

Notices to Members

December 2001

Notices

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INFORMATIONAL

Quarterly Disciplinary Update

NASD Regulation Office
Of General Counsel
Announces The
Publication Of The
Disciplinary Update

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.

- Executive Representatives
- Legal & Compliance
- Registered Representatives
- Senior Management
- Training

KEY TOPICS

- Disciplinary Information

Executive Summary

The NASD Regulation, Inc. (NASD Regulation) Office of General Counsel (OGC) announces the quarterly distribution of a new publication entitled the *Disciplinary Update*. The *Disciplinary Update* will contain straightforward summaries designed to be of instructional value for compliance officials and registered persons. It will focus on factual and legal findings and the sanctions imposed in recent disciplinary decisions and settlements involving registered representatives.

Questions/Further Information

Questions concerning this *Notice* may be directed to Carla J. Carloni, Associate General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8019.

NASD Regulation OGC Announces Publication Of The *Disciplinary Update*

The NASD Regulation OGC announces the publication of the *Disciplinary Update*. The purpose of the *Disciplinary Update* is to provide registered representatives with a summary of select, recent disciplinary actions involving misconduct by registered representatives. The sampling includes settlements and decisions in litigated matters. This document is intended to be easily read and understood by non-lawyers so that it can be most useful to compliance officers and registered persons.

The goal is for the *Disciplinary Update* to serve as a teaching tool that compliance officers can share with all individuals associated with their firms. The *Disciplinary Update* will not report on every

disciplinary decision and settlement. It will report only on selected settlements, Hearing Panel, National Adjudicatory Council, and Securities and Exchange Commission decisions (in NASD disciplinary matters) that NASD Regulation OGC believes would be useful to report in this fashion. Since the *Disciplinary Update* is not intended to be used for legal research, the summaries will not include references to case names or numbers or other identifying factors. Rather, the summaries will be organized by subject matter and will include a brief discussion of facts, findings, and sanctions.

The *Disciplinary Update* is not intended to replace or supplement the disciplinary information and decisions found on the NASD Regulation Web Site (www.nasdr.com) or announced in *NASD Notices to Members*. The decisions and settlements referenced in the *Disciplinary Update* are subject to the restrictions regarding the release of disciplinary information contained in IM-8310-2 (Release of Disciplinary Information) in the *NASD Manual*.

The *Disciplinary Update* will be published quarterly on the NASD Regulation Web Site under the "Brokers" section. NASD Regulation will alert member firms about the posting of this document via the weekly e-mail broadcast sent to NASD Executive Representatives.

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INFORMATIONAL

Selling Away And Outside Business Activities

NASD Reminds Members
Of Their Responsibilities
Regarding Private
Securities Transactions
Involving Notes And Other
Securities And Outside
Business Activities

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.

- Executive Representatives
- Insurance
- Legal & Compliance
- Operations
- Registered Representatives
- Senior Management

KEY TOPICS

- Outside Business Activities
- Private Securities Transactions
- Promissory Notes
- NASD Rule 3030
- NASD Rule 3040
- Supervision

Executive Summary

NASD Regulation, Inc. (NASD Regulation) has brought a number of formal disciplinary actions against registered representatives for selling securities without prior notice to and approval from the representative's employer member firm and for engaging in outside business activities without prior notice to the employer member firm. A registered person who sells a security away from his or her firm without first obtaining written approval from the firm violates NASD Rule 3040, and a registered person who engages in an outside business activity without prior notice to his or her firm, including the sale of non-securities products, violates NASD Rule 3030.

Recently, NASD Regulation has seen an increase in selling away involving independent insurance agents registered solely as Series 6 Investment Company and Variable Contracts Products representatives. These Series 6 representatives are increasingly being targeted by issuers, promoters, and marketing agents to sell short-term promissory notes to their customers. Although in many instances these notes are securities, promoters of these products are marketing them to registered persons as non-securities products that do not have to be sold through a broker/dealer by a registered person. In a significant number of cases, associated persons have sold these notes to their customers away from their firms and without firm approval as required by Rule 3040.

Associated persons are required, either under Rule 3030 or Rule 3040, to report, in writing, any and all types of business that they plan to conduct away from their firms, whether or not it involves a security. Rule 3040 requires

associated persons to obtain written approval from their firms before they sell any security, including securities in the form of promissory notes, and Rule 3030 requires prompt written notice to a member of any outside business activity for which an associated person receives compensation, including the sale of a promissory note that is not a security. Since there has been some confusion among associated persons as to whether particular financial instruments are securities, this *Notice* advises associated persons to provide written notice to their firms **before** they engage in the sale of any financial instrument.

This *Notice* also reminds members that they should: (1) review their supervisory procedures to make sure that they are reasonably designed to achieve compliance with NASD Rules 3030 and 3040 regarding outside business activities and private securities transactions; and (2) appropriately educate their associated persons regarding the requirements of Rules 3030 and 3040.

Questions/Further Information

Questions concerning this *Notice* may be directed to Shirley H. Weiss, Associate General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8844.

Private Securities Transactions Involving Promissory Notes Have Significantly Increased

There has been a significant increase in private securities transactions involving the sale of promissory notes. In 2000, NASD Regulation brought more than 100 formal disciplinary actions involving violations of NASD Rule

3040, including cases against 39 individual representatives who sold more than \$12 million in notes to more than 300 investors. In 2000, the Securities and Exchange Commission (SEC), acting in conjunction with state securities regulators, also brought a series of disciplinary actions against hundreds of individuals and entities that had raised more than \$300 million from the sale of fraudulent promissory notes to thousands of investors.¹

Types Of Notes Being Marketed To The Public Through Associated Persons

Various types of schemes are being marketed to the public through associated persons, including promissory notes, payphone and ATM schemes, prime bank schemes, and Ponzi schemes.² Promoters also are actively marketing associated persons to sell “viatical settlements” away from their firms.³ Members and associated persons should be aware that, depending on its structure, a viatical product may or may not be a security.⁴

Members and associated persons should be on the lookout for the various types of fraudulent statements that are used to market these notes to associated persons. Associated persons may be falsely told that the notes are low risk, with “guaranteed,” high returns, or that they are collateralized. Associated persons also are being told that the notes are not securities, and therefore, persons selling them are not required either to be registered or to report the sales to their firms. Associated persons often are urged to invest themselves and, in some instances, are being offered

large commissions for selling to their customers. Associated persons can avoid the regulatory pitfalls associated with selling notes away from their firms by first obtaining written approval from their firms, as required by Rule 3040, before they sell any note.

How Can An Associated Person Determine Whether A Note Is A Security

There appears to be some uncertainty among associated persons as to whether notes being sold to the public are securities, especially when issuers and marketing agents may insist that they are not. Except for some commercial loans,⁵ most notes are securities. A promissory note is most likely a security if the seller is selling notes to the general public to raise money for the general use of a business enterprise and the buyer is lending money as an investment and is interested primarily in the profit that the note is expected to generate.⁶

Thus, it is likely that promissory notes that are marketed and sold to the general public are securities, and a registered person may not sell these notes without prior notice to and the express written permission of his or her firm. Further, it is not sufficient to have a Series 6 registration to sell promissory notes. An individual who sells promissory notes to public customers must be registered as a Series 7 registered representative.

Associated persons at times solely rely on information provided to them by issuers, issuers’ counsel, or promoters, and they fail to confirm the facts. NASD Regulation strongly urges registered persons not to make

the assessment of whether a particular note is a security, but to give their firms the opportunity to determine whether sale of the note is merely an outside business activity or the sale of a security that requires written notice to the firm and firm permission. Associated persons are reminded that even if the product they wish to sell is a non-securities product, they may not accept compensation away from their firms unless and until they have provided prompt written notice to their firms.

Associated Persons’ Reporting Responsibilities

Associated persons are required, either under Rule 3040 or Rule 3030, to report **any** kind of business activity engaged in away from their firms. Rule 3040 prohibits an associated person from selling any security “away” from the member firm unless the firm has authorized the associated person to make the sale. Rule 3040 applies to all sales of securities, including promissory notes that are securities. Rule 3040 ensures that, if a firm approves an associated person’s participation in a securities transaction,⁷ the firm assumes certain critical regulatory responsibilities that go with offering and selling securities to customers. In addition to requiring that the transactions be recorded on the firm’s books and records, the firm must exercise appropriate supervision over the associated person in order to prevent violations of the securities laws. As recently stated by the SEC, Rule 3040 “protects investors from the hazards of unmonitored sales and protects the firm from loss and litigation.”⁸

Rule 3040 requires registered persons to provide notice of the proposed transaction, in writing, to his or her firm, before the sale is made. The notice must describe the proposed transaction(s) in detail and the associated person's proposed role and must also state whether the individual has received or may receive selling compensation (including any type of referral fee). Oral notice to the firm is not sufficient to meet the requirements of Rule 3040. If the associated person expects to receive compensation, the firm must advise the registered person, in writing, whether it approves or disapproves the person's participation in the proposed transaction. If the firm disapproves the person's participation, he or she may not participate in the transaction in any manner, directly or indirectly. If the member approves the person's participation in the proposed transaction, the firm must record the transaction on its books and records and supervise the person's participation in the transaction as if the transaction were executed on behalf of the member.

If the note in question is not a security, the registered person is required under Rule 3030 to provide prompt written notice to his/her member firm that he or she has accepted compensation outside the scope of his relationship with the firm. Because of the differences in the requirements of Rule 3030 and Rule 3040, it is important for registered persons to establish with their firms whether a particular note is a security and to follow the appropriate NASD rule requirements.

Associated persons are reminded that it is not sufficient to verify the non-securities status of a note solely by relying on the advice of the issuer or issuer's counsel. An associated person who attempts to conduct his or her own investigation of the issuer does so at his or her own regulatory risk, because an associated person's conclusions may be erroneous and because failure to report the proposed sales to the associated person's firm deprives the firm of the opportunity to challenge the issuer's analysis and conclusion. NASD Regulation strongly urges all associated persons to notify their firms in advance of any sales, so that the legal status of the note may be determined, and the proper notice given to the firm prior to any sales.

Members' Supervisory Obligations

Given the significant number of fraudulent promissory note schemes that have been uncovered, members should review their supervisory and compliance procedures to make sure that their reporting requirements are clear and complete and that each associated person receives appropriate education and training regarding the sale of notes. Problems may arise, for example, when insurance sales persons, who also are registered as Series 6 representatives, are not required by their firms to report certain outside business activities, such as the sales of other insurance products. To avoid confusion, members are urged to adopt procedures that would require

registered persons to report any kind of income-producing activity.

NASD Regulation also suggests that firms review their supervisory and compliance programs to determine whether they are adequately educating their registered persons regarding the current proliferation of promissory note schemes and the importance of reporting all sales of notes under either Rule 3030 or Rule 3040. Firms should review their annual compliance checklists to make sure that their registered persons understand that all outside sales of notes, whether securities products or not, should be reported to their firms prior to any sales. Annual audits, compliance meetings, and continuing education programs also should include issues regarding the sale of notes. Firms also might consider conducting "preventive compliance conferences" that specifically address selling notes away from the firm.

Endnotes

- 1 See NASD Regulation Investor Alert, "Promissory Notes Can Be Less Than Promised," Jan. 11, 2001, which can be found on NASD Regulation Web Site (www.nasdr.com).
- 2 For a description of some of these schemes, see "Top 10 Investment Scams List Released by State Securities Regulators" which can be found on the North American Securities Administrators Association (NASAA) Web Site (www.nasaa.org).
- 3 Viatical settlements are interests in the death benefits of terminally ill patients. In a viatical settlement, investors acquire fractional interests in individual insurance policies. In general, the insured gets a percentage of the death benefit in cash, and the investors get a share of the death benefit when the insured dies.
- 4 See *SEC v. Life Partners, Inc.*, 87 F.3d 356 (D.C. Cir), *reh'g denied*, 102 F.3d 587 (D.C. Cir. 1996); *Timothy James Fergus, et al.*, C10990025 (NAC May 5, 2001).
- 5 For example, consumer financing notes, notes secured by mortgages on homes, and short-term business notes secured by the assets of the business or an assignment of accounts receivable generally are not securities.
- 6 *Reves v. Ernst & Young*, 494 U.S. 56, 64 (1990).
- 7 Associated persons are reminded that "participation" in a securities transaction includes not only making the sale, but referring customers, introducing customers to the issuer, arranging and/or participating in meetings between customers and the issuer, or receiving a referral or finder's fee from the issuer.
- 8 *Robin Bruce McNabb*, Exchange Act Rel. No. 43411 (Oct. 4, 2000).

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INFORMATIONAL

**Books And
Records Rules**

**Amendments To
Broker/Dealer Books
And Records Rules
Under The Securities
Exchange Act Of 1934****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.

- Executive Representatives
- Legal & Compliance
- Operations
- Senior Management

KEY TOPICS

- Books and Records
- Exchange Act Rule 17a-3
- Exchange Act Rule 17a-4

Executive Summary

On October 25, 2001, the Securities and Exchange Commission (SEC or Commission) adopted amendments to Rules 17a-3 and 17a-4 of the Securities Exchange Act of 1934 (Exchange Act) to clarify and expand record keeping requirements in connection with purchase and sale documents, customer records, associated person records, customer complaint records, and certain other matters. The amendments also require broker/dealers to maintain or promptly produce certain records at each office to which those records relate.

The amendments become effective on May 2, 2003. The *Federal Register* version of the SEC final rule release is provided in Attachment A. For a more complete description of the amendments, members should review the attached SEC final rule release.

Questions/Further Information

Questions concerning this *Notice* may be directed to Emily Gordy, Acting Director, Office of Regulation Policy, Department of Member Regulation, NASD Regulation, Inc. (NASD Regulation), at (202) 728-8070, or Grace Yeh, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-6939.

Discussion And Background

In general, Rules 17a-3 and 17a-4 of the Exchange Act establish minimum requirements for records that broker/dealers must prepare and periods during which such records must be maintained.

On October 11, 1996, the National Securities Market Improvement Act of 1996 (NSMIA) was enacted, prohibiting states from establishing books and records rules that differ from, or are more burdensome than those established by the Commission's rules. NSMIA also requires that the SEC periodically consult with states concerning the adequacy of the Commission's books and records rules. The SEC originally proposed amendments to its books and records rules in 1996 (the 1996 Amendments) in response to NSMIA and to concerns expressed by the members of the North American Securities Administrator's Association that the existing Commission's books and records rules do not require firms to make and retain records that would facilitate sales practice examinations and enforcement activities in individual broker/dealer offices by state regulators. Based on comments received on the proposed 1996 Amendments, the SEC substantially revised the amendments and re-proposed them in 1998 (the 1998 Amendments). The final rule amendments incorporate many of the suggestions raised in the approximately 115 comment letters and a letter from the Office of Management Budget that the Commission received in response to the proposed 1998 Amendments.

Highlights Of Amendments

The Commission believes that the final amendments balance the interests of securities regulators to obtain information in a time-efficient manner with the concerns expressed by many industry representatives that costs of complying with the proposed requirements, particularly the

customer account record and rules that require records to be maintained at offices, will be unduly burdensome. The Commission further believes that since broker/dealers presently maintain a significant portion of the records required under the adopted amendments in order to comply with federal or self-regulatory organization (SRO) requirements or in the normal course of business, the new requirements should not present considerable additional burdens for most broker/dealers.

Some of the more significant changes to the books and records rules are discussed below.

1. Office – The amended rules define “office” as locations where one or more associated persons regularly conduct a securities business. The definition of office is significant because firms are required to create and maintain certain records at offices for two years. The final rules provide that instead of maintaining records at a particular office, a broker/dealer may choose to produce records promptly upon request at the office to which the records relate or at another place as agreed to by the regulator. In its final rule release, the Commission states that the word “promptly” has deliberately not been defined in the rule, and suggests that in general, records that are readily available at an office should be produced on the day of the request while the time frame for filling large or complex requests should be discussed between the firm and the regulator.

A broker/dealer is not required to maintain records at an office that is a private residence if only one associated person (or multiple associated persons if members of the same immediate family) regularly conducts business at the

office, the office is not held out to the public as an office, and neither customer funds nor securities are handled at the office. Instead, records pertaining to private residence offices may either be maintained at another location within the state of the office at the broker/dealer’s choosing or be produced promptly at an agreed upon location.

The records that broker/dealers must create as to each office include blotters, order tickets, customer account records, records with respect to associated persons, customer complaints, records evidencing compliance with SRO rules with regard to communications with the public, records of persons who can explain the information in the broker/dealer’s records, and records of each principal responsible for establishing record keeping compliance procedures.

2. Customer Account Records – New Rule 17a-3(a)(17) requires broker/dealers to create an account record for each customer. Broker/dealers must make a good faith effort to collect certain information including basic identification and background information on the customer and the account’s investment objectives. Broker/dealers are required to furnish each customer with the information periodically, generally within 30 days of opening the account and at least every 36 months thereafter and when certain information is changed. Broker/dealers have three years from May 2, 2003 to obtain and furnish customers with the account record information for accounts in existence on May 2, 2003.

Since the purpose of the customer account records is primarily to enable regulators to review for

compliance with suitability rules, accounts that are not subject to SRO suitability requirements, including NASD Conduct Rules 2310 and 2860(b)(16)(B),¹ are exempt from the account record requirements.² Accounts that have been inactive for 36 months are also exempt from the customer account requirements.

Broker/dealers should be aware that even if Rule 17a-3(a)(17) does not require them to create a customer account record for certain accounts, they must still comply with federal laws and SRO rules to collect or update information regarding customer accounts.³

3. Order Tickets – To help securities regulators more efficiently determine whether certain individuals are engaged in sales practice violations, Rules 17a-3(a)(6) and 17a-3(a)(7) were amended to require that order tickets identify the time the order was received, even if subsequently executed, the identity of each associated person responsible for the account, if any, and any other person who entered or accepted the order on behalf of the customer, or, if applicable, a notation that a customer entered the order on an electronic system.⁴ Broker/dealers are not required to create a record of sales or purchase transactions entered into on a subscription basis directly from or to the issuer so long as the broker/dealer maintains a copy of the subscription agreement.

4. Associated Persons Records – Rule 17a-3(a)(12) identifies the records and information that must be maintained with respect to each associated person. To help regulators identify associated persons and where they work, amendments to Rule 17a-3(a)(12) require broker/dealers to create

records of all offices at which each associated person regularly conducts business as well as of all identification numbers assigned to the associated person.

The final amendments specify new associated person records requirements, including records of every written complaint received by the broker/dealer against each associated person (or alternatively, firms have the option to keep a copy of the written complaint along with records of the disposition of the complaint),⁵ records of all agreements pertaining to the associated person's relationship with the broker/dealer and a summary of each associated person's compensation arrangement and records listing transactions for which each associated person will be compensated.

5. Communications With Public – Under new Rule 17a-3(a)(20), broker/dealers are required to make records that demonstrate compliance with applicable federal regulations and SRO rules on communications with the public that require principal approval.⁶

6. Record Maintenance –

Amendments to Rule 17a-4 clarify the periods of time that records described in Rule 17a-3 must be maintained. The amended rules also require that broker/dealers maintain other information, including the following:

- for the life of the entity, copies of Forms BD and all amendments thereto;
- for three years after the date of the report, all reports which a securities regulatory authority has requested or required a firm to create and each examination report;
- for three years after the termination of use, all manuals describing the firm's policies and practices with respect to compliance and supervision; and
- for 18 months after the date the report was generated, reports created to review unusual activity in customer accounts.

Endnotes

- 1 NASD Conduct Rules 2310 and 2860(b)(16)(B) require that members use reasonable efforts and exercise diligence to collect customer information, including a customer's investment objective in connection with making investment recommendations or prior to opening up an options trading account for the customer, respectively.
- 2 Firms that do not make investment recommendations are excluded from the customer account requirements.
- 3 Members are required under NASD Conduct Rule 3110(c) maintain certain customer information.
- 4 If the broker/dealer uses an electronic system to generate the order ticket, and such system does not have a field to enter the name of any person, other than the associated person responsible for the account, who accepted the order, the broker/dealer may produce upon request by a regulator a separate record to identify the person rather than identify the person on the order ticket.
- 5 NASD Conduct Rule 2860(b)(17) and IM-3110(d) require each member to keep records of complaints.
- 6 NASD Conduct Rule 2210(b) requires that a principal of the member must approve all items of advertising and sales literature.

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SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 240 and 242

[Release No. 34-44992; File No. S7-26-98]

RIN 3235-AH04

Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934

AGENCY: Securities and Exchange Commission.

ACTION: Final rule; request for comments on Paperwork Reduction Act burden estimate.

SUMMARY: The Securities and Exchange Commission today is adopting amendments to its broker-dealer books and records rules. The amendments clarify and expand recordkeeping requirements with respect to purchase and sale documents, customer records, associated person records, customer complaints, and certain other matters. In addition, the amendments expand the types of records that broker-dealers must maintain and require broker-dealers to maintain or promptly produce certain records at each office to which those records relate. These amendments are specifically designed to assist securities regulators when conducting sales practice examinations of broker-dealers, particularly examinations of local offices.

EFFECTIVE DATE: May 2, 2003.

FOR FURTHER INFORMATION CONTACT:

Michael A. Macchiaroli, Associate Director, at (202) 942-0131; Thomas K. McGowan, Assistant Director, at (202) 942-4886; or Bonnie L. Gauch, Attorney, at (202) 942-0765; Office of Risk Management and Control, Division of Market Regulation, United States Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-1001.

SUPPLEMENTARY INFORMATION:

I. Introduction

The Securities and Exchange Commission's (the "Commission") books and records rules, Rule 17a-3¹ and Rule 17a-4² under the Securities Exchange Act of 1934 ("Exchange Act") (hereinafter the "Books and Records Rules"), specify minimum requirements with respect to the records that broker-dealers must make, and how long those records and other documents relating to a broker-dealer's business must be kept. The Commission has required that broker-dealers create and

maintain certain records so that, among other things, the Commission, self-regulatory organizations ("SROs"), and State Securities Regulators³ (collectively "securities regulatory authorities") may conduct effective examinations of broker-dealers.

The Commission originally proposed amending the Books and Records Rules in 1996 in response to concerns raised by members of the North American Securities Administrator's Association ("NASAA") regarding the adequacy of those Rules.⁴ On October 11, 1996, the National Securities Market Improvement Act of 1996 ("NSMIA") was enacted.⁵ NSMIA prohibits States from establishing books and records rules that differ from, or are in addition to, the Commission's rules. Prior to NSMIA many States had laws or rules that required broker-dealers to make and keep certain books and records that allowed the State Securities Regulators to conduct examinations and investigations to review for, among other things, sales practice violations.⁶ NSMIA also provides that the Commission must consult periodically with the States concerning the adequacy of the Commission's Books and Records Rules,⁷ particularly relating to the need by State Securities Regulators to have records readily accessible for their examinations.⁸

The Commission, recognizing the vital role that State regulators play in providing for customer protection, issued the Proposing Release, in part, to enhance the ability of the State Securities Regulators to conduct effective and efficient sales practice examinations of activities within their respective States, including those involving smaller broker-dealer offices. By adopting these rules, the Commission enables the State regulators to adopt and enforce similar rules on a State level, to support their examination responsibilities, and investigatory and enforcement requirements. An

³ For purposes of this release, "State Securities Regulators" include, as described in Section 15(h) of the Exchange Act, "the securities commissions (or any agency or office performing like functions) of the States." 15 U.S.C. 78o(h).

