lose their independence for purposes of this proposal, so long as a sales principal is otherwise involved in the process. Moreover, the language needs to be more flexible regarding firms where the compliance officer may be entirely independent of the activity in question, but may be in general supervised by the same person who supervises the activity. This may be a recurrent situation in small firms (that may nonetheless have net capital over \$5,000), which will likely not have an independent audit function or other independent control function.

More importantly, this new requirement may cause substantial changes in the organizational structure of firms. Many firms currently have a structure where OSJ's or branch offices have a regional manager. The local/regional compliance officer frequently reports to these regional

managers rather than home office personnel. This meets the needs of many firms by placing the local manager directly in a position of responsibility for proper compliance. By requiring a reporting relationship outside the local chain of command, the sense of responsibility by the local manager may be diminished.

Rule 3012(a) (1) would require a report detailing each member's systems of supervisory controls to be submitted to senior management. We believe this should be modified to be a summary of significant exceptions, for ease of review and follow up by senior management. Since the compliance department would already be required to modify the supervisory system if problems are found, there seems to be little gained by a very detailed report going to senior management.

Further, this proposal speaks of transmittal of funds or securities to locations other than the "primary residence" of the customer. This would require members to interpret where the client's primary residence is, which in many cases is difficult to ascertain. This requirement should be clarified.

### **Rule 3012(b): Self-supervision**

As Rule 3012(a) applies to the "member and its registered representatives and associated persons" we feel that Rule 3012(b), discussing the same requirements for "Managers" is redundant. It has always been acknowledged that a Supervisor/Manager cannot supervise him or her self. Perhaps the same effect could be had by simply prohibiting a registered principal, or anyone under his/her supervision, from reviewing or signing off on such things as his/her own correspondence, and new account documents.

### **Rule 3012(c): Address; Check Transmittal**

In our view, this proposal in Rule 3012(c) (1) appears redundant in light of recent anti-money laundering rules. Prudent firms should already have adopted and implemented controls to detect and deter money laundering. Also note that this will require the addition of substantial software or man-hours for many firms, to track the difference between a payee or payor and the owner of the account. This will be a substantial burden for many firms. Further, subparagraph 3012 (c) (3) may be redundant in light of the new books and records requirements.

Concerning customer changes of address, this has always been an area that should be monitored to ensure that fraud is not occurring without the firm's or the client's knowledge. Concerning customer changes in investment objectives, this seems both prudent and reasonable.

Subparagraph (c) (1) (D), which requires notification of the transmittal of checks between the representative and client, also seems overwhelmingly redundant. In most current systems, check registers are required. Checks are forwarded to or from the appropriate home office processing area, and confirmations are generated. It is difficult to imagine an appropriate situation where a check would be given to a representative from a client that would not be confirmed. In essence, if the rule is adopted as proposed, the client would receive two confirms, one because a check was transferred and a second because an investment event (deposit or withdrawal) occurred.

If the representative is going to convert a check, the chances that he would notify the supervisory system of its transfer would be extremely small. This rule therefore appears to create a lot of paperwork with little chance of being effective in its ultimate purpose, i.e. detecting fraud.

If this rule does go forward, there should be substantial lead-time to allow systems to be devised to comply.

### **Rule 3012(d): Dual membership safe harbor**

Proposed Rule 3012(d) makes sense so firms do not need to be burdened trying to determine fine line distinctions between NASD and NYSE Rules aimed at addressing the same problems.

To the extent that this rule is implemented, the dual membership safe harbor may be somewhat jeopardized if the resulting rule is substantially different from the NYSE rule.

### **Rule 3110(d): Timing of trade allocation among client accounts**

This proposal appears to be a prudent safeguard solely for retail accounts. However, we wish to emphasize that the rule as proposed is unworkable with respect to “bunched” orders from institutions, including investment advisers. Specifically, where money managers exercise discretion they, ordinarily, are not carried as the customer on the books and records of the broker-dealer, their orders frequently are “worked” over several days, and on any given day, the executions may only be partial fills. In this case, the money manager or investment advisor allocates these fills to clients *after* the partial order is filled. The rule as proposed would require the allocation to clients *prior* to execution, thus eliminating an important component of the money manager’s function, and specifically undercutting the ability of the adviser to move quickly in response to market conditions for many of its clients at a time.

We propose that Rule 3110 (d) apply only to retail customer accounts, and request that NASD specifically exclude from the rule institutional or investment advisory accounts. Alternatively, this rule could be applicable solely to non-discretionary accounts.

### **IM-3110 (i): Authorized holding of customer mail**

Regarding the proposed addition to Rule IM-3110, we commend the Association for adopting a rule which will permit broker-dealers that have the Association as their Designated Examining Authority (DEA) to hold customer mail for a short time. We recognize that the adoption of this rule will bring the Association’s rules into line with existing NYSE rules regarding domestic mail holding procedures. However, we also note that the proposed rule includes the same unnecessary and client-intrusive predicates as does the NYSE Rule, namely that the client must represent that he or she is traveling or on vacation. We do not believe that it is necessary or appropriate to limit the availability of this service to these two situations. Nor do we suggest that the rule try to contemplate other entirely legitimate bases for a client’s request (e.g., a client’s hospitalization). Instead, we believe that the NASD should require the following before a firm can temporarily hold client mail: (1) a written authorization from the client, (2) a limited, but renewable, time period in which the mail will be held, and (3) appropriate supervisory checks to ensure that the client is in control of the process and there is no abuse of the policy by the registered representative.

We also believe that the NASD should consider adding to the rule proposal a provision by which member firms can hold mail for foreign clients. Specifically, the NASD’s proposed addition to Rule IM-3110 primarily attempts to address the needs of members’ domestic customers. The proposed addition does not, however, address the special needs of members’ foreign customers, who often need brokers to hold their mail for extended periods of time because of privacy and security concerns in their home countries.

We therefore recommend that the NASD expand its proposed changes and also adopt a rule setting forth the conditions under which a member can hold mail for a foreign customer. We suggest that such a rule require the following before a firm can hold foreign client mail: (1) a written authorization from the client setting forth the request, and (2) written procedures that require appropriate supervisory review of accounts for which mail is being held.

Adoption of such a rule would bring needed consistency to the SRO rules, and would enable broker-dealers to protect the interests and well being of certain foreign clients.

### **Conclusion**

We appreciate your consideration of our comments and recommendations. While we agree that proper supervision is the first line of defense in investor safety, we believe that much of the changes, as proposed, would place an undue burden on member firms.

Sincerely,

The National Society of Compliance Professionals, Inc.

By: Joan Hinchman

NSCP Executive Director, President and CEO

22 Kent Road

Cornwall Bridge, CT 06754

Ph: 860-672-0843 Fx: 860-672-3005 Email: [jhinchman@nscp.org](mailto:jhinchman@nscp.org)