

NASD NOTICE TO MEMBERS 97-79

NASD Regulation
Requests Comment On
Proposed Amendment To
Rule Governing Clearing
Agreements; **Comment
Period Expires
December 1, 1997**

Suggested Routing

- Senior Management
- Advertising
- Continuing Education
- Corporate Finance
- Government Securities
- Institutional
- Insurance
- Internal Audit
- Legal & Compliance
- Municipal
- Mutual Fund
- Operations
- Options
- Registered Representatives
- Registration
- Research
- Syndicate
- Systems
- Trading
- Training
- Variable Contracts

Executive Summary

At its September 1997 meeting, the NASD Regulation, Inc., Board of Directors (Board) approved a proposed amendment to the National Association of Securities Dealers, Inc. (NASD[®]) rule governing clearing agreements (Rule 3230) in response to problems that occurred recently with certain failed introducing firms. The problems that the amendment is designed to address relate to the lack of a regulatory early warning of trouble at the introducing firms, gaps in the introducing firms' supervisory procedures, and potential risks associated with introducing firm check writing privileges. The proposed amendment would: (1) establish standards for the disposition of written customer complaints about member introducing firms relating to their functions and responsibilities under the clearing agreements received by their clearing firms; (2) govern how exception reports are made available to introducing firms and retained by clearing firms; and (3) permit introducing firms to write checks on their clearing firm's account.

Questions regarding this *Request For Comment* may be directed to Elliott R. Curzon, Assistant General Counsel, Office of General Counsel, NASD RegulationSM, at (202) 728-8451, or Robert J. Smith, Senior Attorney, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Request For Comment

NASD Regulation encourages all members and interested parties to respond to the issues raised in this *Notice*. Comments should be mailed to:

Joan Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, N.W.
Washington, D.C. 20006-1500;

or e-mailed to:
pubcom@nasd.com

Comments must be received by **December 1, 1997**. Before becoming effective, any rule change developed as a result of the comments received must be adopted by the NASD Regulation, Inc., Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

We have filed this proposed rule change with the SEC and anticipate that, by the time of publication of this *Notice*, the SEC will have published the rule filing for comment. Because we anticipate the SEC comment period to run, in part, concurrently with the NASD comment period, we are limiting our comment period to December 1, 1997. Notice of publication of the rule change in the *Federal Register* will be provided on the NASD Regulation Web Site, and members may at that time direct their comments to the SEC.

NASD REGULATION REQUEST FOR COMMENT 97-79

Executive Summary

At its September 1997 meeting, the NASD Regulation, Inc., Board of Directors (Board) approved a proposed amendment to the National Association of Securities Dealers, Inc. (NASD[®]) rule governing clearing agreements (Rule 3230) in response to problems that occurred recently with certain failed introducing firms. The problems that the amendment is designed to address relate to the lack of a regulatory early warning of trouble at the introducing firms, gaps in the introducing firms' supervisory procedures, and potential risks associated with introducing firm check writing privileges. The proposed amendment would: (1) establish standards for the disposition of written customer complaints about member introducing firms relating to their functions and responsibilities under the clearing agreements received by their clearing firms; (2) govern how exception reports are made available to introducing firms and retained by clearing firms; and (3) permit introducing firms to write checks on their clearing firm's account. The proposed amendment has been submitted to the Securities and Exchange Commission (SEC) for approval.¹

However, in connection with approving the proposed amendment, the Board directed the staff to publish the proposed amendment for the information of the membership and to advise the membership that the rule proposal has been filed with the SEC. The text of the proposed amendment follows this *Notice*.