⁴ See Exchange Act Release No. 37850 (October 22, 1996), 61 FR 55593 (Oct. 28, 1996) ("Proposing Release" and/or "Proposal") (File No. S7-27-96).

⁵ Pub. L. No. 104-290, 110 Stat. 3416 (1996).

⁶ E.g., violations of State suitability and fraud laws, or federal regulations.

⁷ 15 U.S.C. 78o(h).

⁸ 142 Cong. Rec. S. 12093, S12094 (October 1, 1996) (statement of Sen. Dodd) ("It is the intent of the conferees that the SEC work closely with the States to determine what records should be maintained at branch offices and to establish a mechanism so that States could require such records be kept in the branch office, rather than at a back office halfway across the Nation.").

important aspect of the amendments is that broker-dealers are required to produce records at offices within a State. Moreover, many of these amendments require broker-dealers to make or keep records currently kept by broker-dealers as a matter of business practice or to comply with SRO rules. However, unless these requirements are adopted as Commission rules, the State regulators are unable to apply or enforce them at the State level.

II. Proposing and Reproposing Releases

In response to the comments received on the Proposing Release, the Commission substantially modified the amendments, and repropose them to allow for public comment on the modifications.⁹ In response to the reproposal, the Commission received approximately 115 comment letters from various groups, including broker-dealers, law firms representing broker-dealers, industry associations, and State Securities Regulators. Generally, State Securities Regulators supported the rules as repropose, but suggested some minor changes. While broker-dealers generally supported the Commission's efforts to adopt uniform books and records rules, they opposed various sections of the repropose rules. In particular, firms were opposed to the requirements to periodically update the customer account record and to maintain records at local offices. As discussed in the respective sections throughout this release, the Commission has substantially modified the content of the re-propose amendments and incorporated many of the suggested changes into the final rules.

To a significant degree, the amendments to Rules 17a-3 and 17a-4 adopted by the Commission track existing SRO requirements and certain State regulations that were in place prior to NSMIA. In addition, they largely represent a codification of prudent recordkeeping practices of many broker-dealers. Accordingly, many portions of the Books and Records Rule amendments should not present additional burdens for most broker-dealers.

⁹ Exchange Act Release No. 40518 (Oct. 2, 1998), 63 FR 54404 (Oct. 9, 1998) (the "Reproposing Release" and/or "Reproposal"). The staff of the Division of Market Regulation has prepared a summary of the comment letters received on the repropose rules and rule amendments (hereinafter referred to as "Comment Summary"). Copies of the comment letters and the Comment Summary have been placed in Public Reference File No. S7-26-98 and are available for inspection in the Commission's Public Reference Room.

¹ 17 CFR 240.17a-3.

² 17 CFR 240.17a-4.

III. Amendments to Rule 17a-3

In brief, the amendments to present Rule 17a-3 include revisions to the information that must be recorded on order tickets, and new requirements to: create certain records relating to associated persons; collect certain account record information and verify that information with customers periodically; create a record of customer complaints; create a record indicating compliance with applicable advertising rules; and create records identifying persons responsible for establishing procedures and persons able to explain the broker-dealer's records to a regulator.

A. Memoranda of Brokerage Orders and Dealer Transactions

Rule 17a-3 has been amended to require that a brokerage order ticket contain the identity of the associated person, if any, responsible for the account and any other person who entered or accepted the order on behalf of the customer, and whether it was entered subject to discretionary authority. In addition, a brokerage order ticket must include the time at which the broker-dealer received a customer order, even if the order is subsequently transmitted for execution.¹⁰ A dealer ticket must include information regarding any modifications to the order.¹¹ This will allow securities regulators to better focus their examinations and investigations because they will be able to identify certain types of violative activities and the individuals responsible for those activities more easily.

The Commission clarified that the identity of the associated person responsible for the account must be included only if the broker-dealer assigns to an associated person responsibility for certain accounts. This modification was made in response to broker-dealer comment letters that noted some firms do not assign a particular associated person to each account, and some firms allow customers to enter orders directly into a broker-dealer's systems, such as through an on-line trading account. Further, this modification addresses the concerns of some commenters that without a qualifying phrase, such as "if any," the

¹⁰ 17 CFR 240.17a-3(a)(6). Most broker-dealers are currently required to record the time the order was received from a customer under the National Association of Securities Dealers' ("NASD") Order Audit Trail System ("OATS") rules (NASD rules 6950 through 6957 and 3110) (hereinafter "OATS rules") (See specifically NASD rules 6954(b)(16) and 3110(h)), and New York Stock Exchange ("NYSE") rules 123 and 410A.

¹¹ 17 CFR 240.17a-3(a)(7).

rule may be interpreted erroneously as placing on firms an affirmative obligation to assign an associated person to each account.

If a firm has assigned identification numbers or codes to the persons entering customer orders to comply with the requirement to record the identity of the person entering customer orders, a broker-dealer may record the identification number or code on the order ticket instead of the associated person's name. Further, if the person entering a customer order has been assigned to a computer terminal but does not have a specific identification number or code, it is acceptable for the broker-dealer to identify the number or code of a computer terminal at which an order was entered. In either case, upon request by a representative of a securities regulatory authority, the firm must provide the actual identity of the person who entered the order. Either of these alternatives may be satisfied by using a companion record to the order tickets.¹²

With these amendments, paragraphs (a)(6) and (a)(7) require that broker-dealers record the identity of "any [person other than the associated person responsible for the account] who entered or accepted the order on behalf of the customer." In response to comments by the online brokerage community, the Commission included, after this requirement, the phrase, "if a customer entered the order on an electronic system, a notation of such entry." Because most firms that accept orders through an electronic system already identify, for supervisory purposes, which orders were entered directly by a customer, this requirement will not create much additional burden on the firms. Further, it will assist them in identifying for securities regulatory authorities why certain tickets do not identify the associated person who received the order from the customer.

One commenter argued that firms that primarily accept "unsolicited" orders and do not pay transaction-based commissions should not be required to include on the order ticket information regarding associated persons because no sales practice concerns would be implicated in these types of transactions. However, the Commission believes that recording the identity of the associated person on a broker-dealer's order tickets is essential for

¹² *E.g.*, a firm may satisfy this requirement by using the record listing any internal identification number or code assigned to associated persons which is required under new Rule 17a-3(a)(12)(ii) (17 CFR 240.17a-3(a)(12)(ii)). Additionally, the Commission believes this requirement is consistent with the NASD's OATS rules.

adequate surveillance of, and accountability for, transactions.

One commenter wrote that for some transactions the time of entry frequently is simultaneous or nearly simultaneous with the time the order is received, and suggested that under these conditions, the firm should not have to make a separate entry for each time. In those situations, it must be clear from the order ticket that the time of receipt was the same as the time of entry. However, the time recorded must be accurate and this should not be construed as an exception to allow firms to use an approximate time for one or both entries.¹³

Finally, the Commission recognizes that for some types of transactions, such as purchases of mutual funds or variable annuities, the customer may simply fill out an application or a subscription agreement that the broker-dealer then forwards directly to the issuer.¹⁴ These documents would include the information that is important for and specific to the particular type of transaction. Hence, the Commission has added paragraph (a)(6)(ii) under Rule 17a-3 to allow firms to keep a copy of the application or subscription document instead of making a separate record as to transactions described in the exemption. This paragraph would also exempt transactions such as automatic dividend reinvestments. The Commission views this additional paragraph as a codification of current industry practice, and it is limited to these types of transactions.

B. Associated Person Records

1. New Records Concerning Associated Persons

Rule 17a-3(a)(12) requires a firm to make records relating to associated persons of the firm, including information regarding the associated person's employment and disciplinary history. The amendments require a record listing all of a firm's associated

¹³ A number of firms have asked for guidance on the meaning of the term "to the extent feasible." The time of execution should be included on the order ticket except for situations in which it may be impossible to determine the precise time when the transaction was executed; however, in that case the broker-dealer must note the approximate time of execution. Exchange Act Release No. 3040 (Oct. 13, 1941), 11 FR 10984. The Commission has stated that the "phrase 'to the extent feasible' was intended to be applicable only in exceptional circumstances where it might be actually impossible to determine the exact time of execution." Exchange Act Release No. 13508 (May 5, 1977) 42 FR 25318. However, in that case the broker-dealer must note the approximate time of execution.

¹⁴ This is referred to elsewhere in the rules as a "subscription-way basis" transaction. See 17 CFR.15c3-1(a)(2)(v).

persons showing every office where each associated person regularly conducts business, and listing all internal identification numbers and the CRD number assigned to each associated person.¹⁵ This will allow securities regulators to identify where associated persons work, and to read various records which may identify the associated persons solely through the use of identification numbers. Also, three technical changes were made from the rule as repropounded.¹⁶

2. The Definition of Associated Person

The Commission had proposed to eliminate from Rule 17a-3 a definition of "associated person" and instead use the definition of "associated person" as defined in sections 3(a)(18) and 3(a)(21) of the Exchange Act. However, the statutory definition of "associated person of a broker or dealer" in section 3(a)(18) specifically excludes those persons whose functions are clerical or ministerial from the definition solely for purposes of section 15(b) of the Exchange Act. Current Rule 17a-3 excludes those persons from the recordkeeping requirements. The Commission has determined that those persons should continue to be exempt from the recordkeeping requirements of Rules 17a-3 and 17a-4. Therefore, the Commission believes it is appropriate to retain a definition of the term "associated person" in the rule. This definition has been moved to paragraph (g), however, and has been modified for the sake of uniformity to incorporate the definitions of "associated person of a member" and "associated person of a broker or dealer" as set forth in sections 3(a)(21) and 3(a)(18) of the Exchange Act.¹⁷ In addition, for purposes of Rules 17a-3 and 17a-4, the Commission has excluded from the definition persons whose functions are solely clerical or ministerial. In order to avoid redundancy and achieve greater consistency in interpretation, this phrase shall be interpreted in the same manner as the phrase "solely clerical and ministerial" is interpreted under section 3(a)(18) of the Exchange Act.

¹⁵ 17 CFR 240.17a-3(a)(12)(ii).

¹⁶ First, repropounded paragraphs (a)(12)(ii) and (a)(12)(iii) have been moved to paragraph (a)(19) of Rule 17a-3 to keep all requirements relating to compensation records in the same section (most agreements between associated persons and broker-dealers relate to compensation in some manner). Second, repropounded paragraphs (a)(12)(iv) and (a)(12)(v) have been combined into new paragraph (a)(12)(ii). And finally, the Commission has deleted the references to local offices and state record depositories to make this paragraph consistent with the changes to the definition of "office" in paragraph (g)(1) of Rule 17a-3.

¹⁷ 15 U.S.C. 78c(a)(21) and 15 U.S.C. 78c(a)(18).

The Exchange Act provisions define an associated person to include any partner, officer, director, or branch manager of a broker-dealer (any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with a broker-dealer, or any employee of a broker-dealer. This includes order-takers. The Commission interprets the term associated person to include any independent contractor, consultant, franchisee, or other person providing services to a broker-dealer equivalent to those services provided by the persons specifically referenced in the statute.¹⁸

C. Customer Account Record

The Commission is adopting new Rule 17a-3(a)(17)¹⁹ under the Exchange Act, which requires broker-dealers to create a record containing certain minimum information as to each customer. The primary purpose of Rule 17a-3(a)(17) is to provide regulators, particularly State Securities Regulators, with access to books and records which enable them to review for compliance with suitability rules.²⁰ Rule 17a-3(a)(17) also requires broker-dealers to furnish that information to each customer on a periodic basis. The rule should not be construed to affect or supersede any Federal, State, or SRO requirement, including those relating to

¹⁸ The Commission has consistently taken the position that independent contractors (who are not themselves registered as broker-dealers) involved in the sale of securities on behalf of a broker-dealer are "controlled by" the broker-dealer, and, therefore, are associated persons of the broker-dealer. See, e.g., *In the Matter of William V. Giordano*, 61 S.E.C. Dkt. 345, Exchange Act Release No. 36742 (Jan. 19, 1996) (in finding that an officer of a broker-dealer firm failed reasonably to supervise an independent contractor, the Commission found that the independent contractor was an "associated person" of the firm within the meaning of Section 3(a)(18) of the Exchange Act). See, also, Letter from Douglas Scarff, Director, Division of Market Regulation, to Gordon S. Macklin, NASD; Charles J. Henry, Chicago Board Options Exchange; Robert J. Birnbaum, American Stock Exchange; and John J. Phelan, NYSE, [1982-1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) P77,303 at P77,116 (Jun. 18, 1982); *Hollinger v. Titan Capital Corp.*, 974 F.2d 1564, 1572-76 (9th Cir. 1990), cert. denied, 111 S. Ct. 1621 (1991). A similar analysis would be applicable to other persons, such as consultants and franchisees, performing securities activities with or for the broker-dealer.

¹⁹ This provision was repropounded as Rule 17a-3(a)(16).

²⁰ Generally, suitability rules require that broker-dealers and their associated persons refrain from recommending transactions or investment strategies to a customer that would be "unsuitable" for that customer based upon the customer's situation. Factors that may be considered in assessing a customer's situation include the customer's age, financial situation, and investment experience or knowledge of the industry.

"know your customer," suitability, or supervisory obligations.

1. Account Record Information

The information required under new Rule 17a-3(a)(17)(i)(A) for each account with a natural person as a customer includes the customer's name, tax identification number, address, telephone number, date of birth, employment status (including occupation and whether the customer is an associated person of a member, broker or dealer), annual income, net worth (excluding value of primary residence), and investment objectives. Most broker-dealers already collect this information to assist them in assessing customers' suitability or to comply with other rules. For accounts with more than one owner, the record should include personal information for each owner of the account; however, the record should reflect the investment objectives for the account and not the individual investment objectives for each "joint" owner named on the account. Further, financial information for the owners can be combined. For discretionary accounts, firms also must include as part of the account record the dated signature of each customer granting the discretionary authority and the dated signature of each natural person²¹ to whom discretionary authority was granted. In response to comments received, the Commission did not adopt the repropounded requirement that the account record include information regarding a customer's marital status and number of dependents.²²

Under the final rule, the account record must indicate whether it has been signed by the associated person responsible for the account, and approved or accepted by a principal of the firm.²³ This will identify for regulators the persons responsible for accepting a particular account on behalf of the firm. Similar to the comments made regarding order tickets, some commenters stated that they do not always assign an associated person to each account. Therefore, the Commission has added the phrase "if any" to the requirement that the account record indicate whether it has been approved by an associated person. The account record still must indicate

²¹ See NYSE Rule 408 and NASD Rule 2510(b).

²² See, e.g., Comment Letters from Raymond James, p. 4; Investment Management and Research, p. 3, and Mayer, Brown & Platt, pp. 6-7.

²³ 17 CFR 240.17a-3(a)(17)(i)(A). This requirement is consistent with SRO rules regarding the signatures of associated persons and principals when opening customer accounts. See NYSE Rule 405(3) and NASD Rule 3110(c)(1)(C).

whether it has been approved by a principal.²⁴

In the Reproposal, the Commission specifically sought comment on whether, for joint accounts, the firm should obtain the account record information for each individual. Most commenters that addressed this issue did not object to maintaining personal information for each owner of joint accounts. However, some commenters pointed out that it would be unnecessary and redundant to obtain individual information for certain types of joint accounts, such as a joint account of two spouses with similar information regarding income and net worth. These commenters also contended that the investment objectives should reflect the objectives for the account and not the objectives of the individual owners. In those cases, it is sufficient under paragraph (a)(17) of Rule 17a-3²⁵ that the account record reflect that portions of the account record information are the same for each owner of the account. It is acceptable for firms to combine joint owners' financial information as opposed to obtaining and maintaining that information separately for each of the joint owners. Lastly, the investment objectives recorded should be those for the account, and not those of the individual owners.

Some commenters requested clarification as to how this information must be maintained and whether all the information and signatures must be included on the same form.²⁶ Although a broker-dealer must create a single record for each account, that record may consist of more than one document, such as two or more account applications.

A broker-dealer is not required to furnish a copy of a customer's account record to the customer within thirty days when obtaining new information to complete the initial account record, required under Rule 17a-3(a)(17)(i)(A),²⁷ for an account in existence on the effective date of the rule amendments. However, as stated in Rule 17a-3(a)(17)(i)(B)(1),²⁸ broker-dealers must create a record indicating that the broker-dealer furnished these customers with a copy of the account

record information within three years of the effective date of the rule.

2. Furnishing the Account Record Information

Rule 17a-3(a)(17) requires that the firm periodically furnish account record information to the customer.²⁹ The new requirement allows the customer to review the information regarding the account that the firm has on file and from which the associated person or the firm is making investment recommendations or suitability determinations for the account. The requirement to furnish this record to customers is designed to reduce the number of misunderstandings between customers and broker-dealers regarding the customer's situation or investment objectives. Firms may, of course, elect to provide this information to customers more frequently in order to coincide with other mailings.

Paragraph (a)(17) of the rule identifies four provisions that trigger the requirement that a broker-dealer furnish to a customer a copy of information contained in the account record.³⁰ Those provisions include (i) the opening of a new account;³¹ (ii) the periodic updating of an account that must occur at least once every 36 months;³² (iii) a change of customer name or address;³³ and (iv) a change of other customer information.³⁴

Although paragraph (a)(17)(i) of Rule 17a-3 requires broker-dealers to periodically update customer records, the rule does not affect a broker-dealer's obligations under any SRO "know your customer" rules. It may be appropriate in certain circumstances for broker-dealers to obtain updated information from customers more often than once every 36 months.

Because different terms ascribed to categories of investment objectives may vary among firms, the firms must describe these terms when furnishing the account record to customers. When opening an account, the customer has the opportunity to question the meaning of the investment objective terms, but when the customer receives a copy of the account record at home, that customer may have forgotten or misunderstood the meaning of those

terms. This requirement to describe investment objective terminology should help ensure that the customer and the firm have a mutual understanding of the meaning of each term.

Paragraph (a)(17) of Rule 17a-3 also provides that a broker-dealer is not required to include the customer's tax identification number and date of birth with the information provided to the customer. Several commenters suggested that unauthorized access to such information could facilitate the perpetration of fraud against the customer.³⁵

The Commission did not adopt the portion of the rule as reproposed that would have required firms to send a notification of change of address to both the old and new addresses. This change was in response to comments that prudent business practice requires that this notification be sent only to the old address to prevent misdirection of account information. Therefore, as adopted, firms are required to send a notification of a change of address only to the old address.

Some commenters sought clarification as to whether the amendment required a separate mailing of the customer account record information. This rule does not require a separate mailing, and the Commission anticipates that firms will combine this mailing with other mailings. Further, the account record information may be printed on a customer's account statement. Finally, a firm may mail the customer a copy of the customer's complete account record reflecting any change of other account record information³⁶ on or before the 30th day after the date the member, broker or dealer received notice of any change, or it may choose to send this notification with the next statement scheduled to be mailed to the customer.

3. Explanation of the Neglect, Refusal, or Inability of a Customer To Provide Required Information

As adopted, Rule 17a-3(a)(17)(i)(C) does not require broker-dealers to include an explanation of the customer's neglect, refusal, or inability to provide the required information. However, a broker-dealer is required to make a good faith effort to collect this information. If the account record does not include the required information, the broker-dealer would bear the burden of explaining why this information is not available. Rule 17a-3(a)(17)(i)(C) is

²⁴ The Commission believes that this requirement is consistent with SRO requirements regarding customer accounts such as those discussed above in footnote 23.

²⁵ 17 CFR 240.17a-3(a)(17).

²⁶ See Comment Letters from Donaldson, Lufkin and Jenrette, p. 9, and the International Association for Financial Planning, pp. 2-3.

²⁷ 17 CFR 240.17a-3(a)(17)(i)(A).

²⁸ 17 CFR 240.17a-3(a)(17)(i)(B)(1).

²⁹ Certain SRO rules already require that customer account records be sent to customers who open options accounts. See NASD Rule 2860(b)(16)(C) and IM-2860-2, and NYSE Rule 721(c) and Supplemental Material at .30 regarding options accounts.

³⁰ 17 CFR 240.17a-3(a)(17)(i)(B)(1) through (B)(3).

³¹ 17 CFR 240.17a-3(a)(17)(i)(B)(1).

³² *Id.*

³³ 17 CFR 240.17a-3(a)(17)(i)(B)(2).

³⁴ 17 CFR 240.17a-3(a)(17)(i)(B)(3).

³⁵ See Comment Letters from Fidelity Investments, p. 5, Benefits Communication Corporation, p. 1, American Express Financial Advisors, Inc., p. 4, and Comerica Securities, p. 3.

³⁶ 17 CFR 240.17a-3(a)(17)(i)(B)(4).

specifically limited in application to paragraph (a)(17), and does not apply to any other Federal or SRO rules regarding collections of information (e.g., Rule 17a-3(a)(9)).

4. Exemption From Account Record Information Requirements

A number of broker-dealer firms argued that the Commission should create an exemption from the account record information requirements of Rule 17a-3(a)(17)(i), contending that this record is intended to allow examiners to review for suitability, but broker-dealers are not subject to SRO suitability requirements for all of their accounts.³⁷ Therefore, they argue, where they have no suitability obligation, they should not be required to obtain account record information. The Commission is adopting the account record requirements with an exemption for certain accounts,³⁸ such that a broker-dealer is not required to create an account record for an account if the firm is not required (under any Federal or SRO rules) to make a suitability determination as to the account. However, the obligation to collect and record information of the type enumerated in Rule 17a-3(a)(17)(i)(A) may arise under SRO rules and interpretations. If, after the account is opened, the firm or its associated person engage in conduct that would subject the firm to any requirement to make a suitability determination, the firm must obtain the information before making such a recommendation. The firm would have to comply thereafter with the requirement to furnish customers with a copy of their account record for verification, under paragraph (a)(17)(i)(B)(1) of Rule 17a-3, but the account could re-qualify for the exemption.

For accounts existing on the effective date of these amendments, a broker-dealer will not be required to create or update the account record if, within the 36-month period beginning on the effective date of this rule, the firm has not been required to make a suitability determination as to that account.

For the purposes of paragraph (a)(17)(i)(D) of Rule 17a-3, the term "suitability determination" should be interpreted broadly. A broker-dealer may have an obligation to perform a suitability determination under the

³⁷ See, e.g., NASD Rules 2310 and 2860(b)(16)(B), NYSE Rule 723, Chicago Board Options Exchange Rule 9.9, and Municipal Securities Rulemaking Board Rule G-19.

³⁸ 17 CFR 240.17a-3(a)(17)(i)(D).

Exchange Act,³⁹ Commission rules,⁴⁰ SRO rules,⁴¹ or common law.⁴² Rule 17a-3(a)(17) does not change or limit a broker-dealer's obligation to make a suitability determination.

