

**ACTION REQUESTED
BY JULY 25, 2001**

Taping Rule

NASD Regulation Requests Comment On Proposed Amendments To The Taping Rule; Comment Period Expires July 25, 2001

SUGGESTED ROUTING

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

- Legal & Compliance
- Senior Management

KEY TOPICS

- IM-8310-2
- Public Disclosure Program
- Rule 3010
- Supervision
- Taping Rule

Executive Summary

NASD Regulation, Inc. (NASD Regulation) requests comment on proposed amendments to Rule 3010(b)(2), commonly referred to as the Taping Rule.

In 1998, NASD Regulation adopted the Taping Rule in response to the findings of the “Joint Regulatory Sales Practice Sweep Report” (the “Report”), which found sales practice abuses at selected firms. Based upon the staff’s experience applying the Taping Rule over the past two and one-half years, and input from the National Adjudicatory Council (NAC) and National Association of Securities Dealers, Inc. (NASD®) Committees, NASD Regulation believes that it is appropriate to amend the Taping Rule in certain respects. Generally, the proposed amendments are intended to refine the application of the Taping Rule and provide some additional flexibility to firms that trigger application of the Rule.

Specifically, NASD Regulation seeks comment on five proposed amendments to the Taping Rule that would: 1) add a provision to permit firms that become subject to the Rule 30 days to make a one-time downward adjustment to their roster of registered persons in order to fall below the prescribed Taping Rule threshold levels and thus avoid application of the Rule; 2) revise the criteria by which firms become subject to the Taping Rule by excluding short-term employees of disciplined firms from a firm’s calculation of the threshold levels triggering application of the Rule; 3) expand the time period for implementation of the special supervisory procedures, including the installation of taping systems, required by the Rule from 30 days to 60 days; 4) narrow the NASD’s authority to grant exemptions from

the Rule pursuant to the Rule 9600 Series; and 5) extend the duration of special supervisory procedures, including taping requirements, from two years to three years.

In addition, NASD Regulation requests comment on whether the identity of firms subject to the Taping Rule should be publicly available.

Included with this *Notice* are Attachment A (the text of the proposed amendments) and Attachment B (a checklist that may supplement or be used in place of written comments).

Request For Comment

NASD Regulation solicits comment on the proposed amendments to the Taping Rule as described in this *Notice*. For your convenience, we have provided a checklist (see Attachment B) that offers a convenient method to participate in the comment process concerning the proposed amendments.

Comments must be received by **July 25, 2001**. Members and interested persons can submit their comments using the following methods:

- mailing in the checklist (Attachment B)
- mailing in written comments
- e-mailing written comments to pubcom@nasd.com
- submitting comments online at the NASDR Web Site (www.nasdr.com)

If you decide to submit comments using both the checklist and one of the other methods listed above, please indicate that in your submissions.

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The checklist and/or written comments should be mailed to:

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

The only comments that will be considered are those submitted in writing, either via e-mail or regular mail, or those submitted online through the NASD Regulation Web Site.

Questions/Further Information

Questions regarding this *Notice* may be directed to Greg Dean, Assistant General Counsel, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8159.

Background

In 1995, the NASD participated in a “Joint Regulatory Sales Practice Sweep” (the “Sweep”), an initiative to review the sales practice activities of selected registered representatives and the hiring, retention, and supervisory practices of the brokerage firms employing them. The findings of the Sweep were detailed in the Report.¹ In response to these findings, NASD Regulation and the New York Stock Exchange (NYSE) issued a joint memorandum recommending heightened supervisory procedures for registered representatives with histories of customer complaints, disciplinary actions, or arbitrations.² Based upon the Report’s findings of sales practice abuses, NASD Regulation also adopted Rule 3010(b)(2), the Taping Rule.³

The Taping Rule was designed to ensure that firms that hire a

significant number of registered persons from “disciplined firms”—firms that have been expelled from membership or participation by any self-regulatory organization or have had their registrations revoked by the SEC for sales practice violations—have proper supervision and oversight of their sales force to prevent fraudulent and improper sales practices. Currently, firms that exceed the threshold levels of the Taping Rule (Rule 3010(b)(2)(viii)) must establish, maintain, and enforce special written procedures for supervising the telemarketing activities of all their registered persons. As part of these procedures, firms are required to install taping systems that record all conversations with customers, to review the tape recordings for questionable sales practices, and to file quarterly reports with NASD Regulation describing any sales practice violations discovered during the review of the recordings. All such procedures and systems must be maintained for a period of two years. The Taping Rule permits firms to petition NASD Regulation for exemptive relief pursuant to the Rule 9600 Series.

