



October 29, 2003

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

Re: NASD Request for Comment on Proposed Amendments to Rule 3010 to Require Heightened Supervision Plans for Associated Persons with a Specific Threshold of Industry/Regulatory-Related Events

Dear Ms. Sweeney:

This letter supercedes our previous comment letter dated October 11, 2003. Financial Registrations, Inc.¹ appreciates the opportunity to respond to the request for comment by the NASD on proposed amendments to NASD Rule 3010 ("Notice"). The proposed amendments to Rule 3010 would require heightened supervision plans for associated persons with a specific threshold of industry/regulatory-related events. In general, FR supports the proposed amendments, but believes that the effectiveness of the proposed rule could be enhanced through additional control measures and set guidelines based on the specific type and frequency of sales practice violations or reportable misconduct instead of the time line in which they occur. As such, we respectfully request the following modifications to the proposed rule change:

- Replace the proposed triggering threshold of three events within a five-year period with a threshold of five events involving unrelated sales practice violations or other reportable misconduct within a five year period, or three or more events involving the same sales practice violation or reportable misconduct regardless of the time period;
- Amend the opportunity to opt-out of heightened supervision requirements to include a mandatory notification to NASD of a member's intent to opt-out of such requirements, and to eliminate the opt-out election for those who have met or exceed the revised thresholds of five or more events involving unrelated sales practice violations or reportable misconduct within a five year period, or three or more events involving the same sales practice violation or reportable misconduct regardless of the time period;
- The required time period for the establishment and implementation of heightened supervision should be extended to sixty days from the original thirty day requirement to accommodate most members in the transition process.

In review of the proposed rule, FR agrees with NASD's sentiment that "An effective supervisory system plays an essential role in the prevention of sales practice and other abuses and, thus, enhances investor protection and market integrity." In our experience operating in a consultative capacity for NASD broker-dealers of various sizes and product focus, we have long held that one of the main factors in determining the efficacy of any compliance and supervisory program is a firm's

¹ Financial Registrations, Inc. is a securities compliance consultancy providing registration and compliance management services to securities broker-dealers and registered investment advisers. (More information about Financial Registrations is available on its home page: www.financialregistrations.com.)

ability to implement proactive compliance measures that are customized to the specific needs of the firm. A compliance program that fails to take into account that totality of risk based on a firm's size, scope and operational function may increase a firm's exposure to potential securities violations.

Numerical Threshold Test

NASD proposes to adopt heightened supervision plans for those associated persons who have met or exceeded specified threshold numbers of industry/regulatory-related events, or to document a "clear and well-reasoned rationale" for not doing so. For example, members would be required to impose heightened supervision plans on their associated persons who, within the past five years, are subject to three or more customer complaints and arbitrations, were subject to three or more pending, adjudicated, or settled regulatory actions or investigations, or 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.

With respect to the frequency of incidents triggering heightened supervision, the requirement to impose heightened supervision plans involving three or more regulatory or compliance issues within the past five years, or two or more terminations, may warrant a certain level of scrutiny and consideration toward the implementation of heightened supervision. However, such a proposal does not adequately take into consideration the various types of sales practice violations and other specific violations that are often the subject or basis of a customer-initiated complaint, arbitration, regulatory action or termination.

Modification of the Proposed Triggering Threshold

Although we generally concur with the inclusion of the rules currently listed in the Notice, we realize that there are myriad circumstances under which customer-initiated events alleging violations or other misconduct may occur all with varying degrees of severity and complexity. Some of which are valid with supporting facts and circumstances, while others may be based on conjecture or motivated by matters unrelated to the merits of an event. Therefore, to allow for a certain level of flexibility, we recommend that the appropriate threshold should be amended to five or more events involving unrelated sales practice violations or other reportable misconduct within a five year period, or three or more events involving the same sales practice violation or reportable misconduct regardless of the time period. This proposed alternative would give members certain circumstantial allowances for unrelated events, while focusing attention to those events that may demonstrate a potential "pattern" of misconduct.

Similarity and Frequency of Events

We believe that a greater emphasis should be placed on the specific allegations of sales practice violations as reported through CRD which could demonstrate an early-stage pattern of activity versus an isolated occurrence. Therefore, a more effective approach to the proposed amendment would be to require that members impose heightened supervision requirements in the event that an associated person was subject to three or more of the same type of sales practice violation or other reportable misconduct regardless of the time period.

Our focus on the potential for patterned misconduct would appear to be supported by the Joint Regulatory Sales Practice Sweep Report,² in that, "a heightened level of supervision may be appropriate for a registered representative whose CRD report discloses sales

² NASD Notice to Members 97-19; NASD Regulation And New York Stock Exchange Memorandum Discusses Sweep Report And Provides Guidance On Heightened Supervision Recommendations.

practice problems and not simply isolated instances of customer complaints, minor disciplinary actions, or arbitrations.”