It is important to note that even if a broker-dealer is not required to create an account record under Rule 17a-3(a)(17) for an account, the firm must still comply with federal laws and regulations and SRO rules requiring collections of information regarding customer accounts, including paragraph (a)(9) of Rule 17a-3,⁴³ NYSE Rule 405, and MSRB Rule G-8(a)(xi).

5. Applicability of Account Record Requirements and 36-Month Grace Period

The requirement to create an account record applies to both new and existing accounts. For accounts opened on or after the effective date of these amendments ("new accounts"), the firm must obtain the account record information required under Rule 17a-3(a)(17)(i)(A) when the account is opened.

As originally proposed, the grace period to obtain the customer account record information for accounts existing on the effective date of these amendments would have been one year. However, many commenters⁴⁴ stated that with a large number of accounts it would be unduly burdensome to obtain the account record information within one year. Therefore, the Commission has provided broker-dealers with a 36-month grace period. Specifically, under paragraph (B)(1) of Rule 17a-3(a)(17)(i), for accounts existing on the effective date of these amendments, a firm will have 36 months to obtain the information required on the account record under paragraph (a)(17)(i)(A) of Rule 17a-3. The new 36-month

³⁹ Sections 10(b) and 15(c) (15 U.S.C. 78j(b) and 15 U.S.C. 78o(c)). See e.g., *Hanley v. SEC*, 415 F.2d 589, 596 (2d Cir. 1969); *F.J. Kaufman and Co.*, 50 S.E.C. 164 (1989); *O'Connor v. R.F. Lafferty & Co.*, 965 F.2d 893 (10th Cir. 1992).

⁴⁰ 17 CFR 240.10b-5 and 17 CFR 240.15c1-2.

⁴¹ See *supra* note 37.

⁴² If a recommendation is made, a suitability obligation arises irrespective of the medium used to deliver that recommendation. For example, a broker-dealer can make a recommendation in person, on a website, via telephone, mail, or email. A broker-dealer also can recommend a security online regardless of whether that recommendation is attributable to a specific registered representative. Whether a broker-dealer has made a recommendation is a question that can only be answered by considering all of the facts and circumstances. (See "Suitability Hypotheticals," Report of Commissioner Laura S. Unger, Online Brokerage: Keeping Apace of Cyberspace, pp. 32-4. (Nov. 1999))

⁴³ 17 CFR 240.17a-3(a)(9).

⁴⁴ See, e.g., Comment Letter of Salomon Smith Barney, pp. 3-4.

furnishing cycle under paragraph (a)(17)(i)(B) of Rule 17a-3 will begin when the firm obtains the account record information within the initial 36-month grace period.

6. Written Customer Agreements

New paragraph (a)(17)(iii) of Rule 17a-3 requires each broker-dealer to create a record for each account indicating that each customer was furnished with a copy of any written agreement entered into on or after the effective date of this paragraph pertaining to that account. This will allow customers to review the terms of agreements to which they are subject, and to better understand their rights and responsibilities (and those of the broker-dealer) under these agreements. In addition, if any customer specifically requests a copy of an agreement relating to their account, this paragraph would require that the broker-dealer maintain a record that it was provided to the customer.

D. Complaints

New paragraph (a)(18)(i) of Rule 17a-3⁴⁵ requires firms to make a record as to each associated person that includes every written customer complaint received by the firm concerning that associated person.⁴⁶ This will allow securities regulators to quickly identify any trends, and focus examinations. This record must include complaints received electronically from customers. The rule requires that the record include the complainant's name, address, and account number; the date the complaint was received; the name of each associated person identified in the complaint; a description of the nature of the complaint; and the disposition of the complaint. However, because firms already are required to keep originals of incoming written complaints,⁴⁷ rather than make a separate record, firms have the option under this rule to keep the original complaint along with a record of the disposition of the complaint, if kept by name of associated person. This rule does not limit a broker-dealer's

⁴⁵ This paragraph was proposed as paragraph (a)(17) of Rule 17a-3.

⁴⁶ This requirement is in addition to other recordkeeping requirements such as Rule 17a-4(b)(4), which requires firms to keep originals of all correspondence received. For example, if a broker-dealer firm received a written complaint regarding the firm itself, the firm would be required to keep that complaint under Rule 17a-4(b)(4). If the complaint related to a particular associated person, the firm would also be required to make a record of the complaint as to that associated person under Rule 17a-3(a)(18); however, the firm may keep one copy of the complaint to satisfy both Rules 17a-3(a)(18)(i) and 17a-4(b)(4).

⁴⁷ See 17 CFR 240.17a-4(b)(4), and NASD Rule 3110(d).

responsibilities under SRO and other regulations that may require creation and maintenance of records regarding, or reporting of, oral complaints.

Paragraph (ii) of Rule 17a-3(a)(18) requires firms to make a record indicating that each customer has been provided with a notice of the address and telephone number of the department of the firm to which any complaints may be directed.⁴⁸ This will assist both customers and broker-dealers to ensure that complaints reach the proper person or department so they can be recorded, reported (if necessary), and answered. Some commenters requested clarification of whether, in an introducing/clearing relationship,⁴⁹ the contact information should be that of the introducing firm, the clearing firm, or both. To the extent not otherwise required, this should be a matter of negotiation between the introducing firm and the clearing firm.⁵⁰ If contact information is provided for both firms, the notification should clearly indicate which firm the customer should contact and for what purposes. Two other commenters requested clarification as to whether this notification could take the form of a notice on customer statements.⁵¹ The Commission believes that firms should have flexibility as to how they may deliver this notice to customers, and inserting the notice on a customer statement is one acceptable alternative.

E. Compensation

Paragraph (a)(19)(i) of Rule 17a-3 requires firms to make a record as to each associated person listing each purchase and sale of a security⁵²

⁴⁸ This requirement expands on an existing interpretation of the Commission's financial responsibility rules and the Securities Investor Protection Act of 1970, which states that, for purposes of custody of securities, for a firm to qualify as an introducing firm with a lesser net capital requirement than a clearing firm, its customers must be treated as customers of the clearing firm. In addition, under that interpretation, the clearing firm must issue account statements directly to customers, and each account statement must contain the name, address, and telephone number of a responsible individual at the clearing firm whom a customer can contact with inquiries and complaints regarding the customer's account.

⁴⁹ See, e.g., Comment Letter from Lawrence M. Lowman, p. 1.

⁵⁰ See *supra* note 48; Exchange Act Release No. 31511 at note 21 and accompanying text, (Nov. 24, 1992), 57 FR 56973 (Dec. 2, 1992).

⁵¹ See Comment Letters from the Discount Brokers, p. 7, and Donaldson, Lufkin & Jenrette, p. 10.

⁵² The phrase "and the specific security," which appeared in the Reproposing Release, was not included in the Rule as adopted because it is redundant. The record "listing all purchases and sales of securities for which the associated person was compensated" must provide enough information to identify that purchase or sale to which the compensation was attributable.

attributable, for compensation purposes, to that associated person. Again, the purpose for this requirement is to allow securities regulators to quickly identify compensation trends and focus examinations. The record must include the amount of compensation (if monetary) and a description of the compensation (if non-monetary). Under this requirement, firms must make records of all commissions, concessions, overrides, and other compensation to the extent they are earned or accrued for transactions. In addition, if the compensation is non-monetary, that description should include an estimate of its value.

The term "non-monetary compensation" includes compensation such as sales incentives, gifts, or trips that would be provided to associated persons if certain sales goals were achieved. Such non-monetary compensation should be recorded if directly related to sales. If sales would be counted toward achieving these goals, then a notation of the sales should be made regardless of whether that goal is actually achieved. Non-monetary compensation does not include items of little value distributed by the firm.

Paragraph (ii) of new Rule 17a-3(a)(19)⁵³ requires that firms maintain a record of all agreements pertaining to the relationship between each associated person and the broker-dealer, including a summary of each associated person's compensation arrangement or plan. Further, to the extent that compensation is based on factors other than remuneration on a per trade basis, the firm must make a record that describes the method by which compensation is to be determined.

It should be noted that the requirement under paragraph (ii) that a broker-dealer maintain a record of all agreements between itself and each associated person includes verbal agreements and records, such as commission schedules, which may change on a periodic basis.

The term "relationship," as used in paragraph (a)(19) of Rule 17a-3, solely refers to the employment or contractual relationship between the associated person and the broker-dealer. It would not relate to personal relationships unrelated to the firm's business.

F. Compliance With Requirements for Communications With the Public

New paragraph (a)(20) of Rule 17a-3⁵⁴ requires each firm to make a record

⁵³ This Rule was repropose as Rule 17a-3(a)(12)(ii) and Rule 17a-3(a)(12)(iii).

⁵⁴ This paragraph was repropose as paragraph (a)(19) of Rule 17a-3.

documenting that the firm has complied with, or adopted policies and procedures reasonably designed to establish compliance with, applicable federal regulations and SRO rules which require that a principal approve any advertisements, sales literature, or other communications with the public.⁵⁵ This paragraph would apply to marketing materials, sales scripts, and other paper or electronic material, such as audio or video tapes, used by broker-dealers in communicating with the public. This paragraph, which is designed to allow State Securities Regulators to examine broker-dealers for compliance with SRO rules relating to communications with the public, does not establish a new source of supervisory responsibility. In addition, a broker-dealer has many options as to how it may create this record.⁵⁶

The Commission did not adopt the portion of this rule as repropose that referenced specific types of advertisements or sales literature. Instead, the Commission will defer to SRO rules as to which communications with the public must be approved by a principal of the firm.

G. Persons To Explain Records and Their Content

Paragraph (a)(21) of Rule 17a-3 requires a record listing, by name or title, all personnel at an office who, without delay, can explain the types of records the firm maintains at that office, and the information contained in those records. Commenters, particularly the States, indicated that this requirement is important because recordkeeping practices typically vary from firm to firm in ways ranging from format and presentation to the name of a record. Therefore, each firm must be able to promptly explain how it makes, keeps, and titles its records. To comply with this rule, a firm may identify more than one person and list which records each person is able to explain.

Because it may be burdensome for firms to keep this record current if it lists each person by name, a firm may satisfy this requirement by recording the

⁵⁵ See e.g., NASD Rule 2210(b) and NYSE Rule 472.

⁵⁶ E.g., the record may consist of a principal's signature or initials on the communication, or a signed memo from the principal granting permission for use of the communication. Further, a firm may have policies and procedures designed to establish compliance with applicable federal regulations and SRO rules which require that a principal approve any advertisements, sales literature, or other communications with the public. Thus, records presently used to evidence compliance with SRO rules may also be used to fulfill this requirement.

persons capable of explaining the firm's records by either name or title.

H. Record Listing Principals of the Firm

New paragraph (a)(22) of Rule 17a-3 requires firms to make a record listing each principal of the firm responsible for establishing policies and procedures reasonably designed to ensure compliance with any applicable securities regulatory authority requirements that require acceptance or approval of a record by a principal. This requirement is unchanged from the reproposal, and is intended to assist securities regulators by identifying individuals responsible for designing a broker-dealer's compliance procedures and managing the firm.

I. Definition of Principal

Paragraph 17a-3(g)(2) defines the term "principal" to include any individual registered with a registered national securities association as a principal or branch manager of a member, broker or dealer, or any other person who has been delegated supervisory responsibility for the firm or its associated persons. By including any person who has been delegated supervisory responsibility in the definition of the term "principal," the rule has been modified from the reproposal to include the definitions of "principal" used by other securities regulatory authorities.

J. Definition of Securities Regulatory Authority

The definition of "securities regulatory authority" in paragraph (g)(3) of Rule 17a-3 is substantially similar to that in the Reproposing Release, except that State Securities Regulators are identified as "the securities commissions (or any agency or office performing like functions) of the States * * *"⁵⁷ mirroring the language that Congress used in NSMIA.

K. Miscellaneous

The Commission has not adopted repropose paragraph (a)(20) of Rule 17a-3, which would have required firms to make a record as to each associated person listing chronologically all customer purchase or sale transactions for which the associated person entered the order or was primarily responsible. Commenters stated that the information required in this record would already be maintained in other records, although not necessarily in the chronological format that this paragraph would have required. The Commission also has not adopted repropose paragraph (a)(23) of

Rule 17a-3, which would have required a firm to make a record listing each office of the firm and whether that office had been designated as a State record depository, since firms need no longer designate a State record depository for any purpose. This proposed record also would have required firms to list each associated person working out of or storing records at each office. The Commission has not adopted this requirement because firms are required to make a record of similar information under new paragraph (ii) of Rule 17a-3(a)(12).⁵⁸

IV. Office Records

The Reproposing Release would have required that broker-dealers make certain records for each local office and maintain copies of those records at the office to which the records relate. These requirements were designed to assist securities regulators when conducting sales practice examinations at particular offices. The Commission has adopted the requirements regarding the creation of these records substantially as repropose, but has materially altered the alternatives for maintenance of those records.

Generally, State Securities Regulators supported a requirement that records as to a particular office be maintained at that office, even if only electronically. The State Securities Regulators stated, in their comment letters, that they had encountered excessive and costly delays when conducting examinations when records were kept at another office. In sum, they stated that although firms generally had the records available in local offices, the firms preferred to funnel all records requested by examiners through their centralized compliance departments in order to assure accuracy, anticipate any potential violations, review material for applicable privileges, and make a record of documents reviewed by regulators.⁵⁹ While the State regulators have the power to impose fines and penalties on firms that fail to timely produce records, the delays still result in unnecessary, wasted examination time at firms waiting for the records production. The delay is costly for regulators, particularly when they travel to remote areas to conduct surprise examinations

⁵⁸ New paragraph (a)(12)(ii) of Rule 17a-3 requires firms to make a record showing, for each associated person, every office where the associated person regularly conducts a securities business and certain other information.

⁵⁹ See Comment Letter from Citicorp, p. 3, "RRs in all local offices would have to be trained to do a function outside their current job responsibilities, namely to review material for applicable privileges and make records of documents reviewed by regulators."

at an office where they may spend numerous days awaiting the records.⁶⁰

The broker-dealer commenters were strongly opposed to this requirement for two main reasons. First, they stated that the requirement to maintain copies of documents at all local offices would be costly and burdensome because they would need to create and maintain two sets of records. They stated that even with the flexibility of being able to maintain the records electronically, this requirement would be costly because many firms do not currently have computer systems capable of retaining and producing all the required records. Second, firms stated that maintaining records at all local offices would force them to decentralize their recordkeeping, which would potentially compromise their controls on recordkeeping and supervisory practices.

Requiring records to be maintained at each local office was the requirement most seriously disputed by the firms. The reproposal has been altered to allow a firm, rather than to maintain records at an office, to produce the records promptly at the request of a representative of a securities regulatory authority at the office to which the records relate or at such other place as is agreed to by the representative. These alternative methods for complying with paragraph (k) of Rule 17a-4 were added in response to comments that the requirement, as repropose, would have forced firms to decentralize their recordkeeping systems and would have compromised their internal controls and supervisory practices.⁶¹

The Commission believes that the amendments to Rules 17a-3 and 17a-4 adopted today, which set forth, (i) the definition of "office," (ii) what records must be created as to each office,⁶² and (iii) what records must be maintained at each office,⁶³ address the concerns of both regulators and broker-dealers.

⁶⁰ See, e.g., Comment Letters from Arkansas Securities Department, pp. 1-3; Department of Financial Institutions, Commonwealth of Kentucky, p. 6; and Securities Division, State of Rhode Island and Providence Plantations, p. 1.

⁶¹ This does not relieve broker-dealers from any other Federal or SRO requirements to maintain records at office locations. See, e.g., NASD Rule 3110(d) which requires firms to keep at each Office of Supervisory Jurisdiction (defined at NASD Rule 3010(g)(1)), either a separate file of all written complaints of customers and action taken by the firm, or a separate record of such complaints and a clear reference to the files containing the correspondence connected with such complaint maintained in such office.

⁶² 17 CFR 240.17a-3(f).

⁶³ 17 CFR 240.17a-4(k).

⁵⁷ *Supra* note 7.

A. Definition of Office

For both creation and maintenance of records, the definition of "office" adopted by the Commission includes any location where an associated person regularly conducts business.⁶⁴ However, an office would not include a customer's office that an associated person may visit on a regular basis.

The Commission has also addressed concerns that arise when an associated person's residence is an office. Rule 17a-4(k) states that a broker-dealer is not required to produce records at an office that is a private residence, provided that (i) only one associated person, or multiple associated persons who reside at that location and are members of the same immediate family,⁶⁵ regularly conduct business at the office; (ii) the office is not held out to the public as an office; and (iii) neither customer funds nor securities are handled at that office. Instead, Rule 17a-4(k) allows a broker-dealer to either maintain those records at some other location within the same State as that office as the broker-dealer chooses, or to promptly produce those records at an agreed upon location.

For purposes of paragraph (f) of Rule 17a-3⁶⁶ and paragraph (k) of Rule 17a-4,⁶⁷ in circumstances where an associated person works out of multiple offices, such as bank circuit riders, a firm may treat all the locations where the associated person regularly works as a single office.⁶⁸

B. Records "As To" Each Office

New paragraph (f) of Rule 17a-3 requires firms to make and keep current, separately for each office, certain books and records that reflect the activities of the office.⁶⁹ It should be noted that 75% of broker-dealers have reported that they have no branch locations.⁷⁰ The

definition of "office" may be broader and more inclusive than the definition of "branch," however.

The Commission removed the sentence, "This requirement may be satisfied by demonstrating that the data is maintained in a system which is capable of promptly generating records for each office upon request", because the requirement to either maintain the specified records at each location or produce them on the same day a request is made has been changed to allow firms to produce these records promptly.

C. Records To Be Maintained at Office Locations

There have been two major changes to new paragraph (k) of Rule 17a-4 from the reproposal. First, the requirement to maintain certain records at the office locations has been expanded from one year to two years. This was done to establish parity with the retention requirements for the separate sections as provided under paragraph (b) of Rule 17a-4.

Second, under paragraph (k) of Rule 17a-4, if a broker-dealer does not maintain records at an office, but instead chooses to produce the records upon request, the broker-dealer must produce the records "promptly."⁷¹ The word "promptly" has deliberately not been defined in the rule. Generally, requests for records which are readily available at the office (either on-site or electronically) should be filled on the day the request is made. If a request is unusually large or complex, then the firm should discuss with the regulator a mutually agreeable time-frame for production.⁷²

Based on the foregoing, the Commission has not adopted the repropounded provision of Rule 17a-4(k) that would have allowed firms to maintain records at a State records depository in lieu of maintaining the records at the office to which the records relate.

One commenter requested guidance on how this paragraph relates to a foreign office of a U.S. registered broker-dealer.⁷³ Under paragraph (f) of Rule 17a-3, a broker-dealer must make certain records for a foreign office; however, a broker-dealer is not required to maintain or produce those records at

the foreign office under paragraph (k). Instead, those records would be maintained at the broker-dealer's main office.

V. Rule 17a-4

A. General Record Retention Requirements

Paragraphs (a) and (b)(1) of Rule 17a-4 list certain records required under Rule 17a-3 that must be kept for six and three years, respectively. The amendments to these two paragraphs have been modified from the reproposal to remain consistent with the modifications to Rule 17a-3.

B. Retention of Communications

Paragraph (b)(4) of Rule 17a-4 previously required that each broker-dealer keep originals of all communications received and copies of all communications sent by the firm relating to its business as a broker-dealer, including inter-office memoranda and communications. With respect to memoranda, including e-mail messages, the Commission has stated that the content and audience of the message determine whether a copy must be preserved, regardless of whether the message was sent on paper or sent electronically.⁷⁴ The amendments to this paragraph adopted today will require firms to retain communications that are subject to SRO rules regarding "communications with the public" (such as advertising) as well, a requirement repropounded separately as paragraph (b)(10) of Rule 17a-4. This requirement is designed to provide State Securities Regulators with the ability to access these public communications records so they can enforce their laws relating to the form and use of public communications.

It should be noted that a written advertisement that is never released to the public would not be covered by this rule; however, a sales script that is used by an associated person when communicating with the public would be covered even if the script itself is not delivered to the public.

The requirement, as repropounded, that "any written procedures [a broker-dealer] uses for reviewing the communications received or sent" has been moved to new paragraph (e)(7) of Rule 17a-4, which requires firms to keep all compliance, supervisory, and procedures manuals, including any written procedures for reviewing communications.

⁷⁴ Exchange Act Release No. 38245 (Jan. 31, 1997), 62 FR 6469 (Feb. 12, 1997).

⁶⁴ 17 CFR 240.17a-3(g)(1).

⁶⁵ The term "immediate family," as used in paragraph (k), should be interpreted to have the same meaning as it does in NASD IM-2110-1(I)(2).

⁶⁶ New paragraph (f) of Rule 17a-3 requires firms to make and keep current separately as to each office, the books and records required under various paragraphs in Rule 17a-3.

⁶⁷ New paragraph (k) of Rule 17a-4 requires firms to either keep certain records at each office or produce them at that office or at another agreeable location.

⁶⁸ Firms need not apply to or notify securities regulators as to which office it selects as the associated person's "office." However, pursuant to paragraph (a)(12)(iii) of Rule 17a-3, the firm must identify the office as such.

⁶⁹ The specific paragraphs of Rule 17a-3 that are included in this requirement are (a)(1), (a)(6), (a)(7), (a)(12), (a)(16), (a)(17), (a)(18), (a)(19), (a)(20), (a)(21), and (a)(22).

⁷⁰ Per *Schedule 1* data filed by broker-dealers as of year-ending December 31, 1998. Pursuant to 17 CFR 240.17a-10, Broker-dealers are required to file

Schedule 1, which requires the reporting of general information designed to measure certain economic and financial characteristics.

⁷¹ *Supra* note.

⁷² Valid reasons for delays in producing the requested records do not include the need to send the records to the firm's compliance office for review prior to providing the records.

⁷³ See Comment Letter from A.G. Edwards & Sons, Inc., p. 8.

C. Organizational Documents

The Commission has modified paragraph (d) of Rule 17a-4, which require a broker-dealer to maintain certain organizational records. Specifically, the Commission has added language to clarify that organizational records of legal entities not specifically delineated in the present rule⁷⁵ are still required to be preserved under this rule. Various State statutes use different terms to describe the legal entities that may be created under their rules and the organizational documents necessary to create those entities; accordingly, the Commission has included in this paragraph generic terms to describe the types of records that firms must keep. The Commission believes that generally broker-dealers that are not formed as corporations or partnerships are already keeping these types of records and that this amendment codifies current business practices. Similar to the amendment to paragraph (g)(3) of Rule 17a-3 noted above, the Commission has replaced the phrase "state securities jurisdictions and self-regulatory organizations" in the Reproposing Release with the term "securities regulatory authorities."

Under this paragraph, every broker-dealer is also required to maintain copies of its Form BD and all amendments thereto. To comply with this requirement with respect to amendments to Form BD, a broker-dealer is required to retain a copy of only those portions of the Form that were amended. The Commission believes that generally broker-dealers are already keeping these records and that this amendment codifies current business practices.