Questions regarding this *Request For Comment* may be directed to Elliott R. Curzon, Assistant General Counsel, Office of General Counsel, NASD RegulationSM, at (202) 728-8451, or Robert J. Smith, Senior Attorney, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Background

Recent concerns about questionable sales practices and potentially fraudulent activity by certain introducing firms, and the handling of customer complaints about those firms by their clearing firms, caused the staffs of NASD Regulation and the New York Stock Exchange (NYSE) to examine the relationship between clearing firms and their client introducing firms. The examination resulted in proposals to amend NASD and NYSE rules relating to the content and approval of clearing agreements to specify requirements for handling customer complaints, for providing, requesting and retaining exception reports, and for issuing checks.

The NYSE's proposal to amend its Rule 382 has been filed with the SEC and published for comment by the SEC in the *Federal Register*.² The NASD's proposal to amend Rule 3230 (discussed below) is consistent with the current NYSE proposal to amend NYSE Rule 382 and achieves the regulatory goals identified by the SEC, the NASD, the NYSE and the Securities Industry Association (SIA) without unduly burdening the clearing firms.

While the Board of Directors of NASD Regulation approved the proposed rule in recognition of the importance of maintaining consistency with the NYSE's proposal, the Board expressed strong concerns regarding the proposal, including those relating to two particular issues. First, the Board expressed concern that the proposed rules not change or be interpreted as changing the fundamental nature of the relationship between introducing and clearing firms, or otherwise affect rights, responsibilities or liabilities of the introducing or clearing firm under law or contract. Other than to establish limited requirements to enable the introducing member to carry out its responsibilities under its clearing

or carrying agreement with the clearing member, the proposals are not intended to change the fundamental nature of the relationship between introducing and clearing firms, or otherwise affect any existing rights, responsibilities or liabilities under law or contract.

Second, the Board expressed concern that the requirement that the customer be notified by the clearing firm that he or she has the right to transfer his or her account to another firm may unfairly single out a particular category of complaints, create an unfair implication that each such complaint would warrant the customer's transferring his or her account, or otherwise operate inappropriately to distinguish this class of complaints from others. The NASD is specifically soliciting comments on these and other issues, as discussed more fully below.

Description Of Proposed Rule Change

Customer Complaints. It is generally the practice of clearing firms to forward to introducing firms customer complaints they receive relating to matters that are the responsibility of the introducing firm. Under NASD Rule 3070, a member is required to report to the NASD any written customer complaint against it involving allegations of theft, misappropriation of funds or securities, or forgery. Recently, however, there have been instances where introducing firms may not have complied in a timely manner with the requirements of Rule 3070 when their clearing firms forwarded customer complaints to them, thus delaying receipt of these reports by the NASD. Since there is no mechanism other than Rule 3070 designed to provide this information to NASD Regulation, such late reporting may undermine the purpose of Rule 3070, which is to provide NASD Regulation with early

warning indicators to generate a regulatory response to problems. In addition, receipt by clearing firms of large numbers of complaints regarding introducing firms may be indicative of sales practice problems requiring prompt regulatory attention.

To address this concern, proposed new paragraph (b) states that when a clearing firm receives a customer complaint about an introducing firm relating to the functions and responsibilities of the introducing firm, the clearing firm must forward the complaint to the introducing firm and send a copy of the complaint to the introducing firm's Designated Examining Authority (DEA). The requirement may provide an early warning to the DEA of potential problems at introducing firms. The proposed amendment also provides that the clearing agreement must expressly direct and authorize the clearing firm to forward the complaint to the introducing firm and send a copy of the complaint to the introducing firm's DEA.

The requirement that the complaints be forwarded to the appropriate DEA is intended to provide notice to the DEAs of the types of complaints that are being received and to provide information that may be useful for examining or investigating particular conduct. It is not intended, however, to result in an investigation of each complaint that is received by the DEA.

In addition, the proposed rule provides that the clearing firm must notify the customer in writing that the complaint was received, and was forwarded to the introducing firm and to the introducing firm's DEA. This requirement will serve to alert the customer that the complaint has been received and forwarded to the appropriate entity (the introducing firm) for a response, and that the introduc-

ing firm's regulator has also been made aware of the customer's complaint. This written notice to the customer must also contain a statement that reads substantially as follows: "Please be aware that you retain the right, at your discretion, to transfer your account to another broker/dealer of your choice."