Discussion

Based upon the staff’s experience applying the Taping Rule over the past two and one-half years,⁴ and input from the NAC and NASD Committees, NASD Regulation believes that the Rule should be amended to refine its application and to provide member firms that trigger application of the Rule with some additional flexibility.

1. Establishment Of A 30-Day Staff Adjustment Period

NASD Regulation proposes to add a provision to the Rule to provide firms with a one-time only option of

adjusting their roster of registered persons within 30 days after they become subject to the Rule for the first time in order to fall below the threshold levels contained in paragraph (b)(2)(viii) of the Rule. This proposed amendment would not allow firms to hire additional registered persons to get below the percentage thresholds, but would permit them to reduce their number of registered persons formerly employed by disciplined firms. Under this proposal, once a firm has made the adjustment, the firm would not be permitted to rehire the individuals terminated in the adjustment for a period of at least six months. If a firm chose not to make the adjustment, then it would be required to comply with the Taping Rule.

As noted, this proposed amendment is a one-time only opportunity, available only when a firm triggers application of the Taping Rule for the first time. If a firm subsequently triggers application of the Taping Rule, it would not be able to adjust its staffing levels to avoid imposition of the requirements of the Rule (whether or not it had elected to avail itself of the adjustment option when it first triggered the Rule).

The purpose of this proposed amendment is to provide an opportunity for relief to firms that may become subject to the Rule inadvertently or unintentionally due to sudden turnover among registered persons or other events beyond their control. The one-time adjustment would provide these firms relief from the Rule without detracting from one of the primary objectives of the Taping Rule, to prevent registered persons from disciplined firms from moving, en masse, to another firm. NASD Regulation seeks comment on whether the proposed adjustment option provides sufficient flexibility.

2. Revision Of The Criteria By Which Firms Become Subject To The Taping Rule

NASD Regulation proposes to amend the Rule to exclude individuals who were employed by disciplined firms for a short period of time from the required calculation used to determine whether a firm triggers application of the Taping Rule. Specifically, NASD Regulation proposes that registered persons⁵ who were associated for a total of not more than 90 days in the aggregate with one or more disciplined firms during the prior three years and who have no relevant disciplinary history⁶ may be excluded from a firm's Taping Rule calculations.

NASD Regulation believes that this proposed amendment is consistent with the purpose of the Taping Rule. The amendment recognizes that individuals employed by disciplined firms for a very short period of time may have left the firm voluntarily before engaging in any activities or were unlikely to have been affected by the lack of proper training and inadequate supervision that the Rule seeks to redress. As an added measure of protection, the proposal would require that these individuals have no relevant disciplinary history. Unless both conditions are met, a firm would be required to include these individuals in the firm's Taping Rule calculations. NASD Regulation invites comment on whether it is appropriate to exclude short-term employees in this manner. We also request comment on: 1) whether 90 days, or a shorter period, is an appropriate measure of "short-term"; and 2) whether the use of the definition of disciplinary history contained in IM-1011-1 is appropriate for this proposed amendment to the Taping Rule.

3. Expansion Of The Compliance Deadline From 30 To 60 Days

NASD Regulation proposes to amend the Taping Rule to extend the time for firms to implement the special supervisory procedures, including the installation of a taping system, from 30 days to 60 days. Almost all of the firms that have become subject to the Rule to date requested extensions of time to locate a vendor, purchase a recording system, and complete the installation of the system. The Rule currently does not provide NASD Regulation with the authority to grant such extensions.