D. Account Record Information

New paragraph (e)(5) of Rule 17a-4 requires broker-dealers to retain account record information for six years. The six-year period begins either at the time the account is closed or when the information is replaced or updated. This provision will allow regulators to review account record information for at least the six years immediately prior to the examination or investigation. Broker-dealers generally maintain account record information for at least the life of the account to facilitate a number of business purposes, including suitability determinations and supervision of accounts and representatives.

⁷⁵ For instance, limited liability companies ("LLCs") would be covered.

E. Special Reports

New paragraph (e)(6) of Rule 17a-4 requires a firm to keep for three years a copy of all reports that a securities regulatory authority has requested or required a specific firm to create. Such special reports would include those reports that are requested or required under an order or settlement that requires the firm to produce the report as part of the terms of the order or settlement. The purpose of this paragraph is to clarify that these records must be kept and to provide guidance as to how long firms are expected to maintain these records.

This requirement is not designed to limit the ability of securities regulatory authorities to obtain records that are otherwise required to be created and maintained, such as records of internal communications required to be maintained under paragraph (b)(4) of Rule 17a-4.

F. Compliance, Supervisory and Procedure Manuals

The Commission is also adopting, as repropounded, new paragraph (e)(7) of Rule 17a-4. This paragraph requires firms to retain a copy of all compliance, supervisory, and procedures manuals describing the firm's policies and practices with respect to compliance and supervision, as currently in use and for three years after the termination of the use of each manual, including any updates, modifications, and revisions to the manuals. This will ensure that securities regulators are able to obtain information as to what policies and procedures were in place at a given time.

G. Exception Reports

New paragraph (e)(8)(ii) of Rule 17a-4 requires firms to maintain copies of reports produced to review for unusual activity in customer accounts (commonly referred to as "exception reports"). This paragraph does not obligate broker-dealers to create exception reports. Exception reports would include reports that identify exceptional numerical occurrences, such as frequent trading in customer accounts, unusually high commissions, or an unusually high number of trade corrections or cancelled transactions. These reports will help securities regulators discover sales practice problems such as churning, unauthorized trading, or other indications of micro-cap fraud, and will also provide securities regulators with information as to what type of data may have been available to the broker-dealer.

In lieu of retaining copies of the reports, a member, broker or dealer may

choose to promptly re-create the reports upon request by a securities regulatory authority. If the broker-dealer elects to re-create exception reports instead of maintaining a copy of the report, but the firm has changed its systems so that it cannot re-create the same report, the broker-dealer may provide a copy of the report in the format presently available using historical data,⁷⁶ but must also provide a record explaining each system change that affected each report.⁷⁷ Lastly, if the firm is unable to re-create the report in any format for the most recent 18 months, due to changes, for example, in a database, software, or physical system, the rule provides that the broker-dealer may instead provide a record of the parameters that were used to generate the report for the time period specified by the representative of the securities regulatory authority. The Commission provided these alternatives in order to make this rule less burdensome on broker-dealers.

Many firms commented that this requirement would be potentially counter-productive because, if firms are required to retain copies of all reports that they create, they would create fewer reports. However, the Commission believes that broker-dealers will continue to create those exception reports that are necessary to adequately supervise their business, and that retaining these reports will increase the efficiency of examinations by regulators and may reduce the examination burden on broker-dealers.

VI. Effective Date

The final rules adopted today shall become effective May 2, 2003.

VII. Technical Amendments

A. Electronic Storage Media

On February 5, 1997, the Commission amended Rule 17a-4 to allow broker-dealers to employ, under certain conditions, electronic storage media to maintain its records.⁷⁸ The Commission proposed and is now adopting technical amendments to that rule.⁷⁹ The

⁷⁶ For example, if the original report includes customer name, account number, social security number, and transactional information, however the report that can be re-created at a later date does not include social security numbers, the firm should provide the re-created report to the regulator with an explanation that although social security numbers appeared on the original report, the firm is unable to re-create the report including that information.

⁷⁷ This includes changes to hardware, software, or changes to the database used to produce the exception reports.

⁷⁸ Exchange Act Release No. 38245 (Feb. 5, 1997), 62 FR 6469 (Feb. 12, 1997) ("Electronic Storage Media Release").

⁷⁹ 17 CFR 240.17a-4(f).

Electronic Storage Media Release requires a broker-dealer that employs micrographic or electronic storage media to be ready at all times to immediately provide a facsimile enlargement upon request by the Commission or its representatives.⁸⁰ It also requires a broker-dealer that exclusively uses electronic storage media to fulfill some or all of its record preservation requirements to contract with a third party download provider that will file undertakings with the broker-dealer's designated examining authority indicating that the download provider will furnish promptly to the Commission, its designees or representatives, the information necessary to download information kept on the broker-dealer's electronic storage media.⁸¹ Because SROs and State Securities Regulators are neither representatives nor designees of the Commission but, to the extent that they have jurisdiction over the broker-dealer serviced by the third party download provider, are organizations that should have access to facsimile enlargements and download information, the Commission is adopting these technical amendments to provide them with access to these records. The Commission is also adopting these technical amendments so that when broker-dealers use the undertaking option under Regulation ATS, SROs and State Securities Regulators will have access to those records.⁸²

B. Other Technical Amendments

The Commission is adopting amendments to Rule 17a-3(a)(12)(i) to update the list of stock exchanges for which an associated person's application for registration or approval may be used to satisfy the requirements under that paragraph. This amendment is a codification of current practices. The Commission is also adopting amendments to the language throughout Rules 17a-3 and 17a-4 that eliminate masculine references, and replace them with gender neutral references.

VIII. Costs and Benefits of the Amendments

In the Reproposing Release, the Commission requested comment on the costs and benefits associated with the repropose rules and rule amendments.⁸³ Of the comments received by the Commission, fifty-seven commenters discussed the benefits and

costs associated with the reproposal. Of those commenters, thirty were broker-dealers,⁸⁴ twenty-two were States,⁸⁵ two were consumer groups,⁸⁶ two were other groups,⁸⁷ and one was an individual.⁸⁸ Most of the commenters (including all of the broker-dealer commenters) argued that the costs outweighed the benefits of the repropose amendments and that the cost estimates provided in the Reproposing Release were too low. Although most of those arguments were general in nature, twenty-three commenters specifically referenced paragraph (a)(17)(i) of Rule 17a-3,⁸⁹ and fifteen commenters specifically referenced paragraph (k) of Rule 17a-4.⁹⁰ All the States and the consumer groups that commented argued that most broker-dealers presently maintained most, if not all, the records required under the repropose amendments, and that the benefits, although difficult to quantify, justified any costs which might be incurred.

One commenter stated that well-organized firms are less likely to experience the potentially catastrophic losses that result from serious securities

violations.⁹¹ Many State Securities Regulators indicated in their comment letters that their agencies generally found that firms with inadequate books and records were more likely to have other problems, such as inadequate supervisory systems and selling-away issues. According to the NASD's Office of Dispute Resolution, \$126 million and \$76 million were awarded by NASD arbitrators in 1999 and 2000 respectively in customer claimant cases, of which \$48 million and \$21 million respectively constituted punitive damages.⁹² The vast majority of claims filed for arbitration with the NASD's Office of Dispute Resolution during this time period related to sales practice issues. In addition, two industry participants estimated that they presently pay outside counsel approximately \$50 million and \$25 million respectively each year to deal with sales practice complaints.⁹³

Many States indicated that they believed the amendments would impose only minimal additional costs to broker-dealers because, in their experience, many broker-dealers already maintain the records required by the amendments in order to comply with SRO rules, State laws that applied prior to NSMIA, or simply to properly manage costs and supervise offices. Further, some States indicated that they believed that broker-dealers were exaggerating the potential costs of the repropose amendments.⁹⁴

In fact, the States of Connecticut⁹⁵ and Florida⁹⁶ conducted special reviews, in conjunction with their examination programs, to determine the extent to which broker-dealers already maintained the records required under the Reproposal at office locations. The State of Connecticut concluded that its review "overwhelmingly indicate[d] that all the books and records that would be required by the re-propose

⁸⁴ See Comment Letters from Mutual Service Corporation, p. 6; Titan Value Equities Group, Inc., pp. 2 and 4; USAA, pp. 2 and 6; MetLife, p. 4; A.G. Edwards and Sons, Inc., p. 6; MONY, p. 4; Capital West, p. 2; Comerica Securities, p. 2; Nationwide Investment Services Corporation, p. 2; Edward Jones, pp. 1 and 3; Advest, p. 1; Salomon Smith Barney, pp. 1 to 2; NyLife Securities, pp. 6 to 7; HD Vest, p. 2; American Express Financial Advisors, pp. 2 to 5; First Union, pp. 3 to 4; Charles Schwab, pp. 3 to 4; MML Investors Services, Inc., pp. 2 to 4; National Planning Corporation, p. 1; Pumphrey Securities, p. 2; Citicorp Investment Services, pp. 2 to 3; Discount Brokers, pp. 4 to 5; M & T Securities, pp. 1 and 2; Donaldson, Lufkin & Jenrette, p. 6; Investment Management & Research, Inc., p. 4; John Hancock Distributors, Inc., pp. 3 to 4; Southwest Securities, p. 2; the Securities Industry Association, p. 10; Merrill Lynch, pp. 1, 6 to 7, and 11; and Raymond James, p. 5.

⁸⁵ See Comment Letters from Michigan, pp. 1 to 2; Idaho, pp. 1 and 4; Kansas, pp. 1 to 2; Delaware, pp. 1 to 2; Colorado, p. 2; North Dakota, p. 1; Ohio, p. 1; Texas, pp. 1, 2 to 3, and 6; Hawaii, pp. 1 to 2; Rhode Island, pp. 1 to 2; New Hampshire, pp. 1 and 2; Nebraska, p. 1; Utah, pp. 1 and 3; NASAA, pp. 3 to 5 and 22; New York, pp. 1 and 3; Virginia, pp. 1 to 3; New Jersey, pp. 2 to 7; Washington, pp. 2 and 6; Arkansas, pp. 1, 3, and 5; New Mexico, p. 1; North Carolina, pp. 1 to 2; and Montana, pp. 1, and 3 to 5.

⁸⁶ See Comment Letters from AARP, p. 2; and the Consumer Federation of America, pp. 2 to 3.

⁸⁷ See Comment Letters from American Council of Life Insurance, pp. 12 to 13; and International Association of Financial Planning, p. 6.

⁸⁸ See Comment Letter from Thomas Koutris, p. 1.

⁸⁹ This paragraph provides that broker-dealers must obtain certain information relating to the accounts of natural customers, and that customer account records must be updated regularly.

⁹⁰ In the repropose rule this paragraph provided that certain records had to be maintained at the local office, or that they had to be produced at the local office to which they related on the same day a request for those records was made by a representative of a securities regulatory authority.

⁹¹ See Comment Letter from State of Virginia, pp. 1 to 3.

⁹² Per NASD Dispute Resolution, Inc. website: www.nasdradr.com/statistics.asp.

⁹³ It should be noted that these estimates do not include any internal compliance, operational, and/or legal costs incurred by these firms in dealing with these complaints.

⁹⁴ See, e.g., Comment Letter from the State of New Jersey, p. 5.

⁹⁵ See Second Comment Letter from State of Connecticut. The State of Connecticut performed examinations of forty-nine office locations of twenty-three broker-dealers in five States. Seventeen of these offices had two or less associated persons working there. In addition, the State reviewed the most recent 100 examinations it had performed, and as well as investigatory materials from the prior two years wherein subpoenas were issued to obtain broker-dealer records.

⁹⁶ See Second Comment Letter from NASAA. The State of Florida performed examinations on 19 broker-dealers.

⁸⁰ See 17 CFR 240.17a-4(f)(3)(i).

⁸¹ See 17 CFR 240.17a-4(f)(3)(vii).

⁸² Exchange Act Release No. 40760 (Dec. 8, 1998), 63 FR 70844 (Dec. 22, 1998).

⁸³ See *supra* note 9, at p. 54411.

rule proposal are, at the present time, being maintained in offices within Connecticut and similarly outside the state." Further, Connecticut stated, "During this review process the records were immediately available for inspection upon request," and "the types of records required by the re-proposed rule would not be burdensome in that the firms retained substantially more records than required." Connecticut also stated, "[t]he retention schedules listed in the firms' compliance [manuals] were consistent with the requirements under the re-proposed rule." Florida stated, "[t]he reviews indicated that based on records maintained most branch offices met or exceeded the records requirement for the [re-]proposed rule, and "[a] vast majority of the branch offices maintained the records on-site for periods of at least 2 years (and in some cases up to 6 years)." Further, Connecticut stated, "[t]he firms' recordkeeping requirements did not vary from location to location or even state to state because they were required by the firms' own compliance manuals," and "[i]n certain instances, the firms' compliance manuals indicated that these additional records were necessary to adequately supervise its branch operations." Similarly, Florida stated, "[m]anagement of several firms visited reported that record creation and retention is a nationwide requirement; the same for all offices in all states, not specific to the state of Florida * * * [t]his information was verified by the firms' Operational/Supervisory Compliance Manuals."

A number of the States contend that investors are defrauded of millions and millions of dollars every year as a result of sales practice violations by broker-dealers.⁹⁷ Further, Commission staff found through "The Large Firm Project"⁹⁸ "25% of the branch office examinations conducted in this project resulted in referrals for enforcement

⁹⁷ Four States provided specific information regarding investor losses. Illinois indicated (in its Comment Letter, p. 2) that over the past 8 years, 29 enforcement cases were brought in which Illinois investors lost over \$38.9 million dollars. Kansas indicated (in the attachment to its Comment Letter) that, with respect to cases they have brought over the past ten years, Kansas customers have lost over \$6.4 million dollars. Ohio indicated (in its Comment Letter, p. 3) that in one particular case Ohio investors lost over \$60 million dollars. Lastly, Connecticut indicated (in its Comment letter, p. 2) that, with respect to cases they have brought where the investors' relationship was established through small offices, Connecticut investors have lost over \$12 million.

⁹⁸ Report by the Division of Market Regulation and the Division of Enforcement, U.S. Securities and Exchange Commission, *The Large Firm Project: A Review of Hiring, Retention and Supervisory Practices* (May 1994).

investigation and possible disciplinary action," and "[t]he examinations also revealed that some branch office managers were not implementing firm procedures adequately," and recommended that "the Commission should develop better means of identifying sales practice problems."⁹⁹ The enhanced recordkeeping requirements would help make available critical information necessary for securities regulatory authorities to discover and take appropriate action for various securities violations, particularly sales practice violations. The cost to securities regulatory authorities to obtain the same information and evidence that otherwise would be available by these rules from other methods would be high. In addition, the possibility exists that government regulatory authorities would be unable to obtain certain information by any other means if the information is not required to be kept. Investigatory delays often lead to additional investor losses. The State of New Jersey contended that these delays could lead to an erosion of public confidence in the industry, which can be exacerbated by the public's belief that securities regulatory authorities lack the ability to properly oversee broker-dealers and enforce securities regulations.¹⁰⁰ NASAA commented that lack of public confidence in the marketplace can lead to an inability of issuers to raise capital.¹⁰¹

Most broker-dealer commenters indicated that two of the re-proposed amendments would cause them to incur substantial additional costs. These two amendments were paragraph (k) of Rule 17a-4, which required that records be maintained at local offices or that firms produce those records at the local office on the same day a request for records was made by a regulator at that local office, and paragraph (a)(17)(i) of Rule 17a-3, which required that a broker-dealer provide customers with a copy of their account record at specified times. As a result of comments received in response to the Reproposing Release, the Commission substantially modified those two amendments as described above.

The only other paragraphs broker-dealers specifically identified as resulting in increased costs were (a)(6) and (a)(7) of Rule 17a-3, which require that brokerage order tickets include the time of receipt, and that dealer order tickets include a notation of any

modifications to an order. The Commission addressed some of these comments by modifying paragraph (a)(6) to provide an exemption for mutual fund and variable contract orders processed on a subscription-way basis. Further, for certain securities, the receipt time and notation of modification are already required under SRO rules.¹⁰² The only cost to firms resulting from these paragraphs relate to assuring that processes for recording this information will record the information for all orders that are not exempt and not just those orders covered by SRO rules.

A few commenters attempted to provide alternative cost estimates for use in calculating the costs of the amendments. Some firms provided specific numbers, but provided no explanation as to the source of their estimates or their reason for believing that they would be more accurate than the Commission's estimates. In addition, certain costs are no longer relevant because the Commission substantially modified the amendments in response to comments. Accordingly, after consideration of all of the circumstances, the Commission has altered its cost estimates to reflect the fact that changes were made to the amendments in response to the comments received. Further, where the amendments were not altered significantly, the Commission has substantially increased estimates of costs that commenters argued were significantly underestimated.

The Commission estimates that the aggregate cost of these amendments will be approximately between \$78.2 million and \$84.3 million in the first year, and between \$52.5 and \$58.6 million per year thereafter (depending on what estimated postage cost is included in the calculations). Dollar costs relating to specific amendments are detailed below.

For purposes of this cost-benefit analysis, the amendments to Rules 17a-3 and 17a-4 are divided into three groups: (i) Those pertaining to the maintenance of office records and alternatives to these requirements; (ii) those pertaining to the periodic updating of customer information; and (iii) all other new requirements covered by the amendments.

A. Changes To Rule 17a-4, Including Maintenance of Office Records and Alternatives To These Requirements

As amended, Rule 17a-4 requires broker-dealers to maintain certain

⁹⁹ *Id.*, at pp. 5 and 7.

¹⁰⁰ *See*, Comment Letter from the State of New Jersey, p. 3.

¹⁰¹ *See*, Comment Letter from NASAA, pp. 7-8.

¹⁰² *E.g.*, the NASD's OATS rules, and NYSE rules 123 and 410A.

records at each office. As discussed above, new Rule 17a-4(k) was modified from the reproposal to provide broker-dealers with the alternative of "promptly" producing certain records pertaining to a particular office at that office or at a mutually agreeable alternative location. This modification should significantly reduce the compliance costs associated with the amendments.

The amendments standardize the amount of time broker-dealers must maintain certain records, and may thereby increase the amount of time these records are kept by certain firms. Broker-dealers generally maintain these records already to comply with Federal laws or regulations, SRO rules, or in the normal course of business. These records include, (i) information relating to the principals responsible for reviewing and updating policies and procedures, (ii) copies of Forms BD, BDW and amendments thereto, (iii) copies of compliance, supervisory, and procedures manuals, (iv) customer account records, (v) order ticket information, (vi) records relating to compensation of associated persons, (vii) evidence of compliance with SRO advertising and sales literature rules, (viii) exception reports, and (ix) specialized reports produced pursuant to an order or settlement.

The amendments will also standardize the type of records that must be kept by broker-dealers and the manner in which those records must be produced during examinations. Before NSMIA, States had various books and records requirements. Although these requirements were similar to Commission and SRO requirements, differences existed that broker-dealers had to track and comply with. As one commenter stated, "the cost savings to industry of moving from compliance in the pre-NSMIA days with a variety of State laws to a new uniform should be equally substantial and should more than make up for any [additional] burden imposed by the [amendments]." ¹⁰³ The uniformity provided by NSMIA and these amendments to Rules 17a-3 and 17a-4 should result in significant cost savings to broker-dealers that operate in multiple jurisdictions.

1. Benefits

The amendments should result in increased efficiency and effectiveness of broker-dealer examinations, especially with respect to small offices. Increasing the efficiency of examinations tends to

decrease the costs incurred by both regulators, whose staff spends time conducting examinations, and broker-dealers, whose personnel may be inconvenienced for the period the examiners are present in their offices. One State estimated that the average cost for them to perform an office examination was \$1,300 to \$1,500 per day.¹⁰⁴ Another State suggested that a local office with well organized records normally takes 2 to 3 days to complete, but that an office with incomplete records takes an additional 2 or more days.¹⁰⁵ While average costs and time periods may vary from State to State, their operations tend to be similar and the Commission expects the amendments to reduce the time and costs of State securities examinations. This will also allow regulators to identify abusive practices earlier during inspections and perform more targeted examinations. In addition, broker-dealers should benefit by having their operations interrupted for shorter time periods. Costs of examinations may also be further reduced due to the uniformity of the recordkeeping provided by the amendments, because regulators and broker-dealers will know what records the firms should have on hand.

2. Costs

The amendments were drafted to permit flexible methods for the creation and maintenance of records in order to reduce the burdens on broker-dealers. This gives broker-dealers the flexibility to choose the least costly method to comply with the rules based upon their present processes and systems capabilities.

The Commission believes that the amendments to Rule 17a-4 will not impose significant cost burdens because, in order to comply with federal laws or regulations, SRO rules, or in the normal course of business, broker-dealers already maintain most of the records specified in the amended rule. Similarly, broker-dealers already are required to provide regulators with books and records on demand. The Commission estimates that the amendments to Rule 17a-4 could result in additional costs for some broker-dealers who do not presently maintain certain items for the prescribed periods of time or in a manner where they can be easily segregated by office. On average, the Commission estimates these additional costs incurred by each broker-dealer to ensure compliance with

the amendments to Rule 17a-4 to be approximately \$405.00¹⁰⁶ per year, resulting in an overall cost to the industry of about \$2.9 million per year.¹⁰⁷

Also, as mentioned previously, the State of Connecticut concluded in its study that, "the types of records required by the re-proposed rule would not be burdensome in that the firms retained substantially more records than required."¹⁰⁸

B. Periodic Updating of Customer Account Record Information

Paragraph (a)(17) of Rule 17a-3 requires broker-dealers to obtain additional account record information. Present federal and SRO rules require that firms obtain and maintain that same information in many circumstances,¹⁰⁹ and many broker-dealers presently obtain and maintain this information as a prudent business practice to avoid disputes with customers, or for other business reasons.

The amendments also require that broker-dealers send account record information¹¹⁰ to customers for verification within thirty days of account opening and at least every thirty-six months thereafter¹¹¹ and to require that broker-dealers provide customers with certain account record information when changes are made.¹¹²

¹⁰⁶ The Commission estimates that these amendments to Rule 17a-4 will take broker-dealers an additional four hours each per year. In the Reproposal the Commission estimated that these amendments would take an additional eight hours. Since the amendments being adopted today allow broker-dealers the option of not maintaining records at each office or producing records to the office to which they relate on the same day they are requested, the original estimate was reduced by one-half. The Commission believes that firms will have senior compliance personnel ensure compliance with these amended rules. According to the Securities Industry Association ("SIA") *Management and Professional Earnings 2000* report, Table 051, the hourly cost of a Compliance Manager + 35% overhead is \$101.25. (\$101.25 × 4)=approximately \$405.00 for each respondent, per year.

¹⁰⁷ (\$405.00 per respondent × (7,217 broker-dealers)=approximately \$2.9 million per year.

¹⁰⁸ *Supra* at note 95.

¹⁰⁹ 17 CFR 240.17a-3(a)(9), NASD Rules 2310(b), 3110(c) and IM-2860-2, and NYSE Rules 405, 407, 408, 410A, and 721.10.

¹¹⁰ Including customer name, address, telephone number, employment status, annual income, net worth, and the investment objectives for the account.