Exception Reports. All NASD member firms are required under NASD and federal regulations to establish, maintain and enforce supervisory systems and procedures that are designed to address all areas of a member's business. A key aspect of these supervisory procedures is exception and other compliance reports that a member creates to help meet these supervisory responsibilities. In a fully disclosed clearing arrangement, the clearing member generally provides exception reports to assist the introducing member in carrying out its supervisory obligations. In addition, officers and managers of introducing members should be notified of the reports and information available to them in meeting their supervisory and monitoring obligations. Paragraph (c) of the proposed amendment addresses these issues.

Proposed new paragraph (c)(1) requires the clearing firm to provide its introducing firm, both at the commencement of the introducing/clearing arrangement and annually thereafter, a list or description of all exception or other reports which it offers to introducing firms to assist the introducing firm in supervising its activities, monitoring its accounts and carrying out its functions and responsibilities under the clearing agreement.

Even though the language of the proposed amendment requires the clearing firm to provide the introducing firm with a list or description of reports that it will provide, the staff

recognizes that some clearing firms do not create such reports, but rather provide data and data formatting software to their introducing clients that allow the introducing firms to prepare their own reports. The proposal would permit compliance with this provision in instances where clearing firms inform their introducing firms about available data and data formatting so the introducing firms can determine which reports to create in order to meet their supervisory and monitoring needs.

Paragraph(c)(2) requires the clearing firm to retain, as part of its books and records, copies of any reports requested or provided to the introducing firm. The provision permits a clearing firm to meet the requirement if it retains the data that was used to prepare the report, but only if the clearing member, at the request of the DEA, can recreate the report or provide the data and data formatting that was used to prepare the report. Similarly, if the clearing firm provided data and data formatting to the introducing firm, the clearing firm could provide that same data and data formatting to the DEA to fulfill this requirement.

Paragraph (c)(3) requires the clearing member, immediately after entering into the clearing agreement, to notify the introducing member's chief executive and compliance officers of the reports that it offers to the introducing member, and the reports requested by or supplied to the introducing firm. The clearing member must provide this notice each year thereafter as of June 30, to be provided no later than July 31 of the following year.³

Finally, paragraph (c)(4) requires the clearing member, at the request of the introducing member's DEA, to provide to the DEA reports that were offered to the introducing member, but which the introducing member

did not request. As with the record retention provision in paragraph (c)(2), this requirement may be met if the clearing member retains the data from which the original report was produced, and then either recreates the report or provides the data and data formatting that was used to prepare the report.

Check Writing. Under proposed new Paragraph (d), the clearing agreement may permit the introducing firm to issue checks to the introducing firm's customers that are drawn on the clearing member's account upon written representation from the introducing firm that it has established, and will maintain and enforce, supervisory procedures with respect to the issuance of negotiable instruments. This rule is intended to protect customers by clearly establishing that the clearing member will be the maker or drawer of such instruments and, therefore, liable for any mistakes or fraud by the introducing firm in the making or drawing of the check. This provision is intended to establish that clearing firms are liable to the introducing firm's customer if the introducing firm misuses the authority, thereby protecting the customer with the clearing member's funds.

Solicitation Of Comments

The rule proposals of the NASD and the NYSE may raise important issues for both clearing and introducing member firms. In addition to any other issues that members may wish to address, NASD Regulation specifically solicits comment on the following questions.

General

Will the respective obligations imposed on clearing and introducing firms by the proposal help introducing firms and regulators better address sales practice problems? To what extent would they permit such

problems to be addressed in a more timely way? To what extent would they act to deter sales practice abuses?

To what extent would the proposal discourage members from agreeing to enter into new clearing relationships, or to renew existing ones, or affect the degree of care employed when entering into such a relationship? Would the result that is identified be positive or negative for the markets overall?