Based on the staff's experience, NASD Regulation believes that the proposed expansion of the compliance date from 30 days to 60 days should provide sufficient time for firms to install the taping systems and would eliminate the need for members to request extensions of time to achieve compliance with the Rule.

4. Narrowing Of The Exemptive Relief Authority

Based on experience gained to date,⁷ and with the adoption of the other measures as currently proposed, NASD Regulation believes that the current exemptive authority provisions in the Taping Rule should be narrowed. The proposal would amend paragraph (b)(2)(xi) of the Rule to allow for the NASD to grant exemptive relief in "exceptional" cases only.

Currently, the Rule permits member firms that become subject to the Rule to apply for exemptive relief under the Rule 9600 Series. The Taping Rule states that relief may be granted, "upon satisfactory showing that the member's supervisory procedures ensure compliance with applicable securities laws and regulations and applicable rules of the

Association." In general, NASD Regulation has interpreted this standard to require firms seeking exemptive relief to establish that their supervisory procedures assure supervision at a level functionally equivalent to the protections afforded by a taping system. Substantial resources are devoted to evaluating and ruling on these requests, the overwhelming majority of which were denied.

NASD Regulation believes that the additional flexibility created by the proposed amendments (particularly the proposed one-time adjustment period and the exclusion of short-term employees from a firm's calculations under the Rule) should reduce the number of cases in which firms would need to consider requesting exemptive relief. NASD Regulation also believes, consistent with the underlying purpose of the Rule, that exemptive relief should be limited to truly exceptional cases.

5. Increase Duration Of The Special Supervisory Requirements

NASD Regulation proposes to increase the time during which firms must maintain the prescribed special supervisory procedures, including a taping system, to three years. Currently, the Rule requires firms to establish and maintain these procedures for a period of two years.

NASD Regulation believes that this proposed change is consistent with the underlying purpose of the Taping Rule and will reduce the potential for confusion about the thresholds for applying it. To determine whether application of the Rule has been triggered for any particular firm, Rule 3010(b)(2)(viii) considers the employment history of the firm's registered persons over a

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three-year period. The application of the two-year and three-year periods have caused some confusion. NASD Regulation believes that equalizing these two time periods (*i.e.*, three years) would eliminate ambiguities in the calculation of the Taping Rule thresholds.

Additional Issue For Comment

Recently, NASD Regulation has received requests from a variety of sources, including members of the public, to make the identity of firms subject to the Taping Rule publicly available. To date, NASD Regulation has not publicly disclosed the identity of firms subject to the Rule in recognition of the fact that the Taping Rule is by its nature a supervisory provision, not a disciplinary event. After further consideration of the issue, NASD Regulation believes that public disclosure of the identity of firms subject to the Taping Rule would be consistent with the objectives of the Rule and, moreover, would serve as an appropriate investor education and information vehicle.

NASD Regulation plans to enable investors and the general public to obtain information concerning whether a particular firm is subject to the Rule through the Public Disclosure Program.⁸ NASD Regulation invites comment on this approach as well as on whether a list of firms subject to the Rule should be made available on the NASD Regulation Web Site.

Endnotes

- 1 The Sweep and the Report were undertaken by the Securities and Exchange Commission (SEC), the NASD, the North American Securities Administrators Association, Inc., and the New York Stock Exchange.
- 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" (April 1997).
- 3 *NASD Notice to Members 98-52*, "SEC Approves Taping Rule; Effective August 17, 1998" (July 1998).
- 4 Since the Taping Rule became effective in August of 1998, 24 firms have triggered application of the Rule. Of those firms, 13 are currently active and subject to the Rule. One application for exemptive relief is pending.
- 5 To clarify that the Rule includes independent contractors as well as employees, NASD Regulation intends to make a technical amendment to the current rule language by substituting "associated with" for "employed by" in subparagraph (b)(2)(viii) of the Rule. For a discussion of the supervision of independent contractors, see *Notice to Members 98-38*, "NASD Reminds Members of Supervisory And Inspection Obligations" (May 1998).
- 6 For purposes of this provision, NASD Regulation proposes to use the definition of disciplinary history used in the NASD Membership Rules. Interpretive Material-1011-1 defines "disciplinary history" as, "a finding of a violation by the member or a principal of the member in the past five years by the Securities and Exchange Commission, a self-regulatory organization, or a foreign financial regulatory authority of one or more of the following provisions (or a comparable foreign provision) or rules or regulations thereunder: Sections 15(b)(4)(E) and 15(c) of the Securities Exchange Act of 1934; Section 17(a) of the Securities Act of 1933; SEC Rules 10b-5 and 15g-1 through 15g-9; NASD Rules 2110, 2120, 2310, 2330, 2440, 3010 (failure to supervise only), 3310, and 3330; and MSRB Rules G-19, G-30, and G-37(b) & (c)."
- 7 To date, there have been 17 petitions to NASD Regulation for exemptive relief. Fifteen were denied, one was granted, and one is pending.
- 8 A technical amendment to Interpretive Material-8310-2 is necessary to implement this change. Attachment A includes the proposed amendment to IM-8310-2.