¹¹¹ The Commission originally proposed that broker-dealers verify customer account information at least once each year (*See* Proposing Release), however this was modified and re-proposed as once every thirty-six months in the Reproposal based upon comments received from broker-dealers who contended that it would be too costly to send account information to customers yearly.

¹¹² Broker-dealers must furnish notification of a change in the name or address information to the

¹⁰³ *See*, Comment Letter from the Consumer Federation of America, p. 3, note 4.

¹⁰⁴ *See* Comment Letter from State of Michigan Department of Consumer & Industry Services, p. 1.

¹⁰⁵ *See* Comment Letter from State of Texas' State Securities Board, pp. 2-3.

Many broker-dealers already send customers notification of address changes,¹¹³ and some also send a copy of a customer's new account form to the customer when an account is opened.¹¹⁴ While there is presently no requirement to send a copy of the customer account record at least once every 36 months to verify the information, broker-dealers are required to keep their records current.¹¹⁵

1. Benefits

The amendments should benefit broker-dealers by assuring that they have up-to-date information when making investment recommendations and reviewing suitability of certain transactions or investment strategies. Further, both broker-dealers and their customers will benefit by assuring that there is mutual understanding of the customer's financial position and objectives for the account. Indeed, requiring broker-dealers to update customer account records may assist less well managed firms in better supervising their operations to identify potential problems before they lead to regulatory or legal exposure and monetary losses.

Moreover, the amendments have been modified to exempt corporate accounts, inactive accounts, and accounts not requiring a determination of suitability. These changes reduce the total number of accounts covered by the updating requirements by over 25,000,000.¹¹⁶

2. Costs

The requirement to send account record information to customers will cause firms to incur costs to update their processes, and, with respect to the individual mailings, will add preparation expenses and additional postage charges. Further, firms will incur additional costs to update account information when customers notify the firm that their account record information has changed. Because broker-dealer processes, systems capabilities, and customer bases vary so widely, it is difficult to provide an estimated cost with which all parties will agree; however, the Commission estimates that for each of the 23,500,000 accounts to which a copy of the account record must be sent each year,¹¹⁷

customer's old address, and must furnish a copy of new account record information to the customer if some other information component is changed.

¹¹³ See e.g., Comment Letter from Raymond James Financial, Inc., p. 4.

¹¹⁴ See e.g., Comment Letter from Investment Management & Research, Inc., p. 4.

¹¹⁵ *Supra* note 1.

¹¹⁶ See *infra* note 117.

¹¹⁷ Broker-dealers reported, in their 12/31/00 Schedule 1 filings (required to be filed pursuant to

broker-dealers will spend an average of approximately 3.28 minutes¹¹⁸ (including time for processing and any updating) costing between \$1.36 and \$1.62 per piece,¹¹⁹ including postage.

17 CFR 240.17a-10), that they maintained a total of 97,600,000 customer accounts. The Commission estimates that at least 27,100,000 of these accounts are excluded from the provisions of Rule 17a-3(a)(17) because they are either not accounts of natural persons, inactive, or accounts for which the broker-dealer does not have a suitability requirement (the Commission arrived at this number using estimates provided by the firms, in their comment letters and otherwise, as to how many of their accounts would fit into one or more of these categories. See Rule 17 CFR 240.17a-3(a)(17)(i)(D)). Accordingly, the total number of accounts which would need to be contacted for updating is 70,500,000 every three years. $70,500,000/3 = 23,500,000$ per year.

¹¹⁸ Of the 23,500,000 accounts to which a copy of the account agreement must be sent each year, 22,975,000 (or 97%) of those accounts are attributable to 70 large broker-dealers which maintain over 100,000 customer accounts. Based upon the comment letters and other communications, large broker-dealers are more automated and small broker-dealers have more manual processes. The estimated additional time to send out customer account information is 1½ minutes per account for large broker-dealers and 7 minutes per account for small broker-dealers. The estimated number of customers who will provide updated account record information is 4,700,000 (or 20% of customers to which notification is sent—this estimate is based on a comment letter sent by Merrill Lynch) (4,559,000 the 4,700,000 are estimated to be maintained at large broker-dealers). The estimated time to update these account records is 5 minutes per account record for large broker-dealers and 10 minutes per account for small broker-dealers, and the estimated time to send updated account record to customer to notify of change is 1½ minutes for large broker-dealers and 7 minutes for small broker-dealers. The estimated number of customers who will change their account record without being prompted by a mailing is 3,525,000 (3,419,250 of which are maintained at large broker-dealers), and the estimated time to send updated account record information to those customers is 1½ minutes per account for large broker-dealers and 7 minutes per account for small broker-dealers. Thus it would take approximately 2.25 minutes per account contacted each year to send account records $((22,795,000 \times 1\frac{1}{2}) + (705,000 \times 7)) + ((4,559,000 \times 1\frac{1}{2}) + (141,000 \times 7)) + ((3,419,250 \times 1\frac{1}{2}) + (105,750 \times 7))/23,500,000$ accounts contacted yearly. In addition, it would take approximately 1.03 minutes per account contacted each year to update the account records $((4,559,000 \times 5) + (141,000 \times 10))/23,500,000$ accounts contacted yearly. In total, the Staff estimates that it would take 3.28 minutes per account contacted each year for processing and any updating.

¹¹⁹ The estimated total additional hours to provide customers with account record information is 880,369 hours $((22,795,000 \times 1\frac{1}{2}) + (705,000 \times 7)) + ((4,559,000 \times 1\frac{1}{2}) + (141,000 \times 7)) + ((3,419,250 \times 1\frac{1}{2}) + (105,750 \times 7))/60$ minutes). The estimated total additional hours to update customers accounts is 403,417 hours $((4,559,000 \times 5) + (141,000 \times 10))/60$ minutes in an hour). The hourly wage of the average person who would be providing customers with account record information is \$22.70 per hour (per the SIA Report on Office Salaries In the Securities Industry 2000, Table 082 (Retail Sales Assistant, Registered) and including 35% in overhead charges). The hourly wage of the average person who would be updating account record information is \$25.90 per hour (per the SIA Report on Office Salaries In the Securities

Thus the aggregate cost of Rule 17a-3(a)(17) is estimated to be between \$32 million and \$38.1 million (depending on what estimated postage cost is included in the calculations). In addition, the Commission estimates that all broker-dealers will, on average, incur a one-time cost of approximately \$312.00 each¹²⁰ to update their forms, resulting in an aggregate cost of approximately \$2.25 million.

As described more fully below, the Commission estimates that large broker-dealers (broker-dealers having over 100,000 accounts) will, on average, incur startup costs and ongoing costs to purchase and maintain additional equipment and develop systems of \$.31 per account and \$.25 per account respectively. Based upon the comment letters,¹²¹ the Commission believes that the additional costs for smaller broker-dealers is included in the hourly burden costs delineated above.

Two large broker-dealers estimated the start-up costs of purchasing equipment and modifying systems to range from \$1,000,000¹²² to \$1,300,000.¹²³ These two firms had a total of approximately 7,500,000 accounts which appeared to be subject

Industry 2000, Table 086 (Data Entry Clerk, Senior) and including 35% in overhead charges). Thus the aggregate cost of these hours is about \$30.4 million $((880,369 \text{ hours} \times \$22.70) + (403,417 \text{ hours} \times \$25.90))$. The estimated additional cost of paper, printing, and postage to provide this information to customers is between \$.05 and \$.244 per record sent, or between \$1.6 million and \$7.7 million $((\$0.05 \text{ or } \$0.244) \times (23,500,000 + 4,700,000 + 3,525,000))$. Yielding a total cost per record sent of between \$1.36 and \$1.62 $((\$30.4 \text{ million} + (\$1.6 \text{ million or } \$7.7 \text{ million}))/23,500,000 \text{ records sent per year})$.

¹²⁰ It is estimated that it will take firms 2 hours each, on average, to update their forms to include information regarding the meaning of investment objective terms. The Commission believes that firms will have an attorney perform this task. According to the SIA *Management and Professional Earnings 2000* report, Tables 107 (Attorney) and 108 (Compliance Attorney), the hourly cost of an attorney + 35% overhead is \$156.00 per hour. $(\$156.00 \times 2) =$ approximately \$312.00 per broker-dealer.

¹²¹ One small broker-dealer stated, "smaller firms lack the automation to do this type of action* * * without additional personnel." (See Comment Letter from Titan Value Equities Group, Inc., p. 2) another stated, "[w]e do not have electronic account records." (See Comment Letter from Capital West Securities, Inc., p. 2) and another stated, "for most firms [the] initial identification process would be manual" and "compiling the account record to send would require* * * pulling out a paper file for the account and making photo copies of the documents or pulling up the account on a computer system and printing out the required account information screens." (See Comment Letter from Comerica Securities, p. 2.) No smaller broker-dealer provided information regarding any increased equipment or systems development costs.

¹²² See Comment Letter from Morgan Stanley Dean Witter, p. 4.

¹²³ See Comment Letter from Merrill Lynch, p. 7 $(\$630,000 + \$370,000 + \$300,000)$.

to the updating requirement. The start-up costs per account, based upon these figures, is approximately \$0.31 ((\$1,000,000 + \$1,300,000)/7,500,000 accounts). It is important to note that the firms' estimates were based upon the assumption that they would have to update all of their accounts. Since the amendments adopted today provide an exemption for corporate accounts, inactive accounts, and accounts for which no suitability determination must be made, the actual costs will probably be much lower. These two firms further estimate that ongoing costs for equipment and systems development would range from \$300,000¹²⁴ to about \$1,600,000¹²⁵ per year. The ongoing costs per account would be \$0.25 per account ((\$300,000 + \$1,600,000)/7,500,000 accounts). Therefore, the total additional start-up and ongoing costs to obtain equipment and develop systems for these two large firms would be \$0.56 per account (\$0.31 + \$0.25).

Of the 70,500,000 accounts, 68,385,000 (97%) belong to large broker-dealers that have more than 100,000 accounts, therefore the total start-up costs for large broker-dealers to purchase equipment and develop their systems is about \$21.2 million (68,385,000 × \$0.31). Similarly, the ongoing equipment and systems development costs for large broker-dealers would be about \$17.1 million per year (68,385,000 × \$0.25).

C. Other New Requirements Covered by the Amendments

Paragraphs (a)(12) and (a)(19) of Rule 17a-3 require broker-dealers to keep certain records regarding each associated person, including all agreements pertaining to the associated person's relationship with the broker-dealer and a summary of each associated person's compensation arrangement,¹²⁶ a record delineating all identification numbers relating to each associated person,¹²⁷ a record of the office at which each associated person regularly conducts business,¹²⁸ and a record as to each associated person listing transactions for which that person will be compensated.¹²⁹ The

Commission believes that broker-dealers generally create and maintain these records already under prudent recordkeeping procedures.¹³⁰ The list of transactions for which each associated person will be compensated can be created at the time of an examination.

Paragraph (a)(18) of Rule 17a-3 requires broker-dealers to keep a record relating to written customer complaints and maintain a record of whether customers were provided with an address where they should direct complaints. Firms may, instead of creating a separate record of complaints, simply maintain a copy of each complaint, along with a record of the disposition of the complaint.

Paragraphs (a)(6) and (a)(7) of Rule 17a-3 have been amended to require that broker-dealers also record the identity of the associated person responsible for an account and the identity of the person who accepted the order, and whether the order was entered pursuant to discretionary authority. In addition, the amendment to paragraph (a)(6) requires that firms record the time an order was received from a customer, and the amendments to paragraph (a)(7) require that firms make a record of any modifications to an order. Paragraph (a)(6) now contains an exception providing that, for transactions done on a "subscription-way" basis, where an application or subscription agreement is sent to the issuer in place of an order ticket, broker-dealers may keep the application or subscription agreement in place of the order ticket. In addition, SRO rules already require that firms record and maintain certain of this information,¹³¹ and firms, to assist in their supervision of the activities of their associated persons and to assure that commissions are properly paid, already record the identity of persons as required under the amendments.

The amendments also require broker-dealers to make records indicating that they have complied with applicable regulations of certain securities regulatory authorities,¹³² listing persons who can explain the information in the broker-dealer's records,¹³³ and listing principals who are responsible for establishing compliance policies and procedures.¹³⁴ The Commission believes that these amendments will cause broker-dealers to incur only minimal additional costs. Firms

presently maintain records to evidence compliance with SRO and other rules, they presently maintain lists of principals or branch managers responsible for supervising each of their offices under other SRO rules, and they maintain lists of associated persons operating out of each office location. Firms must, as part of their supervisory system, identify principals responsible for reviewing the firm's procedures and taking action to achieve compliance with applicable securities laws, regulations and rules.¹³⁵

1. Benefits

The records required by these sections are either presently required under other federal laws or rules or SRO rules or currently maintained by many firms as a prudent business practice. These amendments codify current recordkeeping practices and make clear what records broker-dealers may be required to provide to State and other regulators. These records are expected to assist firms in better supervising their operations and identifying potential problems before they lead to regulatory or legal exposure and monetary losses.

2. Costs

The Commission has endeavored to codify present broker-dealer business practices in these amendments and has adjusted the amendments based upon comments received in response to the Proposal and Reproposal, as discussed above. Thus, these amendments are not expected to change market or industry behavior significantly. For example, firms are presently required to maintain copies of all communications under Exchange Act Rule 17a-4(b)(4), and certain SRO rules require that members maintain copies of all written complaints and a record of the actions taken by the broker-dealer with respect to each complaint.¹³⁶ Therefore, the Commission believes that amending Rule 17a-3 to require this information will not cause broker-dealers to incur any additional costs. Similarly, the Commission does not believe that the amendments to Rules 17a-3(a)(6) and 17a-3(a)(7) will cause any additional cost.

Nevertheless, broker-dealers may incur costs in assuring that their present practices comply with the amendments. For example, the Commission believes that the requirement to provide customers with an address where they can send complaints will cause firms to incur a one-time cost of approximately

¹²⁴ See Comment Letter from Dean Witter, p. 4.

¹²⁵ See Comment Letter from Merrill Lynch, p. 7. Merrill Lynch's estimate that they would spend \$3.8 million for ongoing costs was reduced to account for the fact that the Commission has included costs to send account records to customers, costs to update customer account records, costs to send notification of updates to customers, and postage costs, which are included in Merrill's \$3.8 million figure, elsewhere.

¹²⁶ 17 CFR 240.17a-3(a)(19)(ii).

¹²⁷ 17 CFR 240.17a-3(a)(12)(ii).

¹²⁸ 17 CFR 240.17a-3(a)(12)(iii).

¹²⁹ 17 CFR 240.17a-3(a)(19)(i).

¹³⁰ See *supra* text accompanying notes 95 and 96.

¹³¹ See *supra* 102 note.

¹³² 17 CFR 240.17a-3(a)(17)(ii) and 17 CFR 240.17a-4(b)(4).

¹³³ 17 CFR 240.17a-3(a)(21).

¹³⁴ 17 CFR 240.17a-3(a)(22).

¹³⁵ See *e.g.*, NASD Rule 3010.

¹³⁶ See *e.g.*, NASD Rule 3110(d), and for options complaints NASD Rule 2860(b)(17).

\$312.00¹³⁷ each, resulting in an aggregate cost of approximately \$2.25 million. In addition, the Commission estimates that it will cost each firm an average of \$50.83 per year to ensure compliance with paragraphs (a)(12) and (a)(19) of Rule 17a-3 (regarding associated person records),¹³⁸ resulting in an aggregate cost of approximately \$0.4 million per year. Finally, the Commission estimates that each firm will spend an average of approximately \$16.88 per year to ensure compliance with other requirements,¹³⁹ resulting in an aggregate cost of approximately \$0.1 million per year.

IX. Effects on Efficiency, Competition, and Capital Formation

Section 23(a)(2) of the Exchange Act¹⁴⁰ requires the Commission, in adopting Exchange Act rules, to consider the impact any such rule would have on competition and to not adopt a rule that would impose a burden on competition not necessary or appropriate in furthering the purposes of the Exchange Act. Section 3(f) of the Exchange Act¹⁴¹ provides that whenever the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public

¹³⁷ The Commission estimates that it will take each broker-dealer, on average, two hours to update its forms to include the address to which complaints should be sent. This is a very conservative estimate, since it will probably take much less than 2 hours to write down the broker-dealer's address and where it should be placed on the form, but additional time was added to account for supervisory review. The Commission believes broker-dealers would have an attorney perform this task. According to the *SIA Management and Professional Earnings 2000* report, Tables 107 (Attorney) and 108 (Compliance Attorney), the hourly cost of an attorney + 35% overhead is \$156.00 per hour. ($\156.00×2) = approximately \$312.00 per broker-dealer.

¹³⁸ The Commission estimated in its Reproposal that, on average, this requirement will obligate a broker-dealer to spend approximately 30 minutes each year to ensure that the records are in compliance with these amendments. The Commission received no specific comments relating to this estimate. The Commission believes firms may have senior compliance personnel perform this task. According to the *SIA Management and Professional Earnings 2000* report, Table 051, the hourly cost of a Compliance Manager + 35% overhead is \$101.25. ($\$101.25 \times \frac{1}{2}$ hour) = approximately \$50.63 per broker-dealer.

¹³⁹ The Commission estimated in its Reproposal that it will take each firm 10 additional minutes each year to assure compliance with the amendments, and it received no specific comments relating to this estimate. The Commission believes that firms will have senior compliance personnel perform this task. According to the *SIA Management and Professional Earnings 2000* report, Table 051, the hourly cost of a Compliance Manager + 35% overhead is \$101.25. ($\101.25×10 minutes/60 minutes in an hour) = approximately \$16.88 per broker-dealer.

¹⁴⁰ 15 U.S.C. 78w(a)(2).

¹⁴¹ 15 U.S.C. 78c(f).

interest, the Commission shall consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation. The Commission has considered the amendments to Rules 17a-3 and 17a-4 in light of the standards in Sections 23(a)(2) and 3(f) of the Exchange Act.

In the Reproposing Release, the Commission requested comment on the effect of the repropose rule amendments on competition, efficiency, and capital formation.¹⁴² The Commission received 115 substantive comment letters¹⁴³ in response to the Reproposal. Approximately 44% were from broker-dealers opposing particular amendments and approximately 37% were from State Securities Regulators supporting the amendments. Few commenters provided any information on how these amendments would affect competition, efficiency, or capital formation. One commenter argued that, "[c]ompetition among broker-dealers is facilitated by the amendments to the [Books and Records Rules]" because they "[allow] firms to create and maintain records by alternative means * * *."¹⁴⁴ Conversely, a few of commenters argued that; (i) the requirement to maintain records at local offices would place an unfair competitive burden upon smaller broker-dealers who do not have the resources to utilize imaging technology,¹⁴⁵ and (ii) the amendments would have a disparate impact on non-traditionally organized broker-dealers with limited businesses.¹⁴⁶ In addition, a number of commenters, while not specifically addressing this issue, did argue that it would be duplicative to maintain records at a local office while also maintaining the same documents at a main office. In response to these concerns and others, the Commission has modified the amendments to allow firms the flexibility to promptly produce records at the offices to which they relate instead of maintaining those records at the offices,¹⁴⁷ and has added exemptions in recognition of present business practices.¹⁴⁸

¹⁴² *Supra* note 9, at 54411.

¹⁴³ Of the 144 total "comment letters" on file, seventeen are memos by the staff of the Commission relating to meetings with various industry groups, and twelve simply request that the comment period be extended.

¹⁴⁴ *See*, Comment Letter from NASAA, p. 7.

¹⁴⁵ *See*, Comment Letters from Titan Value Equities Groups, Inc., p. 3; BenefitsCorp Equities, Inc., p. 2; and One Orchard Equities, Inc. p. 2.

¹⁴⁶ *See*, Comment Letter from MML Investor Services, Inc., pp. 5 to 6.

¹⁴⁷ Paragraph (k) of Rule 17a-4.

¹⁴⁸ *See* paragraphs (a)(6)(ii) and (a)(17)(i)(D) of Rule 17a-3. In addition, paragraph (a)(17) of Rule

The Commission believes that any burden imposed by the amendments is justified by the enhanced investor protections described above. Further, as NASAA pointed out in its comment letter, when addressing Section 23(a) concerns, "the [amendments] to Rules 17a-3 and 17a-4, pursuant to a directive by Congress, must also reflect the needs of the State Securities Regulators as well as federal regulators."¹⁴⁹ In addition, by improving examination capabilities of all securities regulatory authorities, the amendments should improve investor confidence in broker-dealer firms and help to maintain fair and orderly markets.

Broker-dealers with larger customer bases would have correspondingly greater obligations under the amendments than smaller broker-dealers. Accordingly, any burden on competition should be slight, especially in light of the significant regulatory benefits discussed above.

X. Summary of Final Regulatory Flexibility Analysis

A Final Regulatory Flexibility Analysis ("FRFA") regarding the amendments to Rules 17a-3 and 17a-4 under the Exchange Act,¹⁵⁰ which require broker-dealers to maintain certain additional records, specify that certain books and records must be maintained at each office, and set forth the length of time these records must be kept, has been prepared in accordance with the provisions of the Regulatory Flexibility Act (5 U.S.C. 604).

A. Need for the Rules and Rule Amendments

As discussed more fully in the FRFA, these amendments are intended to provide the Commission, SROs, and State Securities Regulators with timely access to broker-dealers' books and records to conduct effective examinations, investigations and enforcement actions. NSMIA prohibits States from establishing books and records rules that differ from, or are in addition to, the Commission's rules, and provides that the Commission must consult periodically with the States concerning the adequacy of the Commission's books and records rules,¹⁵¹ particularly with regard to whether the Commission's rules satisfy State Securities Regulators' need to have

17a-3 was modified to limit the requirement to accounts with a natural person as the customer.

¹⁴⁹ *See* Comment Letter from NASAA, p. 4.

¹⁵⁰ 15 U.S.C. 78a et. seq., adopted on October 11, 1996.

¹⁵¹ 15 U.S.C. 78o(h).

records readily accessible for their examinations.¹⁵²

If these amendments are not adopted, the Commission believes that the Commission staff and State Securities Regulators will be hampered in their efforts to obtain documentation, because the books and records that broker-dealers maintain may not always be sufficient or in such order as to enable regulators to conduct thorough and effective examinations, investigations, and enforcement proceedings. The Commission further believes that a failure to re-establish certain customer protection safeguards present in the marketplace prior to the enactment of NSMIA would reduce the regulatory oversight of broker-dealers. In addition, the Commission believes that this may also reduce customer confidence in the marketplace, which would be detrimental to market integrity and capital formation.

B. Small Entities Subject to the Rule

It is expected that these amendments will affect the approximately 1,000 broker-dealers that fall within the category of "small business"¹⁵³ ("Small Business Broker-Dealers"). The amendments would affect these Small Business' Broker-Dealers because they, like other broker-dealers, would have to create and maintain certain additional books and records and would have to provide access to specific books and records at each office. An OTC Derivatives Dealer would not be considered a small entity because of the minimum net capital requirement.

