

# NASD NOTICE TO MEMBERS 96-82

## NASD Regulation Solicits Comment On Proposed Rules Governing Supervision, Review, And Record Retention Of Correspondence; Comment Period Expires January 30, 1997

### Suggested Routing

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In the following document, NASD Regulation, Inc. (NASD Regulation) requests comment on proposed amendments to NASD<sup>®</sup> Conduct Rules 3010 (Supervision) and 3110 (Books and Records) (formerly Article III, Sections 27 and 21 of the NASD Rules of Fair Practice). The amendments would require firms to establish reasonable procedures for the supervision of correspondence relating to their business but would not require endorsement of each item of correspondence. Where such procedures do not require pre-use approval of correspondence, members would be required to provide education and training about the firm's procedures for the review of correspondence, document such education and training, and monitor to ensure compliance with such procedures. The amendments also clarify that retention of correspondence records must comply with Securities and Exchange Commission (SEC) rules.

Questions concerning this Notice should be directed to R. Clark Hooper, Senior Vice President, Office of Disclosure and Investor Protection, NASD Regulation, at (202) 728-8325 or Mary N. Revell, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8203.

### Request For Comment

The NASD encourages all interested parties to comment on the proposed amendments to Rules 3010 and 3110. Comments can be mailed to:

Joan Conley  
Office of the Corporate Secretary  
NASD Regulation, Inc.  
1735 K Street, NW  
Washington, DC 20006-1500

or e-mailed to:  
[pubcom@nasd.com](mailto:pubcom@nasd.com).

Comments must be received by **January 30, 1997**. Before becoming effective, the Rule amendments must be adopted by the NASD Regulation Board of Directors, reviewed by the NASD Board of Governors, and approved by the SEC.

# NASD REGULATION REQUEST FOR COMMENT 96-82

## Executive Summary

NASD Regulation, Inc. (NASD Regulation) requests comment on proposed amendments to NASD<sup>®</sup> Conduct Rules 3010 (Supervision) and 3110 (Books and Records) (formerly Article III, Sections 27 and 21 of the NASD Rules of Fair Practice). The amendments would require firms to establish reasonable procedures for the supervision of correspondence relating to their business but would not require endorsement of each item of correspondence. Where such procedures do not require pre-use approval of correspondence, members would be required to provide education and training about the firm's procedures for the review of correspondence, document such education and training, and monitor to ensure compliance with such procedures. The amendments also clarify that retention of correspondence records must comply with Securities and Exchange Commission (SEC) rules.

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## Background

In May 1996, the SEC issued an "Interpretive Release on the Use of Electronic Media by Broker-Dealers, Transfer Agents, and Investment Advisers for Delivery of Information."<sup>1</sup> That release expressed the views of the SEC with respect to the delivery of information through electronic media in satisfaction of requirements in the federal securities laws and did not address the applicability of any self-regulatory organization (SRO) rules. In the release the SEC did, however, strongly encourage the SROs to work with broker/dealer

firms to adapt SRO supervisory review requirements governing communications with customers to accommodate the use of electronic communications.<sup>2</sup>

On September 12, 1996, the New York Stock Exchange (NYSE) filed a proposal with the SEC to update NYSE rules governing supervision of member firms' communications with the public.<sup>3</sup> According to a press release issued by the NYSE, the proposal is designed to recognize the growing use of electronic communications such as "e-mail" while still providing for appropriate supervision.

The NYSE's current rules require firms to review all communications with the public relating to their business. For example, a registered representative's correspondence to a customer must be reviewed prior to being sent, and all incoming correspondence must be reviewed by the firm before it is given to the representative. Under the NYSE proposal, prior review of all outgoing correspondence and review of all incoming correspondence would no longer be required. Instead, firms would be allowed flexibility in developing procedures for review of such correspondence tailored to the nature and size of a firm's business and customers. Other communications with the public, such as advertisements, sales literature, and research reports, would continue to be subject to prior approval.