Customer Complaints

How quickly are customer complaints that are directed to clearing members and that concern introducing firms or their associated persons forwarded to introducing firms? What proportion of these complaints concerns matters identified in NASD Rule 3070(a)(2), *i.e.*, allegations of theft, misappropriation of funds or securities, or forgery? What other types of complaints typically are received?

Why, in general, are complaint letters addressed to clearing firms rather than introducing firms, when they concern conduct of the introducing firms? Please address the extent to which this occurs because of confusion by customers over the relative responsibilities of the firms, or for other reasons, *e.g.*, the failure to receive a response from the introducing firm.

Should the requirements of the proposed rule regarding customer complaints apply equally to complaints against a clearing firm sent by a customer to an introducing firm with whom the clearing firm has a clearing agreement?

Presently, copies of customer complaints received by securities firms are not required to be forwarded to the SEC or any self-regulatory organization. To the extent that this

requirement is imposed, does it make sense to distinguish letters concerning introducing firms, or their associated persons addressed to clearing firms, from other types of customer complaints?

Does the requirement that, upon the clearing firm's receipt of a customer complaint, the customer be notified by the clearing firm that he or she has the right to transfer his or her account to another firm, serve a useful purpose, unfairly single out a particular category of complaints, or otherwise operate inappropriately? Does it create an unfair implication that each such complaint would warrant the customer's transferring his or her account, or otherwise unfairly tarnish the introducing firm? To the extent that this type of information is useful to investors, does it make sense to provide this notice only in the circumstances identified?

Exception Reports

What compliance or cost burdens would result from the requirement that clearing firms retain copies of exception reports or data that is provided to introducing firms? To what extent is this data now stored, and for how long?

What are the relative costs and benefits of the requirements for annual reports to the executive officers of introducing firms as to the exception reports that were offered and supplied, and for reports to the DEAs as to reports that the introducing firm did not request?

Request For Comment

NASD Regulation encourages all members and interested parties to respond to the issues raised in this *Notice*. Comments should be mailed to:

Joan Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, N.W.
Washington, D.C. 20006-1500;

or e-mailed to:
pubcom@nasd.com

Comments must be received by **December 1, 1997**. Before becoming effective, any rule change developed as a result of the comments received must be adopted by the NASD Regulation, Inc., Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

We have filed this proposed rule change with the SEC and anticipate that, by the time of publication of this *Notice*, the SEC will have published the rule filing for comment. Because we anticipate the SEC comment period to run, in part, concurrently with the NASD comment period, we are limiting our comment period to December 1, 1997. Notice of publication of the rule change in the *Federal Register* will be provided on the NASD Regulation Web Site, and members may at that time direct their comments to the SEC.

Text of Proposed Amendment To Rule 3230 Of The NASD Conduct Rules

(Note: New text is underlined; deletions are bracketed.)

3230. Clearing Agreements

(a) All clearing or carrying agreements entered into by a member, except where any party to the agreement is also subject to a comparable rule of a national securities exchange, shall specify the respective functions and responsibilities of each party to the agreement and shall, at a minimum, specify the responsibility of

each party with respect to each of the following matters:

- (1) opening, approving and monitoring customer accounts;
- (2) extension of credit;
- (3) maintenance of books and records;
- (4) receipt and delivery of funds and securities;
- (5) safeguarding of funds and securities;
- (6) confirmations and statements;
- (7) acceptance of orders and execution of transactions;
- (8) whether, for purposes of the Commission's financial responsibility rules adopted under the Act, and the Securities Investor Protection Act, as amended, and regulations adopted thereunder, customers are customers of the clearing member; and
- (9) the requirement to provide customer notification under paragraph [(d)] (g) of this Rule.