A summary of the Initial Regulatory Flexibility Analysis ("IRFA") appeared in the Reproposing Release,¹⁵⁴ where the Commission specifically requested comment with respect to the IRFA. In response to the Reproposing Release, the Commission received only one comment letter specifically concerning

the IRFA.¹⁵⁵ In addition, three other commenters addressed aspects of the repropose rules and rule amendments that could potentially affect small businesses.¹⁵⁶

The commenter that did specifically discuss the IRFA stated, "The Initial Regulatory Flexibility Analysis does not give careful consideration to the economic impact on [broker-dealers that limit their business in certain ways¹⁵⁷] of the new account cards, blotter records, and signatures of principals on account cards." However, the Commission has carefully considered the economic impact of these rules on various types of broker-dealers. Furthermore, the Commission notes that the commenter does not take into account the fact that, even with respect to broker-dealers that limit their business, existing NASD rules¹⁵⁸ require that broker-dealers maintain certain customer account information, including the signature of a principal accepting the account, and that Rule 17a-3(a)(1)¹⁵⁹ presently requires that broker-dealers retain blotter records. The Commission has amended new paragraph 17a-3(a)(17) to provide an exemption from obtaining certain information where broker-dealers have no Federal or SRO suitability requirement and are therefore not otherwise required to obtain that information.

Of the three commenters that addressed aspects of the repropose rules and rule amendments that could potentially affect small businesses, one stated, "[t]he proposal to require blotters in local offices may cause an initial financial burden to firms which have * * * three or less broker offices."¹⁶⁰ Another argued that the requirement to maintain records at local offices "place[s] an unfair competitive burden on smaller broker-dealers who do not have the resources to image the required documents and place them upon a network that is available to both the firm's principal office and the local branch."¹⁶¹ While the amendments as repropose would require that firms maintain certain records in each local office or produce those records within

the same business day that they are requested, the amendments have been changed in order to give firms the flexibility to produce those records promptly when they are requested by a representative of a securities regulatory authority. This change significantly reduces the cost of the amendments for most firms. In addition, recognizing that broker-dealers may not be required to maintain those records under SRO rules or other regulations, the Commission has attempted to reduce the impact of these amendments on firms that engage in certain specialized types of businesses by changing the amendments to allow those broker-dealers to utilize records they presently create and maintain in compliance with SRO or other rules and prudent business practices.

Another firm contended that the requirement to update account records is unduly burdensome on smaller firms because such firms lack the automation to perform that task quickly and without additional personnel.¹⁶² The Commission has attempted to make these amendments sufficiently flexible to accommodate different types of operational systems, and broker-dealers may choose the operational methods that best suit their business in order to comply with the amendments.

Lastly, another firm disagreed with the Commission's statement in the Reproposing Release that, "[l]arger broker-dealers would have correspondingly greater obligations under the amendments,"¹⁶³ stating, "the 'wire house' firms will be virtually unaffected by this proposal," because "wire houses * * * have very few small offices."¹⁶⁴ To the extent that Small Business Broker-Dealers service fewer customer accounts, employ fewer associated persons, and operate fewer offices than larger broker-dealers, they will be affected by the rule in proportion to their size.

C. Projected Reporting, Recordkeeping, and Other Compliance Requirements

Most broker-dealers, including Small Business Broker-Dealers, already maintain many of the records specified in the amendments in the ordinary course of business. The Commission's intent has been to minimize the impact of the amendments on all broker-dealers by limiting, consistent with the objectives of the amendments, the number of instances in which broker-dealers would be obligated to create or

¹⁵² See *supra* note 8.

¹⁵³ Pursuant to 17 CFR 240.0-10, the term "small business" or "small organization" when used with reference to a broker or dealer means a broker or dealer that: (i) had total capital (net worth plus subordinated liabilities) of less than \$500,000 on the date its audited financial statements for the prior fiscal year were prepared pursuant to 17 CFR 240.17-5(d) or, if not required to file such statements, a broker-dealer that had total net capital (net worth plus subordinated liabilities) of less than \$500,000 on the last business day of the preceding fiscal year (or in the time that it has been in business, if shorter); and (ii) is not affiliated with any person (other than a natural person) that is not a small business or small organization as defined in 17 CFR 240.0-10. In addition, Exchange Act Release No. 40122 (June 24, 1998) 63 FR 35508 (June 30, 1998) recently amended standard that defines what it means to be "affiliated" with any person that is not a small business.

¹⁵⁴ See *supra* note 9.

¹⁵⁵ See Comment Letter from American Council of Life Insurance, p. 16.

¹⁵⁶ See Comment Letters from Titan Value Equities Group, Inc., pp. 2-3; Lawrence Lowman, p. 1; and John Hancock Distributors, Inc., p. 3.

¹⁵⁷ E.g., broker-dealers which only facilitate transactions in certain types of products or broker-dealers which do not make recommendations.

¹⁵⁸ See e.g., NASD Rule 3110(c).

¹⁵⁹ 17 CFR 240.17a-4(a)(1).

¹⁶⁰ See Comment Letter from Lawrence Lowman, p. 1.

¹⁶¹ See Comment Letter from Titan Value Equities, p. 3.

¹⁶² *Id.*, p. 2.

¹⁶³ See Comment Letter from John Hancock Distributors, Inc., p. 3.

¹⁶⁴ *Id.*

maintain records that they do not already maintain in the ordinary course of business. In addition, the amendments were designed to be sufficiently flexible to accommodate different types of recordkeeping systems, and broker-dealers may choose the format in which they wish to maintain those records.

D. Agency Action To Minimize Effect on Small Entities

As discussed further in the FRFA, the Commission has attempted to minimize the economic impact these amendments might have on broker-dealers, including Small Business Broker-Dealers, while still achieving the overall objective of assuring that regulators have the ability to perform effective examinations, including examinations for sales practice issues. In response to comments elicited by the Reproposing Release, many significant changes were made to the amendments to reduce the burdens associated with these amendments.

The Regulatory Flexibility Act directs the Commission to consider significant alternatives that would accomplish the stated objective, while minimizing any significant adverse impact on small entities. The Commission considered the following alternatives: (i) The establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (ii) the clarification, consolidation, or simplification of compliance and reporting requirements under the rules for small entities; (iii) the use of performance rather than design standards; and (iv) an exemption from coverage of the rule, or any part thereof, for small entities. The Commission also considered whether these alternatives to the reproposed rules and rule amendments would accomplish the stated objectives of improving the effectiveness of the Commission's and State regulatory agencies' ability to perform investigations, examinations and enforcement actions.

The additional burdens placed on Small Business Broker-Dealers will vary depending upon the number of customer accounts at the firm, the number of associated persons employed by the firm, and the number of offices that the firm operates. Further, the rule provides substantial flexibility in the manner in which firms may comply with the amendments. Additionally, the Commission believes that obtaining essential information regarding the sales practices of all broker-dealers, including Small Business Broker-Dealers, is necessary to permit securities regulators

to effectively oversee the securities markets and protect investors; therefore, the Commission does not believe that establishing differing compliance or reporting requirements for Small Business Broker-Dealers would be appropriate.

The Commission believes that the proposal could not be formulated differently for Small Business Broker-Dealers and still achieve the stated objectives. The Commission has considered Small Business Broker-Dealers in developing the amendments and has determined that all types of broker-dealers, including Small Business Broker-Dealers, engage in sales practice abuses; therefore, the Commission does not believe that further clarification, consolidation, or simplification of the proposed amendments would be appropriate. As stated previously, however, the Commission has made every effort to assure that, to the extent possible, the amendments require broker-dealers to maintain the same types of records required under other federal and SRO rules or that firms usually maintain as part of their present business practices, and has highlighted instances where records that broker-dealers presently maintain may serve to fulfill the requirements under these amendments.

The Commission does not believe that it would be appropriate to use performance standards, rather than design standards, with relation to these amendments. Because information must be collected and maintained in a uniform manner to be useful, design standards are necessary to achieve the objectives of the proposal. Any additional burden placed on broker-dealers by these amendments is dependent on the number of accounts serviced, the number of associated persons employed, and the number of offices operated. Thus, although the use of performance standards would be an inappropriate measure with relation to these amendments, the standards used do take into account the size of each firm. The Commission also notes that the recordkeeping requirements permit broker-dealers to keep records in different formats or systems as long as specified information can be sorted and produced upon request.

Lastly, customers may be exposed to fraud and sales practice violations by Small Business Broker-Dealers as well as other firms. Exempting Small Business Broker-Dealers from coverage of the rules, or any part thereof, would create a gap in industry oversight, where regulatory authorities may be unable to obtain documentation necessary to conduct comprehensive examinations of

Small Business Broker-Dealers. Therefore, the Commission believes that it should not exempt Small Business Broker-Dealers from the requirements of the amendments.

The Commission believes that enacting the amendments in their present form is the best way to assure that regulators have the ability to perform effective examinations, including examinations for sales practice issues, and that no less burdensome alternatives are available to accomplish the objectives of the amendments. As stated previously, after NSMIA, States were constrained from "establishing books and records rules that differ from, or are in addition to the Commission's rules."¹⁶⁵ The States play an integral role in achieving customer protection by performing examinations on broker-dealers within their jurisdiction and reviewing for sales practice violations. Without these amendments, the States may be unable to obtain those books and records necessary to conduct comprehensive examinations. Finally, the Commission believes that most Small Business Broker-Dealers currently maintain certain of the additional records specified in the amendments.

A copy of the FRFA may be obtained by contacting Bonnie L. Gauch, Attorney, United States Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-1001.

XI. Paperwork Reduction Act

Certain provisions of the amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995.¹⁶⁶ The Commission has submitted the amendments to the Office of Management and Budget ("OMB") for review in accordance with 44 U.S.C. 3507(d) and 5 CFR 1320.11 under the title "Books and Records Rule Amendments." The rules being amended contain currently approved collections of information under OMB control numbers 3235-0033 and 3235-0279 respectively. The collections and maintenance of information, and the reports made to the SEC and others that are required pursuant to Rules 17a-3 and 17a-4 are mandatory. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number.

¹⁶⁵ 15 U.S.C. 78o(h).

¹⁶⁶ 44 U.S.C. 3502 *et seq.*

A. Collection of Information Under the Amendments

As discussed previously in this release, the Books and Records Rule Amendments would require registered broker-dealers to maintain additional records with respect to purchase and sale documents, customer information, associated person information, customer complaints and certain other matters.

B. Proposed Use of Information

The information collected pursuant to the Books and Records Rule Amendments would be used by the Commission, SROs, and other securities regulatory authorities for examinations, investigations, and enforcement proceedings regarding broker-dealers and associated persons. No governmental agency would regularly receive any of the information described above. Instead, the information would be stored by the registered broker-dealer and made available to the various securities regulatory authorities as required to facilitate examinations, investigations, and enforcement proceedings. To comply with the amendments that require broker-dealers to update customer account records at least once every 36 months, broker-dealers would have to furnish the customers with copies of their account records. This requirement and the estimated burden associated with it are discussed in detail below.

C. Respondents

The Books and Records Rule Amendments would apply to all of the approximately 7,217 active broker-dealers that are registered with the Commission.¹⁶⁷

D. Total Annual Reporting and Recordkeeping Burden

The hour burden of the Books and Records Rule Amendments is difficult to ascertain, because any additional burdens would vary widely due to differences in broker-dealer activity levels and current recordkeeping systems employed by the broker-dealers. Therefore, the estimates in this section are based on averages among the various types and sizes of broker-dealers.

¹⁶⁷ Of approximately 7,739 broker-dealers registered with the Commission, approximately 341 are not yet active because their registration is pending SRO approval and approximately 181 are inactive because they have ceased doing a securities business and have filed a Form BDW with the Commission. Of these 7,217 active, registered broker-dealers, three are registered OTC Derivatives Dealers. OTC Derivatives Dealers are a special class of broker-dealers that limit their business to dealer activities in eligible over-the-counter derivative instruments and that meet certain financial responsibility and other requirements.

Recognizing that large broker-dealers maintaining over 100,000 customer accounts are generally more automated than small broker-dealers maintaining less than 100,000 customer accounts with relation to certain of the amendments, the Commission has attempted to provide for these differences in its calculations.

Most of the requirements of the Books and Records Rule Amendments involve collections of information that broker-dealers already maintain pursuant to prudent business practices or to comply with existing SRO regulations. While some of the comment letters argued that the Commission's estimates set forth in the Reproposing Release were low, few contained actual alternative cost estimates, and none contained estimates which could be applied generally to broker-dealer firms. The Commission has increased its estimation of the expected burden of the amendments where, in general, commenters felt that the estimates were too low, and has provided a more detailed explanation of its estimates where it believes the amendments will impose little or no additional burden on broker-dealers. In addition, in response to the comments received relating to the Reproposing Release, the Commission modified its proposal and adopted amendments that reduce the amount of additional records that firms will be required to create and maintain.

1. Rule 17a-3

The amendments modify Rule 17a-3 by, among other things, requiring broker-dealers to send account information to customers for verification within 30 days of account opening and at least once every 36 months thereafter. As stated above, the total number of accounts that would need to be contacted for updating is 70,500,000.¹⁶⁸ Approximately 70 of the 7,217 active, registered broker-dealers maintain over 100,000 accounts, and the remaining broker-dealers (7,147) maintain less than 100,000 accounts each. Of the 70,500,000 accounts which may be affected by these amendments, approximately 68,385,000 (or 97%) are maintained at these large broker-dealers, and 2,115,000 (or 3%) are maintained at broker-dealers with less than 100,000 accounts each.

The Commission estimates that, as their processes are more automated, it will take large broker-dealers an average of 1½ additional minutes per account every three years,¹⁶⁹ thus requiring large

¹⁶⁸ *Supra* note 117.

¹⁶⁹ The Commission, in its Reproposal, estimated that it would take broker-dealers 10 seconds to

broker-dealers to spend an additional 569,875 hours per year (68,385,000 account records/3 years × 1.5 minutes / 60 minutes) to send account information to customers. As small broker-dealers utilize processes which are more manual in nature,¹⁷⁰ the Commission estimates that it will take small broker-dealers an average of 7 minutes per account¹⁷¹ every three years, thus requiring small broker-dealers to spend an additional 82,250 hours per year (2,115,000 account records/3 years × 7 minutes/60 minutes) to send account records to customers. Thus the total additional burden on the industry to send account records to customers is 652,125 hours.

The Commission estimates that approximately 20%¹⁷² of the customers from whom information is requested will update their account record resulting in 4,700,000 updated account records each year (70,500,000/3 years × 20%). The Commission estimates that it would take, on average, 5 minutes for large broker-dealers to update each account and 10 minutes¹⁷³ for small broker-dealers to update each account, resulting in an additional burden of 403,417 hours per year ((4,559,000 account records × 5 minutes/60 minutes) + (141,000 account records × 10 minutes/60 minutes)). This estimate takes into account the amount of time it would take to receive the returned data and input any changes into the account record. While it is acknowledged that some customers will provide broker-dealers with changes to their account information outside of this update process, as those are changes broker-dealers must contend with in the present environment, the amendments create no additional burden in this regard. Broker-dealers presently maintain current account records in the ordinary course of their business because existing SRO rules require them to maintain current information about their customers.

If a customer has provided the broker-dealer with updated account record information, under paragraphs (a)(17)(i)(B) (2) and (3) of Rule 17a-3 the broker-dealer must send a copy of the revised account record to the customer within 30 days after it received notification of the change or, under paragraph (a)(17)(i)(B)(3), the broker-

furnish the account record to customers. Because many commenters contended that this estimate was too low, the Commission raised its estimates.

¹⁷⁰ *Supra* note 121.

¹⁷¹ See Comment Letter from Comerica Securities, p. 2.

¹⁷² See Comment Letter from Merrill Lynch, p. 7.

¹⁷³ See Comment Letter from Titan Value Equities, Inc., p. 2.

dealer may send the notification with the next statement mailed to the customer. The Commission estimates that, in addition to the 70,500,000 updated account records discussed above, 3,525,000 customers (5% of the 70,500,000 accounts for which firms will be required to make the account record) will initiate changes to their account records on a yearly basis, just as they do now, with no prompting from any account record mailing. The Commission estimates, as stated above, that it will take large broker-dealers 1½ minutes and smaller broker-dealers 7 minutes to send out account information to each customer who updated their account. The Commission estimates that 8,225,000 (4,700,000 + 3,525,000) customers will update their account record, and that broker-dealers will spend an additional 228,244 hours each year ((7,978,250 account records x 1.5 minutes / 60 minutes) + (246,750 account records x 7 minutes / 60 minutes)) sending the updated account records to customers.

The amendments also impose a requirement that broker-dealers obtain the following additional information for each account with a natural person as the customer: the customer name, tax identification number, address, telephone number, date of birth, employment status, annual income, net worth, investment objectives, and the signature of the associated person and a principal. Present Rule 17a-3(a)(9) already requires that a firm maintain a record of a customer's name and address. Further, SRO rules require that firms obtain and maintain records of: whether a customer is of legal age (firms usually obtain a customer's date of birth to satisfy this requirement), the signature of the registered representative and principal, a customer's tax identification number, the customer's occupation, and whether or not the customer is associated with another broker-dealer.¹⁷⁴ In addition, certain SRO rules require that before making any recommendations to customers, broker-dealers obtain information, regarding the customer's annual income, net worth, and the investment objectives for the account in question in order to formulate a basis for any recommendation.¹⁷⁵

In addition, the amendments require that, if the account is a discretionary account, the firm must obtain (i) The signature of the customer granting discretion, (ii) the date discretion was granted, and (iii) the signature of the

person to whom discretion was granted. Certain SRO rules require that for discretionary accounts, broker-dealers must obtain the signature of the person who was granted discretion, and the date discretion was granted,¹⁷⁶ while other SRO rules require that firms obtain written authorization of the customer before exercising discretion in an account.¹⁷⁷ Further, the Commission believes that obtaining these records is a prudent business practice followed by most broker-dealers to avoid disputes with customers.

In addition to the account record requirements, the amendments require broker-dealers to keep certain records regarding their associated persons, including all agreements pertaining to the associated persons relationship with the broker-dealer and a summary of each associated person's compensation arrangement,¹⁷⁸ a record delineating all identification numbers relating to each associated person,¹⁷⁹ a record of the office at which each associated person regularly conducts business,¹⁸⁰ and a record as to each associated person listing transactions for which that person will be compensated.¹⁸¹ The Commission believes that broker-dealers generally create and maintain these records under prudent recordkeeping procedures. Therefore, the Commission estimates that, on average, these records would require each broker-dealer to spend approximately 30 minutes each year to ensure that it is in compliance with these amendments, a total of about 3,609 hours ((7,217 broker-dealers x 30 minutes/60 minutes).

The amendments also require broker-dealers to keep a record relating to written customer complaints that includes: the complainant's name, address, and account number; the date the complaint was received; the name of any associated person identified in the complaint; a description of the nature of the complaint; and, the disposition of the complaint. In order to account for differing broker-dealer practices, the Commission has provided broker-dealers with an alternative; instead of creating what may be a new record, broker-dealers can simply maintain a copy of each complaint, along with a record of the disposition of the complaint.¹⁸² Firms are presently required to maintain copies of all communications under Rule 17a-

4(b)(4), and certain SRO rules require that members maintain copies of all written complaints and a record of the actions taken by the broker-dealer in specified offices, and that copies of options-related complaints be maintained in both the main office and in the branch office to which they relate.¹⁸³ Most firms maintain copies of all complaints and related information and documents at their headquarters, and some already maintain both option and non-option complaints at all offices as well. While the Reproposal would have required that complaints relating to an office be maintained in that office or be produced on the business day they are requested, the amendments as adopted require only that records of complaints for an office be produced promptly at the office to which the complaints relate.

The amendments also require broker-dealers to make records which indicate that they have complied with applicable regulations of certain securities regulatory authorities,¹⁸⁴ which list persons who can explain the information in the broker-dealer's records,¹⁸⁵ and that list principals responsible for establishing compliance policies and procedures.¹⁸⁶ Firms presently maintain records to evidence compliance with SRO and other rules; therefore, no additional burden is created by this amendment. The Commission believes that broker-dealers presently maintain lists of principals or branch managers responsible for supervising each of their offices under applicable SRO rules, and that they also have lists of associated persons operating out of each office location. Under certain SRO rules, broker-dealers must presently have supervisory systems in place that include identification of principals responsible for reviewing the firm's procedures and taking action to achieve compliance with applicable securities laws, regulations and rules.¹⁸⁷ The Commission estimates, therefore, that on average each broker-dealer would spend 10 minutes each year to ensure compliance with these requirements, yielding a total additional burden of about 1,203 hours ((7,217 broker-dealers x 10 minutes/60 minutes).

The amendments relating to order tickets require that broker-dealers note, in addition to information already required, the identity of the associated

¹⁷⁴ *Supra* note 158.

¹⁷⁷ *See e.g.*, NYSE Rule 408.

¹⁷⁸ *Supra* note 126.

¹⁷⁹ *Supra* note 127.

¹⁸⁰ *Supra* note 128.

¹⁸¹ *Supra* note 129.

¹⁸² 17 CFR 240.17a-3(a)(18)(i).

¹⁸³ *Supra* note 136.

¹⁸⁴ 17 CFR 240.17a-3(a)(17)(ii) and 17 CFR 240.17a-3(a)(20).

¹⁸⁵ *Supra* note 133.

¹⁸⁶ *Supra* note 134.

¹⁸⁷ *Supra* note 135.

¹⁷⁴ *See* NASD Rules 3110(c) and IM-2860-2, and NYSE Rules 405, 407, 410A, and 721.10.

¹⁷⁵ *See e.g.*, NASD Rule 2310(b) and IM-2860-2.

person responsible for an account and the identity of the person who accepted the order, and whether the order was entered pursuant to discretionary authority. In addition, the amendments to Rule 17a-3(a)(6) require that firms record the time an order was received from a customer, and the amendments to Rule 17a-3(a)(7) require that firms make a record of any modifications to an order. SRO rules already require that firms record, maintain, and in some cases report, the time an order was received, and information regarding modification and cancellation including instructions and the time.¹⁸⁸ Further, firms who assign associated persons to particular accounts usually refer the customer to that person to initiate transactions. The identity of the person who accepted the order from the customer, whether or not it was the person assigned to the account, is generally recorded and maintained at the present time by firms as a prudent business practice that assists the firm in properly supervising the activities of their associated persons and assuring that commissions are properly paid. In addition, the amendment to Rule 17a-3(a)(6) contains an exception for transactions done on a "subscription-way" basis, where an application or subscription agreement is sent to the issuer in place of an order ticket. For these types of transactions, broker-dealers may keep the application or subscription agreement in the place of the order ticket. Thus the Commission does not believe that the amendments to Rules 17a-3(a)(6) and 17a-3(a)(7) will cause any additional burden.

In total, the Commission estimates that compliance with the amendments to Rule 17a-3 will require an additional 1,288,598 hours (1,283,786¹⁸⁹ + 3,609¹⁹⁰ + 1,203¹⁹¹).

2. Rule 17a-4

The amendments modify Rule 17a-4 by requiring broker-dealers to maintain certain additional books and records, including a record listing all persons who are qualified to explain a broker-dealer's books and records. The amendments also require broker-dealers to make available certain records at each office. As discussed above, new Rule 17a-4(k) was modified to provide that, instead of requiring that firms either maintain copies of records in the office to which they pertain, broker-dealers now have the option of producing certain records which relate to a

particular office "promptly." This significantly reduces the additional burden caused by the amendments to Rule 17a-4.