The NYSE proposal would require firms to develop written procedures for review of communications with the public that are designed to provide reasonable supervision of each registered representative. In addition, any firm that does not conduct pre-use review of correspondence (whether electronic or manual) would be required to regularly educate and train employees about the organization's

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policies and procedures governing review of communications, document such education and training, and conduct surveillance to ensure compliance with the procedures.

The proposed rule change filed by the NYSE directly responds to the SEC's request to adapt supervision rules to accommodate the use of electronic communications. The proposed amendments to NASD rules governing review of correspondence would similarly respond to this request and would provide firms with flexibility in developing reasonable procedures for the review of correspondence. The proposed approach is designed to be consistent with the one adopted by the NYSE and thereby help to ensure a coordinated regulatory framework for supervision of manual and electronic correspondence.

### Description

Amended Rule 3010(d)(1) would provide that a firm must establish written procedures for review of outgoing and incoming manual and electronic correspondence of its registered representatives relating to the business of the member. The procedures must be designed to provide reasonable supervision of each registered representative, and implementation and execution of these procedures must be clearly evidenced.

In developing procedures for the review of correspondence, NASD Regulation, Inc. (NASD Regulation) agrees with the views expressed in the draft NYSE Information Memorandum submitted to the SEC to explain the proposed changes to NYSE rules governing supervision and review of communications with the public (NYSE Information Memo).<sup>4</sup> In the NYSE Information Memo, the NYSE notes that the supervisory procedures should specify, among other things, what is to be pre- or post-reviewed, the level and

qualifications of persons who will conduct the reviews, the frequency of review, and how the review will be evidenced. NASD Regulation agrees with these suggestions.

Consistent with the NYSE proposal, members will be required to review correspondence relating to the firm's business, rather than just correspondence pertaining to the solicitation or execution of a securities transaction. However, firms would no longer be required to review each item of correspondence. Instead, firms could use reasonable sampling techniques, such as random spot-checking of e-mail logs. NASD Regulation expects that making this method effective would require review of some portion of the electronic mail sent by each registered representative, with special emphasis on messages delivered to customers of the members.

In addition, while written approval of correspondence no longer would be mandated, firms should specify the means for evidencing review. For example, firms could electronically record evidence of supervisory review of e-mail correspondence relating to the firm's business.

Amended Rule 3010(d)(2) would require each member to develop written procedures for review of incoming and outgoing correspondence tailored to its structure and the nature and size of its business and customer base. Any member that does not conduct prior review of correspondence will be required to: regularly educate and train registered representatives as to the firm's procedures governing review of communications; document such education and training; and monitor to ensure implementation and compliance with the procedures.

In developing supervisory procedures for the review of correspondence, NASD Regulation notes, in accor-

dance with similar views expressed in the NYSE Information Memo,<sup>5</sup> that members should consider whether it is more appropriate to implement uniform procedures or procedures tailored to specific functions, offices or locations, individuals, groups of persons, or specific registration categories. In this regard, the NYSE Information Memo states that members may consider such factors as "the number, size and location of offices, the volume of communications overall and in specific areas of the organization, the activities conducted by registered representatives and other applicable persons, the nature and extent of training provided, the complaint and overall disciplinary record, if any, of registered representatives and other applicable persons (with particular emphasis on complaints regarding written or oral communications with clients) and the overall experience levels of applicable persons using communications media."<sup>6</sup> NASD Regulation agrees with these views and notes in addition that reasonable procedures in some cases might require review of all correspondence of particular individuals.

With regard to procedures for the review of outgoing and incoming correspondence, NASD Regulation agrees with the views expressed in the NYSE Information Memo. In particular, NASD believes that members' supervisory systems should provide specific processes for the receipt and handling of incoming checks and customer complaints as well as standards for correspondence indicating permitted and prohibited activities and any restrictions imposed by the member upon such correspondence.<sup>7</sup>

Under amended Rule 3010(d)(3), each member must retain correspondence in accordance with amended Rule 3110. Rule 3010(d)(3) also requires that the names of the persons who prepared and reviewed cor-

respondence must be ascertainable from the retained records and the records must be made available to the NASD upon request.