(b)(1) In order for the introducing member to carry out its functions and responsibilities under the agreement, each clearing member must forward promptly any written customer complaint received by the clearing member regarding the introducing member or its associated persons relating to functions and responsibilities allocated to the introducing member under the agreement directly to: (A) the introducing member; and (B) the introducing member's examining authority designated under Section 17 of the Act ("DEA") (or, if none, to its appropriate regulatory agency or authority). The clearing or carrying agreement must specifically

direct and authorize the clearing member to do so.

(2) The clearing member must also notify the customer, in writing, that it has received the complaint, and that the complaint has been forwarded to the introducing member and to the introducing member's DEA (or, if none, to its appropriate regulatory agency or authority). This written notice to the customer must also contain a statement that reads substantially as follows: "Please be aware that you retain the right, at your discretion, to transfer your account to another broker/dealer of your choice."

(c)(1) A clearing member, when it enters into a clearing agreement, must immediately, and annually thereafter, provide the introducing member a list or description of all reports (exception and other types of reports) which it offers to the introducing member to assist the introducing member in supervising its activities, monitoring its customer accounts, and carrying out its functions and responsibilities under the clearing agreement.

(2) The clearing member must retain as part of its books and records required to be maintained under the Act and the Association's rules, copies of the reports requested by or provided to the introducing member. For purposes of this Rule, the clearing member will be in compliance with the requirements of this paragraph if it retains the data from which the original report was produced, provided, the clearing member can, at the request of the DEA, either (1) recreate the report; or (2) provide the data and the data formatting that was used to prepare the report.

(3) Each year, no later than July 31, the clearing member must notify in writing the introducing member's chief executive and compliance officers of the reports offered to the introducing member and the reports requested by or supplied to the introducing member during the previous year ending June 30. The clearing member must also provide a copy of the notice to the introducing member's DEA.

(4) The clearing member must provide, at the request of the introducing member's DEA, any reports (or, if the reports are not available, information or data from which the reports could have been prepared) that were offered to the introducing member but which the introducing member did not request.

(d) The clearing or carrying agreement may permit the introducing member to issue negotiable instruments directly to the introducing member's customers using instruments for which the clearing member is the maker or drawer. The clearing member may not grant the introducing member the authority to issue negotiable instruments until the introducing member has notified the clearing member in writing that it has established, and will maintain and enforce, supervisory procedures with respect to the issuance of such instruments.

[(b)] (e) Whenever a clearing member designated to the Association for oversight pursuant to Section 17 of the Act, or a rule of the Commission adopted thereunder, amends any of its clearing or carrying agreements with respect to any item enumerated in subparagraphs (a)(1) through (a)(9) or enters into a new clearing or carrying agreement with an introduc-

ing member, the clearing member shall submit the agreement to the Association for review and approval.

[(c)] (f) Whenever an introducing member designated to the Association for oversight pursuant to Section 17 of the Act, or a rule of the Commission adopted thereunder, amends its clearing or carrying agreement with a clearing member designated to another self-regulatory organization for oversight with respect to any item enumerated in subparagraphs (a)(1) through (a)(9) enters into a new clearing agreement with another clearing member, the introducing member shall submit the agreement to its local Association district office for review.

[(d)] (g) Each customer whose account is introduced on a fully disclosed basis shall be notified in writing upon the opening of his account of the existence of the clearing or carrying agreement.

Endnotes

¹ See File No. SR-NASD-97-76 (October 14, 1997).

² See File No. SR-NYSE-97-25 (September 12, 1997); Securities Exchange Act Release No. 39200 (October 3, 1997); 62 FR 53369 (October 14, 1997).

³ The clearing member must also provide a copy of the notice to the introducing firm's DEA. This provision is designed to make the responsible principals of the introducing firm aware of the reports and dates available from the clearing firm to assist the introducing firm in meeting supervisory and other functions and responsibilities under the clearing agreement, and to alert the DEA.

© 1997, National Association of Securities Dealers, Inc. (NASD). All rights reserved.