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ATTACHMENT A

Proposed Rule Language

Note: New language is underlined; deletions are in brackets.

3010. Supervision

(a) No Change.

(b)(2) Tape recording of conversations

(i) Each member that either is notified by NASD Regulation or otherwise has actual knowledge that it meets one of the criteria in paragraph (b)(2)(viii) relating to the employment history of its registered persons at a Disciplined Firm as defined in paragraph (b)(2)(x) shall establish, maintain, and enforce special written procedures for supervising the telemarketing activities of all of its registered persons.

(ii) The member must establish the supervisory procedures required by this paragraph within [30] 60 days of receiving notice from NASD Regulation or obtaining actual knowledge that it is subject to the provisions of this paragraph. A member that meets one of the criteria in paragraph (b)(2)(viii) for the first time may reduce its staffing levels to fall below the threshold levels within 30 days after receiving notice. Once a member has made the adjustment, the member shall not rehire a person terminated to accomplish the staff reduction for a period of 180 days.

(iii) The procedures required by this paragraph shall include tape-recording all telephone conversations between the member's registered persons and both existing and potential customers.

(iv) The member shall establish reasonable procedures for reviewing the tape recordings made pursuant to the requirements of this paragraph to ensure compliance with applicable securities laws and regulations and applicable rules of this Association. The procedures must be appropriate for the member's business, size, structure, and customers.

(v) All tape recordings made pursuant to the requirements of this paragraph shall be retained for a period of not less than three years from the date the tape was created, the first two years in an easily accessible place. Each member shall catalog the retained tapes by registered person and date.

(vi) Such procedures shall be maintained for a period of [two] three years from the date that the member establishes the procedures required by the provisions of this paragraph.

(vii) By the 30th day of the month following the end of each calendar quarter, each member firm subject to the requirements of this paragraph shall submit to the Association a report on the member's supervision of the telemarketing activities of its registered persons.

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(viii) The following members shall be required to adopt special supervisory procedures over the telemarketing activities of their registered persons:

- A firm with at least five but fewer than ten registered persons, where 40% or more of its registered persons have been [employed by] associated with one or more Disciplined Firms within the last three years;
- A firm with at least ten but fewer than twenty registered persons, where four or more of its registered persons have been [employed by] associated with one or more Disciplined Firms within the last three years;
- A firm with at least twenty registered persons, where 20% or more of its registered persons have been [employed by] associated with one or more Disciplined Firms within the last three years.

For purposes of this paragraph, registered persons associated with one or more Disciplined Firms shall not include persons who: (1) have been registered for an aggregate total of 90 days or less with one or more Disciplined Firms; and (2) do not have a disciplinary history as defined in IM-1011-1.

(ix) For purposes of this Rule, the term “registered person” means any person registered with the Association as a representative, principal, or assistant representative pursuant to the Rule 1020, 1030, 1040, and 1110 Series or pursuant to Municipal Securities Rulemaking Board (“MSRB”) Rule G-3.