The amendments also increase the amount of time broker-dealers must maintain certain records. Broker-dealers generally maintain these records to comply with other federal or SRO Rules or in the normal course of business. These records include, (i) information relating to the principals responsible for reviewing and updating policies and procedures, (ii) copies of Forms BD, BDW and amendments thereto, (iii) copies of compliance, supervisory, and procedures manuals, (iv) customer account records, (v) order ticket information, (vi) records relating to compensation of associated persons, (vii) evidence of compliance with SRO advertising and sales literature rules, (viii) exception reports, and (ix) specialized reports produced pursuant to an order or settlement.

Based upon the information above, and due to the fact that the amendments to Rule 17a-4 require only that information be kept for prescribed periods of time, the Commission estimates that, on average, each broker-dealer would spend four hours each year to ensure that it is in compliance with the amendments to Rule 17a-4 and to produce required records promptly at an office when so required. Therefore, the Commission estimates that compliance with the amendments for Rule 17a-4 would require an additional 28,868 hours each year ((7,217 broker-dealers x 4 hours).

E. Request for Comment

Pursuant to 44 U.S.C. 3506(c)(2)(B), the Commission solicits comments to— (i) Evaluate whether the proposed collections of information are necessary for the proper performance of the functions of the agency, including whether the information shall have practical utility; (ii) Evaluate the accuracy of the agency's estimate of the burden of the proposed collections of information; (iii) Enhance the quality, utility, and clarity of the information to be collected; (iv) Minimize the burden of the collections of information on those who are to respond, including through the use of automated collection techniques or other forms of information technology. The Commission encourages commenters to identify and supply any relevant data, analysis and estimates concerning the burden of the proposed rules, especially where any commenter believes the Commission's estimates to be inaccurate.

Persons desiring to submit comments on the collection of information

requirements proposed above should direct them to the following persons: (1) Desk Officer for the Securities and Exchange Commission, Office of Information and Regulatory Affairs, Office of Management and Budget, Room 10102, New Executive Office Building, Washington, DC 20503; and (2) Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549-0609 with reference to File No. S7-26-98. OMB is required to make a decision concerning the collections of information between 30 and 60 days after publication, so a comment to OMB is best assured of having its full effect if OMB receives it within 30 days of publication. The Commission has submitted the proposed collections of information to OMB for approval. Requests for the materials submitted to OMB by the Commission with regard to these collections of information should be in writing, refer to File No. S7-26-98, and be submitted to the Securities and Exchange Commission, Records Management, Office of Filings and Information Services, 450 Fifth Street, NW., Washington, DC 20549.

XII. Statutory Basis

The amendments are adopted pursuant to the authority conferred on the Commission by the Exchange Act, including Sections 17(a) and 23(a).

List of Subjects in 17 CFR Parts 240 and 242

Brokers, Reporting and recordkeeping requirements, Securities.

For the reasons set forth in the preamble, Title 17 Chapter II of the Code of Federal Regulation is amended as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 is amended by adding the following citation:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s, 78u-5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

* * * * *

Section 240.17a-4 also issued under secs. 2, 17, 23(a), 48 Stat. 897, as amended; 15 U.S.C. 78a, 78d-1, 78d-2; sec. 14, Pub. L. 94-29, 89 Stat. 137 (15 U.S.C. 78a); sec. 18, Pub. L. 94-29, 89 Stat. 155 (15 U.S.C. 78w);

* * * * *

¹⁸⁸ *Supra* note 102.

¹⁸⁹ 17 CFR 240.17a-3(a)(17).

¹⁹⁰ 17 CFR 240.17a-3(12) and (19).

¹⁹¹ 17 CFR 240.17a-3(a)(20) to (22).

2. The authority citations following §§ 240.17a-3 and 240.17a-4 are removed.

3. Section 240.17a-3 is amended by: a. Revising paragraphs (a)(6) and (a)(7);

b. Revising the introductory text of paragraph (a)(12)(i);

c. Revising paragraph (a)(12)(ii);

d. Redesignating paragraphs (a)(12)(i)(a) through (a)(12)(i)(h) as paragraphs (a)(12)(i)(A) through (a)(12)(i)(H); and

e. Adding paragraphs (a)(17), (a)(18), (a)(19), (a)(20), (a)(21), (a)(22), (f) and (g).

The revisions and additions read as follows:

§ 240.17a-3 Records to be made by certain exchange members, brokers and dealers.

(a) * * *

(6)(i) A memorandum of each brokerage order, and of any other instruction, given or received for the purchase or sale of securities, whether executed or unexecuted. The memorandum shall show the terms and conditions of the order or instructions and of any modification or cancellation thereof; the account for which entered; the time the order was received; the time of entry; the price at which executed; the identity of each associated person, if any, responsible for the account; the identity of any other person who entered or accepted the order on behalf of the customer or, if a customer entered the order on an electronic system, a notation of that entry; and, to the extent feasible, the time of execution or cancellation. The memorandum need not show the identity of any person, other than the associated person responsible for the account, who may have entered or accepted the order if the order is entered into an electronic system that generates the memorandum and if that system is not capable of receiving an entry of the identity of any person other than the responsible associated person; in that circumstance, the member, broker or dealer shall produce upon request by a representative of a securities regulatory authority a separate record which identifies each other person. An order entered pursuant to the exercise of discretionary authority by the member, broker or dealer, or associated person thereof, shall be so designated. The term instruction shall include instructions between partners and employees of a member, broker or dealer. The term time of entry shall mean the time when the member, broker or dealer transmits the order or instruction for execution.

* * * * *

(ii) This memorandum need not be made as to a purchase, sale or redemption of a security on a subscription way basis directly from or to the issuer, if the member, broker or dealer maintains a copy of the customer's subscription agreement regarding a purchase, or a copy of any other document required by the issuer regarding a sale or redemption.

(7) A memorandum of each purchase and sale for the account of the member, broker, or dealer showing the price and, to the extent feasible, the time of execution; and, in addition, where the purchase or sale is with a customer other than a broker or dealer, a memorandum of each order received, showing the time of receipt; the terms and conditions of the order and of any modification thereof; the account for which it was entered; the identity of each associated person, if any, responsible for the account; the identity of any other person who entered or accepted the order on behalf of the customer or, if a customer entered the order on an electronic system, a notation of that entry. The memorandum need not show the identity of any person other than the associated person responsible for the account who may have entered the order if the order is entered into an electronic system that generates the memorandum and if that system is not capable of receiving an entry of the identity of any person other than the responsible associated person: in that circumstance, the member, broker or dealer shall produce upon request by a representative of a securities regulatory authority a separate record which identifies each other person. An order with a customer other than a member, broker or dealer entered pursuant to the exercise of discretionary authority by the member, broker or dealer, or associated person thereof, shall be so designated.

* * * * *

(12)(i) A questionnaire or application for employment executed by each "associated person" (as defined in paragraph (g)(4) of this section) of the member, broker or dealer, which questionnaire or application shall be approved in writing by an authorized representative of the member, broker or dealer and shall contain at least the following information with respect to the associated person:

* * * * *

(ii) A record listing every associated person of the member, broker or dealer which shows, for each associated person, every office of the member, broker or dealer where the associated

person regularly conducts the business of handling funds or securities or effecting any transactions in, or inducing or attempting to induce the purchase or sale of any security for the member, broker or dealer, and the Central Registration Depository number, if any, and every internal identification number or code assigned to that person by the member, broker or dealer.

* * * * *

(17) For each account with a natural person as a customer or owner:

(i)(A) An account record including the customer's or owner's name, tax identification number, address, telephone number, date of birth, employment status (including occupation and whether the customer is an associated person of a member, broker or dealer), annual income, net worth (excluding value of primary residence), and the account's investment objectives. In the case of a joint account, the account record must include personal information for each joint owner who is a natural person; however, financial information for the individual joint owners may be combined. The account record shall indicate whether it has been signed by the associated person responsible for the account, if any, and approved or accepted by a principal of the member, broker or dealer. For accounts in existence on the effective date of this section, the member, broker or dealer must obtain this information within three years of the effective date of the section.

(B) A record indicating that:

(1) The member, broker or dealer has furnished to each customer or owner within three years of the effective date of this section, and to each customer or owner who opened an account after the effective date of this section within thirty days of the opening of the account, and thereafter at intervals no greater than thirty-six months, a copy of the account record or an alternate document with all information required by paragraph (a)(17)(i)(A) of this section. The member, broker or dealer may elect to send this notification with the next statement mailed to the customer or owner after the opening of the account. The member, broker or dealer may choose to exclude any tax identification number and date of birth from the account record or alternative document furnished to the customer or owner. The member, broker or dealer shall include with the account record or alternative document provided to each customer or owner an explanation of any terms regarding investment objectives. The account record or alternate document

furnished to the customer or owner shall include or be accompanied by prominent statements that the customer or owner should mark any corrections and return the account record or alternate document to the member, broker or dealer, and that the customer or owner should notify the member, broker or dealer of any future changes to information contained in the account record.

(2) For each account record updated to reflect a change in the name or address of the customer or owner, the member, broker or dealer furnished a notification of that change to the customer's old address, or to each joint owner, and the associated person, if any, responsible for that account, on or before the 30th day after the date the member, broker or dealer received notice of the change.

(3) For each change in the account's investment objectives the member, broker or dealer has furnished to each customer or owner, and the associated person, if any, responsible for that account a copy of the updated customer account record or alternative document with all information required to be furnished by paragraph (a)(17)(i)(B)(1) of this section, on or before the 30th day after the date the member, broker or dealer received notice of any change, or, if the account was updated for some reason other than the firm receiving notice of a change, after the date the account record was updated. The member, broker or dealer may elect to send this notification with the next statement scheduled to be mailed to the customer or owner.

(C) For purposes of this paragraph (a)(17), the neglect, refusal, or inability of a customer or owner to provide or update any account record information required under paragraph (a)(17)(i)(A) of this section shall excuse the member, broker or dealer from obtaining that required information.

(D) The account record requirements in paragraph (a)(17)(i)(A) of this section shall only apply to accounts for which the member, broker or dealer is, or has within the past 36 months been, required to make a suitability determination under the federal securities laws or under the requirements of a self-regulatory organization of which it is a member. Additionally, the furnishing requirement in paragraph (a)(17)(i)(B)(1) of this section shall not be applicable to an account for which, within the last 36 months, the member, broker or dealer has not been required to make a suitability determination under the federal securities laws or under the requirements of a self-regulatory

organization of which it is a member. This paragraph (a)(17)(i)(D) does not relieve a member, broker or dealer from any obligation arising from the rules of a self-regulatory organization of which it is a member regarding the collection of information from a customer or owner.

(ii) If an account is a discretionary account, a record containing the dated signature of each customer or owner granting the authority and the dated signature of each natural person to whom discretionary authority was granted.

(iii) A record for each account indicating that each customer or owner was furnished with a copy of each written agreement entered into on or after the effective date of this paragraph pertaining to that account and that, if requested by the customer or owner, the customer or owner was furnished with a fully executed copy of each agreement.

(18) A record:

(i) As to each associated person of each written customer complaint received by the member, broker or dealer concerning that associated person. The record shall include the complainant's name, address, and account number; the date the complaint was received; the name of any other associated person identified in the complaint; a description of the nature of the complaint; and the disposition of the complaint. Instead of the record, a member, broker or dealer may maintain a copy of each original complaint in a separate file by the associated person named in the complaint along with a record of the disposition of the complaint.

(ii) Indicating that each customer of the member, broker or dealer has been provided with a notice containing the address and telephone number of the department of the member, broker or dealer to which any complaints as to the account may be directed.

(19) A record:

(i) As to each associated person listing each purchase and sale of a security attributable, for compensation purposes, to that associated person. The record shall include the amount of compensation if monetary and a description of the compensation if non-monetary. In lieu of making this record, a member, broker or dealer may elect to produce the required information promptly upon request of a representative of a securities regulatory authority.

(ii) Of all agreements pertaining to the relationship between each associated person and the member, broker or dealer including a summary of each associated person's compensation arrangement or plan with the member, broker or dealer,

including commission and concession schedules and, to the extent that compensation is based on factors other than remuneration per trade, the method by which the compensation is determined.

(20) A record, which need not be separate from the advertisements, sales literature, or communications, documenting that the member, broker or dealer has complied with, or adopted policies and procedures reasonably designed to establish compliance with, applicable federal requirements and rules of a self-regulatory organization of which the member, broker or dealer is a member which require that advertisements, sales literature, or any other communications with the public by a member, broker or dealer or its associated persons be approved by a principal.

(21) A record for each office listing, by name or title, each person at that office who, without delay, can explain the types of records the firm maintains at that office and the information contained in those records.

(22) A record listing each principal of a member, broker or dealer responsible for establishing policies and procedures that are reasonably designed to ensure compliance with any applicable federal requirements or rules of a self-regulatory organization of which the member, broker or dealer is a member that require acceptance or approval of a record by a principal.

* * * * *

(f) Every member, broker or dealer shall make and keep current, as to each office, the books and records described in paragraphs (a)(1), (a)(6), (a)(7), (a)(12), (a)(17), (a)(18)(i), (a)(19), (a)(20), (a)(21), and (a)(22) of this section.

(g) When used in this section:

(1) The term *office* means any location where one or more associated persons regularly conduct the business of handling funds or securities or effecting any transactions in, or inducing or attempting to induce the purchase or sale of, any security.

(2) The term *principal* means any individual registered with a registered national securities association as a principal or branch manager of a member, broker or dealer or any other person who has been delegated supervisory responsibility over associated persons by the member, broker or dealer.

(3) The term *securities regulatory authority* means the Commission, any self-regulatory organization, or any securities commission (or any agency or office performing like functions) of the States.

(4) The term *associated person* means an "associated person of a member" or "associated person of a broker or dealer" as defined in sections 3(a)(21) and 3(a)(18) of the Act (15 U.S.C. 78c(a)(21) and (a)(18)) respectively, but shall not include persons whose functions are solely clerical or ministerial.

§ 240.17a-3 [Amended]

4. Section 240.17a-3 is amended by:

- a. Removing from the introductory text of paragraph (a) and paragraph (a)(5) the word "his" and in its place adding "it";
 - b. Removing from paragraph (a)(11)(ii) the word "he" and in its place adding "it";
 - c. Removing from redesignated paragraphs (a)(12)(i)(A) and (a)(12)(i)(B) the word "His" and in its place adding "The associated person's";
 - d. Removing from redesignated paragraphs (a)(12)(i)(A), (a)(12)(i)(C), and (a)(12)(i)(H) the word "his" and in its place adding "the associated person's";
 - e. Removing from redesignated paragraphs (a)(12)(i)(D) and (a)(12)(i)(F) the word "him" and in its place adding "the associated person";
 - f. Removing from redesignated paragraphs (a)(12)(i)(D), (a)(12)(i)(E), (a)(12)(i)(F) and (a)(12)(i)(H) the word "he" and in its place adding "the associated person" and
 - g. Removing from redesignated paragraph (a)(12)(i)(H) the phrase "or the American Stock Exchange, the Boston Stock Exchange, the Midwest Stock Exchange, the New York Stock Exchange, the Pacific Coast Stock Exchange, or the Philadelphia-Baltimore Stock Exchange" and in its place adding "the American Stock Exchange LLC, the Boston Stock Exchange, Inc., the Chicago Stock Exchange, Inc., the New York Stock Exchange, Inc., the Pacific Exchange, Inc., the Philadelphia Stock Exchange, Inc., the Chicago Board Options Exchange, Inc., the Cincinnati Stock Exchange, Inc. or the International Securities Exchange".
5. Section 240.17a-4 is amended by:
- a. Revising paragraph (a);
 - b. Revising the introductory text of paragraph (b);
 - c. Revising paragraphs (b)(1), (b)(4), (c) and (d);
 - d. Revising the introductory text of paragraph (e);
 - e. Adding paragraphs (e)(5), (e)(6), (e)(7), (e)(8);
 - f. Revising paragraph (j); and
 - g. Adding paragraphs (k) and (l).
- The revisions and additions read as follows:

§ 240.17a-4 Records to be preserved by certain exchange members, brokers and dealers.

(a) Every member, broker and dealer subject to § 240.17a-3 shall preserve for a period of not less than six years, the first two years in an easily accessible place, all records required to be made pursuant to paragraphs § 240.17a-3(a)(1), (a)(2), (a)(3), (a)(5), (a)(21), (a)(22), and analogous records created pursuant to paragraph § 240.17a-3(f).

(b) Every member, broker and dealer subject to § 240.17a-3 shall preserve for a period of not less than three years, the first two years in an easily accessible place:

(1) All records required to be made pursuant to § 240.17a-3(a)(4), (a)(6), (a)(7), (a)(8), (a)(9), (a)(10), (a)(16), (a)(18), (a)(19), (a)(20), and analogous records created pursuant to § 240.17a-3(f).

* * * * *

(4) Originals of all communications received and copies of all communications sent (and any approvals thereof) by the member, broker or dealer (including inter-office memoranda and communications) relating to its business as such, including all communications which are subject to rules of a self-regulatory organization of which the member, broker or dealer is a member regarding communications with the public. As used in this paragraph (b)(4), the term communications includes sales scripts.

* * * * *

(c) Every member, broker and dealer subject to § 240.17a-3 shall preserve for a period of not less than six years after the closing of any customer's account any account cards or records which relate to the terms and conditions with respect to the opening and maintenance of the account.

(d) Every member, broker and dealer subject to § 240.17a-3 shall preserve during the life of the enterprise and of any successor enterprise all partnership articles or, in the case of a corporation, all articles of incorporation or charter, minute books and stock certificate books (or, in the case of any other form of legal entity, all records such as articles of organization or formation, and minute books used for a purpose similar to those records required for corporations or partnerships), all Forms BD (§ 249.501 of this chapter), all Forms BDW (§ 249.501a of this chapter), all amendments to these forms, all licenses or other documentation showing the registration of the member, broker or dealer with any securities regulatory authority.

(e) Every member, broker and dealer subject to § 240.17a-3 shall maintain

and preserve in an easily accessible place:

* * * * *

(5) All account record information required pursuant to § 240.17a-3(a)(17) until at least six years after the earlier of the date the account was closed or the date on which the information was replaced or updated.

(6) Each report which a securities regulatory authority has requested or required the member, broker or dealer to make and furnish to it pursuant to an order or settlement, and each securities regulatory authority examination report until three years after the date of the report.

(7) Each compliance, supervisory, and procedures manual, including any updates, modifications, and revisions to the manual, describing the policies and practices of the member, broker or dealer with respect to compliance with applicable laws and rules, and supervision of the activities of each natural person associated with the member, broker or dealer until three years after the termination of the use of the manual.

(8) All reports produced to review for unusual activity in customer accounts until eighteen months after the date the report was generated. In lieu of maintaining the reports, a member, broker or dealer may produce promptly the reports upon request by a representative of a securities regulatory authority. If a report was generated in a computer system that has been changed in the most recent eighteen month period in a manner such that the report cannot be reproduced using historical data in the same format as it was originally generated, the report may be produced by using the historical data in the current system, but must be accompanied by a record explaining each system change which affected the reports. If a report is generated in a computer system that has been changed in the most recent eighteen month period in a manner such that the report cannot be reproduced in any format using historical data, the member, broker or dealer shall promptly produce upon request a record of the parameters that were used to generate the report at the time specified by a representative of a securities regulatory authority, including a record of the frequency with which the reports were generated.

* * * * *

(j) Every member, broker and dealer subject to this section shall furnish promptly to a representative of the Commission legible, true, complete, and current copies of those records of the member, broker or dealer that are

required to be preserved under this section, or any other records of the member, broker or dealer subject to examination under section 17(b) of the Act (15 U.S.C. 78q(b)) that are requested by the representative of the Commission.

(k) Records for the most recent two year period required to be made pursuant to § 240.17a-3(f) and paragraphs (b)(4) and (e)(7) of this section which relate to an office shall be maintained at the office to which they relate. If an office is a private residence where only one associated person (or multiple associated persons who reside at that location and are members of the same immediate family) regularly conducts business, and it is not held out to the public as an office nor are funds or securities of any customer of the member, broker or dealer handled there, the member, broker or dealer need not maintain records at that office, but the records must be maintained at another location within the same State as the member, broker or dealer may select. Rather than maintain the records at each office, the member, broker or dealer may choose to produce the records promptly at the request of a representative of a securities regulatory authority at the office to which they relate or at another location agreed to by the representative.

(l) When used in this section:

(1) The term *office* shall have the meaning set forth in § 240.17a-3(g)(1).

(2) The term *principal* shall have the meaning set forth in § 240.17a-3(g)(2).

(3) The term *securities regulatory authority* shall have the meaning set forth in § 240.17a-3(g)(3).

(4) The term *associated person* shall have the meaning set forth in § 240.17a-3(g)(4).

§ 240.17a-4 [Amended]

6. Section 240.17a-4 is amended by:

a. Removing from paragraph (b)(7) the word “his” and in its place adding “its”; and

b. Removing from paragraph (e)(1) the phrase “the “associated person” has terminated his employment and any other connection with the member, broker or dealer.” and in its place adding “the associated person’s employment and any other connection with the member, broker or dealer has terminated.”.

c. Removing from paragraph (f)(3)(ii) the phrase “the Commission or its representatives” and in its place adding “the staffs of the Commission, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer”.

d. Removing from paragraph (f)(3)(vii):

i. The phrase “the U.S. Securities and Exchange Commission (“Commission”), its designees or representatives,” and in its place adding “the U.S. Securities and Exchange Commission (“Commission”), its designees or representatives, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer,”;

ii. The phrase “the Commission’s or designee’s staff” and in its place adding “the staffs of the Commission, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer”; and

iii. From each place it appears, the phrase “the Commission’s staff or its designee” and in its place adding “the staffs of the Commission, any self-regulatory organization of which it is a member, or any State securities regulator having jurisdiction over the member, broker or dealer”.

PART 242—REGULATIONS M and ATS

7. The authority citation for part 242 continues to read as follows:

Authority: 15 U.S.C. 77g, 77q(a), 77s(a), 78b, 78c, 78i(a), 78j, 78k-1(c), 78l, 78m, 78mm, 78n, 78o(b), 78o(c), 78o(g), 78q(a), 78q(b), 78q(h), 78w(a), 78dd-1, 80a-23, 80a-29, and 80a-37.

8. In § 242.303, paragraph (d) is amended by removing the phrase “representatives or designees of the Securities and Exchange Commission, and to promptly furnish to the Commission or its designee” and in its place adding “the staff of the Securities and Exchange Commission, any self-regulatory organization of which the alternative trading system is a member, or any State securities regulator having jurisdiction over the alternative trading system, and to promptly furnish to the Commission, self-regulatory organization of which the alternative trading system is a member, or any State securities regulator having jurisdiction over the alternative trading system.”