Furthermore, we would recommend that the sales practice violations focus on the following regulatory and compliance issues requiring disclosure on the Form U-4:

- Regulatory Disciplinary Actions. A pending or adjudicated regulatory action or an investigation by the SEC; the CFTC; a federal, state, or foreign regulatory agency; or an SRO.
- Domestic or Foreign Civil Judicial Actions. A pending investment-related civil action or arbitration proceeding; an injunction in connection with an investment-related activity; a violation of an investment-related statute or regulation; or a settlement of an investment-related civil action.
- Customer Complaints. A customer complaint, arbitration, or civil action that is investment-related alleging sales practice violations that is still pending, that was settled, or that resulted in an award or judgment (alleging sales practice violations and damages of \$5,000 or more).
- Terminations. Termination for cause or a permitted resignation after investigations or allegations of violation of investment-related statutes, regulations, rules, industry standards of conduct, fraud, wrongful taking of property, or failure to supervise in connection with investment-related activity.

Amendment to the Opt-Out Opportunity

In review of the proposed rule which would require members to document their rationale (which must be a “clear and well-reasoned”) for not implementing a heightened supervision plan, it appears that such a proposal may raise more questions than answers. Although we believe this inclusion is intended to assist members in providing some form of exemptive relief under the rule, such an opt-out method would raise doubts as to its efficacy without the necessary correspondence and clarification as to a standard definition of what is considered “clear and well-reasoned” between NASD and its members. For example, what may be considered a clear and well-reasoned response for opting-out of heightened supervision requirements from a member’s perspective may differ from that of a regulatory agency.

Therefore, we believe that by amending the opportunity to opt-out of heightened supervision requirements, and replacing it with clear and distinct guidance, specific thresholds and time parameters would provide more clarity than uncertainty. Members could elect to opt-out of heightened supervision requirements while operating below the minimum thresholds by notifying NASD of the totality of circumstances under which the opt-out is applied. This would give the NASD the opportunity to review the notification and to make any comments or recommendations as appropriate.

However, once a particular threshold is met, members would be triggered to impose heightened supervision requirements that are customized to the size, scope and operational function of the member firm. It is our belief that most member firms who employ or otherwise affiliate with associated persons who have met or exceed the revised thresholds of five or more events involving unrelated sales practice violations or reportable misconduct within a five year period, or three or more separate events involving the same sales practice violation or reportable misconduct regardless of the time period, would impose at least some form of heightened supervision as a risk management measure.

Supervisory Approval

NASD proposes that a member’s heightened supervision plan should be approved in writing by the person responsible for supervising the associated person subject to the plan. As part of the approval of the plan, such supervisor would acknowledge responsibility for execution of the plan. This rule

change is intended to ensure effective implementation of the heightened supervision plans and coordination between the personnel responsible for hiring and compliance personnel by encouraging more awareness and careful consideration of a person's background during the hiring process.

We agree with NASD's requirement to impose a supervisory approval process on a member's heightened supervision plan. Similar to earlier proposed certification requirements,³ a well documented supervisory approval process, which includes some form of attestation by a supervisor or other authorized party, would help increase the overall efficacy of the plan as well as impute a heightened sense of responsibility and "connection" to the implementation of heightened supervision.

Thirty Day Implementation Requirement

The proposed amendment would also require that members establish and implement heightened supervision procedures within thirty days of receiving notice from NASD or obtaining actual knowledge that it is subject to such requirements.

In review of the proposed thirty day requirement, we feel that such a time requirement may be insufficient under most circumstances. For example, certain member firms maintaining a relatively limited staff and resources may find it difficult to establish and implement a heightened supervision plan within the prescribed time requirement. Conversely, some of the larger member firms, although possessing the necessary staff and resources, may not possess the speed of the approval process to execute such heightened supervision requirements within the prescribed time period. Therefore, to resolve this matter, the required time period for the establishment and implementation of heightened supervision should be extended to sixty days to accommodate for general unforeseen staffing, resource allocation and other logistical matters.

Conclusion

In conclusion, we realize that there are myriad circumstances under which customer-initiated events alleging sales practice violations or other reportable misconduct may occur all with varying degrees of severity, complexity and validity. Therefore, although we generally concur with the inclusion of the rules currently listed in the Notice, we believe that the proposed amendment could be enhanced by requiring a member firm to adopt heightened supervision plans for those associated persons who have five or more events involving unrelated sales practice violations or other reportable misconduct within a five year period, or three or more events involving the same sales practice violation or reportable misconduct regardless of the time period. This, we believe, would allow a member firm to implement additional control measures and set guidelines based on the specific type and frequency of sales practice violations or reportable misconduct instead of the time line in which they occur. Such an approach would focus attention on those events that may demonstrate a pattern of similar misconduct over those that may appear to be isolated or circumstantial in nature.

We appreciate the opportunity to comment on this important issue. If you have any questions about this matter, please contact the undersigned at (949) 770-6154.

Sincerely,



Scott P. Tarra
Managing Principal

³ NASD Notice to Members 03-29; Certification by Chief Executive Officer and Chief Compliance Officer: NASD Requests Comment on Proposal to Amend Rule 3010 and Adopt Interpretive Material 3010-1.