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MADISON

## MEMORANDUM

TO: Our Clients and Friends

FROM: Godfrey & Kahn, S.C.

DATE: December 27, 2005

RE: Annual Certification of Broker-Dealer Compliance Programs

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The NASD recently granted an extension to broker-dealer firms until April 1, 2006 to submit to management the initial annual report regarding the firm's supervisory program and for the firm's CEO to execute the related certification regarding the compliance program. The NASD granted the extension to permit firms to combine the report and certification into one document and to coordinate certain NYSE and NASD deadlines. Although firms must already have compliance policies and procedures in place, these requirements are intended to strengthen the effectiveness of supervisory systems.

### **Supervisory Control Report**

Pursuant to NASD Rule 3012, each firm must designate one or more principals (typically the Chief Compliance Officer ("CCO")) to establish, maintain and enforce a system of supervisory control policies designed to achieve compliance with applicable SEC and NASD regulations. As part of this requirement, the CCO must submit to the firm's senior management at least annually a report that details the firm's supervisory controls and summarizes the test results, including any significant exceptions and any additional or amended supervisory procedures that have been created.

The NASD has issued the following guidelines for firms to consider when designing their supervisory procedures and preparing the report regarding the testing of these procedures:

Firms should first conduct an inventory of their businesses and applicable securities laws, regulations and NASD rules.

Firms should then analyze the requirements of the applicable securities laws, regulations and NASD rules and determine (i) what conduct is prohibited, compelled, limited or conditioned, (ii) how to comply with all legal and regulatory requirements, (iii) who will

be responsible for supervising the conduct of the firm's employees, and (iv) the methods and parameters of such supervision.

Firms should analyze their internal compliance procedures and determine whether such procedures will further restrict conduct.

Firms should compare the information gathered from the analysis of their compliance procedures to their existing compliance procedures to identify any evident gaps, deficiencies or inaccuracies.

Firms should then analyze how to address identified gaps or deficiencies by using the same approach outlined above. As part of this process firms should consider:

- any new businesses or new aspects of existing business products;
- whether existing procedures have become inaccurate, obsolete or incomplete; and
- the firm's history of compliance, including its history with respect to customer complaints, litigation, regulatory inquiries or actions, internal reviews and audits, branch office examinations and any matters reported by the media or by regulators.

Firms should use the information obtained through this process to design new or amended supervisory procedures that resolve any identified gaps or deficiencies.

The NASD cautioned that its guidance, set forth in NTM 05-29, does not constitute a safe harbor and firms are responsible for implementing a supervisory control system that is appropriate for their specific organization.

### **Annual CEO Certification**

NASD Rule 3013 and related IM-3013 require the CEO (or equivalent officer) to make an annual certification regarding the firm's compliance policies. The certification must cover the following four items:

#### **1. Process Certification**

The CEO must certify that the firm has in place processes to:

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

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

test the effectiveness of such policies and procedures on a periodic basis.

## 2. Meeting Certification

The CEO must certify that he or she has conducted one or more meetings with the CCO in the preceding 12 months. This requirement is intended to foster regular interaction between senior management and the CEO regarding the firm's compliance program.

## 3. Report Certification

The CEO must certify that the firm's processes are described in a report that has been reviewed by the CEO and CCO and submitted to the firm's board of directors and audit committee (or a committee serving similar functions). The report must be produced prior to execution of the certification and may be combined with the Rule 3012 report provided that the sections applicable to each rule are clearly identified.

## 4. Consultation Certification

The CEO must certify that he or she has consulted with the CCO and other officers as applicable and such other employees, outside consultants, lawyers and accountants, to the extent deemed appropriate, in order to attest to the statements made in the certification.

## **Other Considerations**

The NASD has emphasized that the certification requirements are principle-based and therefore compliance activities will vary depending on the facts and circumstances of the firm's business activities.

The NASD has stated that Rule 3013 requires the CEO to certify only that the member firm has a *process*, evidenced in a report, to establish, maintain, test and modify its compliance procedures. The CEO is not required to certify that the supervisory control policies and procedures are effective or adequate.

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Please do not hesitate to contact us if we can be of assistance with respect to your efforts to comply with these requirements.

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