(x) For purposes of this Rule, the term “disciplined firm” means a member that, in connection with sales practices involving the offer, purchase, or sale of any security, has been expelled from membership or participation in any securities industry self-regulatory organization or is subject to an order of the Securities and Exchange Commission revoking its registration as a broker/dealer.

(xi) Pursuant to the Rule 9600 Series, the Association may in exceptional circumstances, taking into consideration all relevant factors, exempt any member unconditionally or on specified terms and conditions from the requirements of this paragraph [upon satisfactory showing that the member’s supervisory procedures ensure compliance with applicable securities laws and regulations and applicable rules of the Association].

(c) through (g) No Change.

IM-8310-2. Release of Disciplinary [Information] and Other Information Through the Public Disclosure Program

(a) In response to a written inquiry, electronic inquiry, or telephonic inquiry via a toll-free telephone listing, the Association shall release certain information contained in the Central Registration Depository regarding a current or former member, an associated person, or a person who was associated with a member within the preceding two years, through the Public Disclosure Program. Such information shall include:

- (1) the person’s employment history and other business experience required to be reported on Form U-4;
- (2) currently approved registrations for the member or associated person;
- (3) the main office, legal status, and type of business engaged in by the member; and

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(4) an event or proceeding—

- (A) required to be reported under Item 23 on Form U-4;
- (B) required to be reported under Item 11 on Form BD; or
- (C) reported on Form U-6.

The Association also shall make available through the Public Disclosure Program certain arbitration decisions against a member involving a securities or commodities dispute with a public customer. In addition, the Association also shall make available in response to telephonic inquiries via the Public Disclosure Program's toll-free telephone listing whether a member is subject to the provisions of Rule 3010(b)(2). The Association shall not release through the Public Disclosure Program social security numbers, residential history information, or physical description information, or information that the Association is otherwise prohibited from releasing under Federal law.

(b) through (l) No Change.

ATTACHMENT B

Request For Comment Checklist

We have provided below a checklist that members and other interested parties may use in addition to or in lieu of written comments. This checklist is intended to offer a convenient way to participate in the comment process, but does not cover all aspects of the proposal described in the *Notice*. We therefore encourage members and other interested parties to review the entire *Notice* and provide written comments, as necessary.

Instructions

Comments must be received by **July 25, 2001**. Members and interested parties can submit their comments using the following methods:

- mailing in this checklist
- e-mailing written comments to *pubcom@nasd.com*
- mailing in written comments
- submitting comments online at the NASDR Web Site (*www.nasdr.com*)

The checklist and/or written comments should be mailed to:

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

Proposed Amendments Concerning The Taping Rule

- | | |
|---|--|
| <p>1. Is the addition of a one-time staff adjustment for firms that become subject to the Rule for the first time an appropriate mechanism to address firms that inadvertently or unintentionally trigger the application of the Rule?</p> <p><input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> See my attached written comments</p> <p>2. Is it appropriate to exclude “short-term employees” of disciplined firms from the calculations that trigger application of the Taping Rule?</p> <p><input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> See my attached written comments</p> <p>3. Is 90 days an appropriate measure of “short-term employee” for purposes of the proposed exclusion?</p> <p><input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> See my attached written comments</p> | <p>4. Should the time period for a firm to achieve compliance with the Taping Rule be increased from the current requirement of 30 days?</p> <p><input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> See my attached written comments</p> <p>5. Is the proposal to increase the time period for achieving compliance to 60 days sufficient?</p> <p><input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> See my attached written comments</p> <p>6. Should NASD Regulation make available through the Public Disclosure Program the identity of firms subject to the Taping Rule?</p> <p><input type="checkbox"/> Yes <input type="checkbox"/> No <input type="checkbox"/> See my attached written comments</p> |
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7. Should NASD Regulation publish on its Web Site a list of all of the firms subject to the Taping Rule?

Yes No See my attached written comments

8. Should there be other changes to the Taping Rule or are there areas in the proposal that require further clarification?

Yes No See my attached written comments

Contact Information

Name: _____

Firm: _____

Address: _____

City/State/Zip: _____

Phone: _____

E-Mail: _____

Are you:

An NASD Member

An Investor

A Registered Representative

Other: _____