Rule 3110(a) has been amended to recognize that retention of records must be made and preserved as prescribed by Rule 17a-3 under the Securities Exchange Act of 1934 (Exchange Act). The recordkeeping format, medium, and retention period must comply with Rule 17a-4 under the Exchange Act.<sup>8</sup>

### Request For Comment

The NASD encourages all interested parties to comment on the proposed amendments to Rules 3010 and 3110. Comments can be mailed to:

Joan Conley  
Office of the Corporate Secretary  
NASD Regulation, Inc.  
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or e-mailed to:  
[pubcom@nasd.com](mailto:pubcom@nasd.com).

Comments must be received by **January 30, 1997**. Before becoming effective, the Rule amendments must be adopted by the NASD Regulation Board of Directors, reviewed by the NASD Board of Governors, and approved by the SEC.

### Text Of Proposed Amendments

(Note: Proposed new language is underlined; deletions are bracketed.)

#### Rule 3010. Supervision

(a) through (c) No change

(d) [Written Approval] Review of Transactions and Correspondence

(1) Supervision of Registered Representatives. Each member shall establish procedures for the review and

endorsement by a registered principal in writing, on an internal record, of all transactions and for the review by a registered principal of [all] written and electronic correspondence of its registered representatives relating to the business of such member [pertaining to the solicitation or execution of any securities transactions]. Such procedures should be in writing and be designed to reasonably supervise each registered representative. Evidence that these supervisory procedures have been implemented and carried out must be maintained and made available to the Association upon request.

(2) Review of correspondence. Each member shall develop written procedures that are appropriate for its business, size, structure, and customers for the review of written and electronic correspondence relating to its business. Where such procedures for the review of correspondence do not require pre-use review, they must include provision for the education and training of registered representatives as to the firm's procedures; documentation of such education and training; and surveillance and follow-up to ensure that such procedures are implemented and adhered to.

(3) Retention of correspondence. Each member shall retain correspondence of registered representatives relating to its business in accordance with Rule 3110 ("Books and Records"). The names of the persons who prepared and who reviewed the correspondence shall be ascertainable from the retained records and the retained records shall be readily available to the Association, upon request.

(e) through (g) No change

#### Rule 3110. Books and Records

(a) Requirements

Each member shall make [keep] and preserve books, accounts, records,

memoranda, and correspondence in conformity with [all applicable laws, rules, regulations, and statements of policy promulgated thereunder and with] the Rules of this Association and as prescribed by Rule 17a-3 under the Securities Exchange Act of 1934 (Exchange Act). The record-keeping format, medium, and retention period shall comply with Rule 17a-4 under the Exchange Act.

(b) through (g) No change

### Endnotes

<sup>1</sup> Release No. 33-7288; 34-37182; IC-21945; IA-1562 (May 9, 1996); 61 FR 24644 (May 15, 1996) (File No. S7-13-96).

<sup>2</sup> Id., note 5.

<sup>3</sup> See Release No. 34-37941 (November 13, 1996); 61 FR 58919 (November 19, 1996) (File No. SR-NYSE-96-26) (soliciting comment on the NYSE's proposed rule change).

<sup>4</sup> Id., notes 1 and 2.

<sup>5</sup> Id., notes 1 and 3.

<sup>6</sup> Id., note 3.

<sup>7</sup> Id., notes 1 and 4.

<sup>8</sup> With regard to record retention requirements, it should be noted that the SEC recently proposed for comment amendments to its broker/dealer books and records rules. The SEC's proposal responds to concerns raised by members of the North American Securities Administrators Association. See *Special Notice to Members 96-80* and Release No. 34-37850 (October 22, 1996); 61 FR 55593 (October 28, 1996) (File No. S7-27-96) for a discussion of the proposed amendments to SEC Rules 17a-3 and 17a-4.

One of the SEC's proposed amendments to Rule 17a-4 would require broker/dealers to preserve books and records indicating that all outgoing communications have been approved by a principal of the broker/dealer (emphasis added). If approved, this amendment would have the effect of indirectly imposing a more stringent correspondence approval requirement than the approval requirement that would be imposed under the proposed amendments to NASD Conduct Rule 3010 discussed in this Notice. The comment period on the SEC's proposed rule amendments expires on December 27, 1996.