Dated: October 26, 2001.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 01-27439 Filed 11-1-01; 8:45 am]

BILLING CODE 8010-01-P

INFORMATIONAL

Conduct Of Business Abroad

NASD Provides Interpretive Guidance On The Conduct Of Business Abroad

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 and Compliance
- Operations
- Registration
- Senior Management

KEY TOPICS

- Business Abroad

Executive Summary

The National Association of Securities Dealers, Inc. (NASD®) is issuing this *Notice to Members* as part of its continuing effort to provide members with guidance on complying with rules that govern their business in foreign locations. The NASD also reminds members and persons associated with members considering doing business in foreign jurisdictions of their obligations to comply with the applicable U.S. and foreign laws.¹

Questions concerning this *Notice* should be directed to: Grace Yeh, Assistant General Counsel, Office of General Counsel, NASD Regulation, Inc. (NASD Regulation), at (202) 728-6939, or Kyra Armstrong, Senior Attorney, Department of Member Regulation, at (202) 728-6962.

Discussion

The NASD has rules that apply to U.S.-based member firms conducting business in foreign locations, to member firms based in other countries that do business in the United States, and to foreign representatives who wish to engage in securities business in the U.S. Collectively, these rules and programs make it easier for NASD members to conduct business abroad. These rules include the following:

- The NASD permits firms to register certain persons working in foreign offices as Foreign Associates without requiring qualification examinations (*NASD Rule 1100*).
- The NASD authorizes member firms to maintain registrations for persons who are engaged

in the investment banking or securities business of a foreign securities affiliate or subsidiary (*NASD Rules 1021(a) and 1031(a)*).

- The NASD allows, in limited circumstances, member firms and persons associated with a member to pay transaction-related compensation to non-registered foreign persons, or foreign finders (*NASD Rule 1060(b)*).
- The NASD permits persons registered in certain foreign countries to work in the U.S. as general securities representatives after taking an abbreviated examination (*NASD Rule 1032*).

The NASD also offers examinations and continuing education programs abroad.

In addition, the NASD has issued previous *Notices to Members* that provide guidance concerning the conduct of business abroad. For example, in *NASD Notice to Members 98-91*, the NASD alerted members to their obligations with respect to cold calling and advertising to persons in the United Kingdom. In *NASD Notice to Members 00-02*, the NASD reminded members and persons associated with members of their obligations to comply with applicable U.S. laws and foreign laws when soliciting business in any foreign jurisdiction.

In order to further facilitate member firms' awareness and understanding of their responsibilities, the NASD has prepared answers to the following frequently asked questions concerning the conduct of business abroad.

Questions And Answers

I. Foreign Associates

Q 1. Who may be designated a Foreign Associate?

- A. Under NASD Rule 1100, a Foreign Associate is an individual who is not a citizen, national, or resident of the United States or any of its territories or possessions. A Foreign Associate cannot engage in securities activities with or for any resident, citizen, or national of the United States. This person may engage in securities activities for the member firm outside the jurisdiction of the United States only.
-

Q 2. What is the scope of permissible business activity for a Foreign Associate?

- A. A Foreign Associate must be registered with the NASD and will be deemed an associated person or employee of the member. A Foreign Associate may act in any registered capacity on behalf of the member, consistent with their designation as a Foreign Associate. This can include acting as a general securities representative or trader. See *Notice to Members 95-37*. The limited supervisory functions that can be properly delegated to general securities representatives also may be assigned to Foreign Associates. However, the NASD rules do not permit Foreign Associates to perform functions that require principal registration, e.g., serving as the office supervisor for an

Office of Supervisory Jurisdiction. As always, ultimate supervisory responsibility for every registered and unregistered branch office must be assigned to one or more appropriately registered principals.

Q 3. Does a Foreign Associate have to take any U.S. qualifications examinations?

- A. No. Under NASD Rule 1100, Foreign Associates are exempt from the requirement to pass a qualification examination.
-

Q 4. Does a Foreign Associate have to register?

- A. Yes. Under NASD Rule 1100, all persons associated with a member who are designated as Foreign Associates are required to be registered with the NASD.
-

Q 5. How does a firm register a Foreign Associate?

- A. Before a member can classify a person as a Foreign Associate, it must:
- file a form designated "Application for Classification as a Foreign Associate" (Form U-4 is currently used) with the NASD and certify that the person meets the criteria for Foreign Associate;
 - attest that the person is not disqualified from registration;
 - certify that service of process for any proceeding by the NASD for such person may be sent to an address designated by the member; and

- submit a Form U-4 through the Central Registration Depository (CRD) system to request registration as a Foreign Associate on behalf of an individual.

The member must notify the NASD immediately if the Foreign Associate is terminated by filing a Form U-5.

II. Foreign Finder

Q 6. What is a foreign finder, and in what capacity may a foreign finder act on behalf of a member firm?

- A. Foreign finders are non-registered foreign persons who refer non-U.S. customers to a member firm. Because foreign finders are not considered associated persons of a member, the sole involvement of a foreign finder in the business of a member firm is the initial referral of non-U.S. customers to the firm. See *Notice to Members 95-37*.
-

Q 7. May a member pay finders' fees to foreign finders?

- A. Yes. NASD Rule 1060(b) provides that member firms and persons associated with a member may pay transaction-related compensation to foreign finders, based upon the business of customers such persons direct to member firms ("foreign finder exemption"). See *Notice to Members 95-37*.

NASD Rule 1060(b) states that for the foreign finder exemption to apply, the member firm must assure itself that the foreign finder receiving

the compensation neither is required to register in the U.S. as a broker/dealer nor is subject to a disqualification as defined in Article III, Section 4 of the NASD's By-Laws and must further assure itself that the compensation arrangement does not violate applicable foreign law.

The following conditions must also be met:

- the finder must be a foreign national (not a U.S. citizen) or a foreign entity domiciled abroad;
- the customers are foreign nationals (not U.S. citizens) or foreign entities domiciled abroad transacting business in foreign or U.S. securities;
- the customers must receive a descriptive document, similar to that required by Rule 206(4)-3(b) of the Investment Advisers Act of 1940, that discloses what compensation is being paid to finders;
- the customers must provide written acknowledgement to the member firm of the existence of the compensation arrangement and it must be retained and made available for inspection by the NASD;
- records reflecting payments to finders must be maintained on the member firm's books and the actual agreements between the member firm and persons compensated must be available for inspection by the NASD; and
- the confirmation of each transaction must indicate that a referral or finders' fee is being paid pursuant to an agreement.

III. Maintenance Of Registrations While Working Abroad

Q 8. Can persons working for U.S. broker/dealers maintain their registrations while working abroad?

- A. Yes. *NASD Rules 1021(a) and 1031(a)* permit members to maintain individual registrations as a principal or representatives, as applicable, for persons who are engaged in the investment banking or securities business of a foreign securities affiliate or subsidiary of the member.
-

IV. Foreign Members

Q 9. What is a foreign member?

- A. NASD Rule 1090 defines a foreign member as a member firm that does not maintain an office in the U.S. responsible for preparing and maintaining financial and other reports required to be filed with the Securities and Exchange Commission (SEC) and the NASD.
-

Q 10. What special obligations must a foreign member perform?

- A. Under NASD Rule 1090, a foreign member must:
- prepare all reports required to be filed with the SEC and the NASD and maintain a general ledger chart of account and any description thereof, in English and U.S. dollars;
 - reimburse the NASD for any expenses incurred in connection with the examinations of the member to the extent such expenses exceed the cost of examining

a member located within the continental U.S. in the geographic location most distant from the District Office of appropriate jurisdiction;

- ensure the availability of an individual fluent in English and knowledgeable in securities and financial matters to assist representatives of the NASD during examinations; and
- utilize, either directly or indirectly, the services of a broker/dealer registered with the SEC, a bank or clearing agency registered with the SEC located in the U.S. in clearing all transactions involving members of the NASD, except where both parties to a transaction agree otherwise.

V. Supervision And Inspection Obligations Of Member Firms With Foreign Offices

Q 11. What level of supervision is required in foreign offices?

- A. Foreign offices of member firms must comply with the same rules of supervision as U.S. locations pursuant to NASD Rule 3010. *See Notice to Members 99-45.*

Member firms must supervise all of their associated persons, regardless of location, compensation or employment arrangement, or registration status, in accordance with the NASD By-Laws and rules. *See Notice to Members 98-38.* Both the SEC and NASD have emphasized that small, dispersed offices need close attention and supervision. *See In re Royal Alliance Associates Inc., Release No. 34-38174 (Jan. 15, 1997); Notice to Members 98-38.*

Q 12. What is a branch office?

A. A branch office generally is defined in NASD Rule 3010(g)(2) as any location identified by any means to the public or customers as a location where an investment banking or securities business is conducted, subject to certain exclusions set forth in NASD Rule 3010(g)(2).

Pursuant to Article IV, Section 8 of the NASD By-Laws, the NASD must be advised of the opening or closing of any branch office within 30 days of the opening or closing. Such notice must be filed with the NASD on Schedule E to Form BD. See *Notice to Members 88-51*.

Q 13. What is an Office of Supervisory Jurisdiction (OSJ)?

A. An OSJ is defined in *NASD Rule 3010(g)(1)* as any office of a member at which any of the following activities take place:

- order execution and/or market making;
- structuring of public offerings or private placements;
- maintaining custody of customers' funds and/or securities;
- final acceptance (or approval) of new accounts on behalf of a member;
- review and endorsement of customer orders;
- final approval of advertising or sales literature for use by persons associated with the member; or

- responsibility for supervising the activities of persons associated with the member at one or more other branch offices of the member.

Under NASD Rule 3010(a)(4), every OSJ must have a registered principal located at the office. Foreign associates are not allowed to act in a registered principal capacity.

Q 14. Must foreign offices be registered?

A. Yes. All branch offices and OSJs, regardless of their location, must be registered with the NASD. Any location at which a member is conducting a securities business that does not fall within the definition of an OSJ or a branch office can be referred to as an "unregistered office." While "unregistered offices" do not have to be registered with the NASD, member firms should keep a list of and supervise such offices.²

Q 15. Must firms inspect foreign offices?

A. Yes. Firms must inspect all offices regardless of their location. Unregistered offices must have regularly scheduled inspections. Branch offices must have cyclical inspections and OSJs must have annual inspections. See *In re Royal Alliance Associates Inc., Release No. 34-38174 (Jan. 15, 1997)* (where the SEC stated that it harbored grave doubts that a practice of conducting a pre-announced compliance examination only once a year would necessarily discharge the supervisory

obligations of any firm that incorporates a structure in which smaller offices are operated by only one or two representatives); *Notice to Members 99-45: NASD Rule 3010*.

Q 16. Are firms required to supervise independent contractors?

A. Yes. Independent contractors performing investment banking or securities services for a member firm are considered associated persons. See *Notice to Members 98-38*. Irrespective of an individual's location or compensation arrangements, all associated persons must be supervised by the firm with which they are registered. See *Notice to Members 86-65*. The fact that an associated person conducts business at a separate location or is compensated as an independent contractor does not alter the obligations of the individual and the firm to comply fully with all applicable regulatory requirements. See *Notice to Members 86-65*.

VI. NASD Inspections**Q 17. Are foreign offices subject to inspections by the NASD?**

A. Yes. Member firms with offices located outside the United States are assigned to an NASD District Office for purposes of examination, elections, and other functions. See *Notice to Members 88-51*. District Office staff may conduct onsite cause and cycle examinations at foreign locations of a member firm.

VII. Compliance With Laws

Q 18. What laws must members comply with when soliciting business in a foreign jurisdiction?

A. Members and persons associated with members must comply with applicable U.S. and foreign laws when soliciting business in a foreign jurisdiction. See *Notices to Members 00-02* and *98-91*. Members should carefully review all foreign laws as foreign jurisdictions may have different laws and policies than the U.S. and the NASD.

Q 19. What activities may be considered a “solicitation”?

A. The term “solicitation” generally has been viewed as an expansive, fact-specific, and variable concept. Depending on the laws of the applicable foreign jurisdiction, a wide variety of firm activities may constitute solicitation of business for purposes of foreign local law. For example, solicitation of business may be deemed to occur through newspaper ads, Internet postings, e-mails, telephone calls, or facsimile transmissions. See *Notice to Members 00-02*.

Q 20. What are the consequences of breaching applicable foreign laws?

A. The consequences of breaching applicable foreign laws can be far reaching. Among other things, member firms in violation of particular

foreign laws may be committing a criminal offense and be liable to prosecution. See *Notices to Members 00-02* and *98-91*.

VIII. Qualification Requirements

Q 21. What are the qualification requirements for persons registered in a foreign jurisdiction who want to work in the United States as general securities representatives?

A. In general, the NASD requires persons registered in foreign jurisdictions to take the Series 7 examination prior to working in the U.S. as a general securities representatives. However, the NASD permits persons registered in Canada and the United Kingdom to work in the U.S. as general securities representatives after taking abbreviated versions of the Series 7 examination. Because the NASD relies, in part, on foreign regulators to ensure that representatives have attained certain minimal levels of qualification, these abbreviated examinations are meant to supplement tests that foreign representatives have already taken in their original jurisdiction.

The examination for United Kingdom representatives (Series 17) consists of 90 questions and is 120 minutes long. The examination for Canadian representatives (Series 37) consists of 90 questions and is 150 minutes long, or alternatively, if the

Canadian representative also has the Canadian options and futures program, such representative may choose to take the Series 38 examination, which contains 45 questions long and is 75 minutes long.

Q 22. Do foreign regulators offer abbreviated qualification examinations for U.S. representatives?

A. Yes. The United Kingdom and Canada currently offer abbreviated qualification examinations for U.S.-qualified registered representatives.

Q 23. Have any foreign regulators waived their examination requirements?

A. The NASD understands that some foreign regulators may waive their examination requirements for persons with significant experience. Member firms should contact foreign regulators with regard to any examination waiver programs and the application of such programs.

Q 24. Can the NASD waive examination requirements for foreign representatives?

A. *NASD Rule 1070(e)* provides that the NASD may waive the applicable qualification examination, on a case-by-case basis, in exceptional cases and where good cause is shown and accept other standards as evidence of an applicant’s qualifications for registration.

Q 25. Does the NASD offer examinations abroad?

- A. Yes. The NASD currently offers automated examinations in (1) Sydney, Australia, (2) Hong Kong, (3) Paris, France, (4) Frankfurt, Germany, (5) Tokyo, Japan, (6) Singapore, (7) Seoul, South Korea, and (8) London, England. To schedule an appointment at a foreign examination location, a member firm must submit a foreign appointment request form one month before the desired test date. Candidates may make arrangements for a paper examination in other locations. See www.nasdr.com.

All candidates taking NASD examinations overseas may request an extra hour and the use of an English/native language dictionary. However, these requests are not automatically granted and must be approved by the staff. Upon arrival at the test center, candidates must provide an originally executed letter from the firm verifying that the candidate speaks English as a second language.

IX. Continuing Education**Q 26. Are foreign representatives required to comply with continuing education requirements?**

- A. In general, yes. Under *NASD Rule 1120*, foreign representatives and domestic representatives are subject to the same continuing education requirements.

The continuing education program is comprised of a Regulatory Element and a Firm Element. The Regulatory

Element is computer-based training in which participants work through real-life regulatory and compliance problems. The Firm Element is internal training administered by firms and may include written material, computer-based training, videos, audio tapes, classroom training, direct broadcasts, or other presentations.

Q 27. How can a registered person residing outside North America satisfy the regulatory element requirement?

- A. Registered persons outside North America are subject to the requirements of the Regulatory Element. A registered person subject to the Regulatory Element may satisfy his or her requirement at any Sylvan/Prometric Center in the United States and Canada, or one of the VUE Centers in Europe and the Pacific Rim. Registered persons outside the United States and Canada who are not living within 350 miles of a VUE Center may have their Regulatory Element requirement deferred until facilities are available. To obtain a deferral, a registered principal or supervisor of the firm must make the request in writing to the Continuing Education Department of NASD Regulation. The letter should contain the person's name, Social Security or CRD number, and the city and country in which the person resides. See *Notices to Members 01-50 and 01-73* for more information.
-

Q 28. Are Foreign Associates required to comply with continuing education requirements?

- A. No. Foreign Associates are exempt from the Regulatory Element and the Firm Element of the continuing education requirement.
-

X. Miscellaneous**Q 29. In connection with the establishment of a foreign office by a member firm, foreign regulators may ask for confirmation that the member firm is in good standing. Can the NASD opine on the good standing of a member?**

- A. As a matter of policy, the NASD does not opine that a member is in "good standing" because that term may have different meanings in different jurisdictions. The NASD can confirm that a member is registered with the NASD as a broker/dealer and as such has initially satisfied and continues to meet certain mandatory qualification standards, and is subject to NASD rules and regulations requiring it to operate in a just and equitable manner.
-

Q 30. How can foreign regulators be contacted?

- A. The International Organization of Securities Commissions (IOSCO), an organization of securities regulators, maintains a listing of regulators around the world. IOSCO can be contacted by e-mail at mail@oicv.iosco.org. IOSCO maintains a Web Site at www.iosco.org.

Endnotes

- 1 It is not the intent of this *Notice* to describe any specific foreign laws applicable to any foreign jurisdiction. Rather, the NASD urges members considering the conduct of business in foreign jurisdictions to carefully review and comply with all applicable U.S. and foreign laws.
- 2 Members should review the rules and regulations in all applicable jurisdictions to determine whether offices may need to be registered with other regulators, including state and foreign regulators.

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NASD[®]

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INFORMATIONAL

**Trade Date—
Settlement Date**

Trade Date—Settlement
Date For 2002

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.

- Internal Audit
- Legal & Compliance
- Municipal/Government Securities
- Operations
- Trading & Market Making

KEY TOPICS

- Holiday Trade Date—
Settlement Date Schedule

**Martin Luther King, Jr., Day: Trade Date—Settlement Date
Schedule**

The Nasdaq Stock Market® and the securities exchanges will be closed on Monday, January 21, 2002, in observance of Martin Luther King, Jr., Day. “Regular way” transactions made on the business days noted below will be subject to the following schedule:

Trade Date	Settlement Date	Reg. T Date*
Jan. 15	Jan. 18	Jan. 23
16	22	24
17	23	25
18	24	28
21	Markets Closed	—
22	25	29

Presidents Day: Trade Date—Settlement Date Schedule

The Nasdaq Stock Market and the securities exchanges will be closed on Monday, February 18, 2002, in observance of Presidents Day. “Regular way” transactions made on the business days noted below will be subject to the following schedule:

Trade Date	Settlement Date	Reg. T Date*
Feb. 12	Feb. 15	Feb. 20
13	19	21
14	20	22
15	21	25
18	Markets Closed	—
19	22	26

Good Friday: Trade Date—Settlement Date Schedule

The Nasdaq Stock Market and the securities exchanges will be closed on Good Friday, March 29, 2002. "Regular way" transactions made on the business days noted below will be subject to the following schedule:

Trade Date	Settlement Date	Reg. T Date*
March 25	March 28	April 2
26	April 1	3
27	2	4
28	3	5
29	Markets Closed	—
April 1	4	8

Memorial Day: Trade Date—Settlement Date Schedule

The Nasdaq Stock Market and the securities exchanges will be closed on Monday, May 27, 2002, in observance of Memorial Day. "Regular way" transactions made on the business days noted below will be subject to the following schedule:

Trade Date	Settlement Date	Reg. T Date*
May 21	May 24	May 29
22	28	30
23	29	31
24	30	June 3
27	Markets Closed	—
28	31	4

Independence Day: Trade Date—Settlement Date Schedule

The Nasdaq Stock Market and the securities exchanges will be closed on Thursday, July 4, 2002, in observance of Independence Day. "Regular way" transactions made on the business days noted below will be subject to the following schedule:

Trade Date	Settlement Date	Reg. T Date*
June 28	July 3	July 8
July 1	5	9
2	8	10
3	9	11
4	Markets Closed	—
5	10	12

Labor Day: Trade Date—Settlement Date Schedule

The Nasdaq Stock Market and the securities exchanges will be closed on Monday, September 2, 2002, in observance of Labor Day. "Regular way" transactions made on the business days noted below will be subject to the following schedule:

Trade Date	Settlement Date	Reg. T Date*
Aug. 27	Aug. 30	Sept. 4
28	Sept. 3	5
29	4	6
30	5	9
Sept. 2	Markets Closed	—
3	6	10

Columbus Day: Trade Date—Settlement Date Schedule

The schedule of trade dates-settlement dates below reflects the observance by the financial community of Columbus Day, Monday, October 14, 2002. On this day, The Nasdaq Stock Market and the securities exchanges will be open for trading. However, it will not be a settlement date because many of the nation's banking institutions will be closed.

Trade Date	Settlement Date	Reg. T Date*
Oct. 8	Oct. 11	Oct. 15
9	15	16
10	16	17
11	17	18
14	17	21
15	18	22

Note: October 14, 2002, is considered a business day for receiving customers' payments under Regulation T of the Federal Reserve Board.

Transactions made on Monday, October 14, will be combined with transactions made on the previous business day, October 11, for settlement on October 17. Securities will not be quoted ex-dividend, and settlements, marks to the market, reclamations, and buy-ins and sell-outs, as provided in the Uniform Practice Code, will not be made and/or exercised on October 14.

Veterans' Day And Thanksgiving Day: Trade Date—Settlement Date Schedule

The schedule of trade dates-settlement dates below reflects the observance of the financial community of Veterans' Day, Monday, November 11, 2002, and Thanksgiving Day, Thursday, November 28, 2002. On Monday, November 11, The Nasdaq Stock Market and the securities exchanges will be open for trading. However, it will not be a settlement date because many of the nation's banking institutions will be closed in observance of Veterans Day. All securities markets will be closed on Thursday, November 28, 2002, in observance of Thanksgiving Day.

Trade Date	Settlement Date	Reg. T Date*
Nov. 5	Nov. 8	Nov. 12
6	12	13
7	13	14
8	14	15
11	14	18
12	15	19
22	27	Dec. 2
25	29	3
26	Dec. 2	4
27	3	5
28	Markets Closed	—
29	4	6

Note: November 11, 2002, is considered a business day for receiving customers' payments under Regulation T of the Federal Reserve Board.

Transactions made on November 11 will be combined with transactions made on the previous business day, November 8, for settlement on November 14. Securities will not be quoted ex-dividend, and settlements, marks to the market, reclamations, and buy-ins and sell-outs, as provided in the Uniform Practice Code, will not be made and/or exercised on November 11.

Christmas Day And New Years Day: Trade Date—Settlement Date Schedule

The Nasdaq Stock Market and the securities exchanges will be closed on Wednesday, December 25, 2002, in observance of Christmas Day, and Wednesday, January 1, 2003, in observance of New Years Day. "Regular way" transactions made on the business days noted below will be subject to the following schedule:

Trade Date	Settlement Date	Reg. T Date*
Dec. 19	Dec. 24	Dec. 27
20	26	30
23	27	31
24	30	Jan. 2, 2003
25	Markets Closed	—
26	31	3
27	Jan. 2, 2003	6
30	3	7
31	6	8
Jan. 1, 2003	Markets Closed	—
2	7	9

Brokers, dealers, and municipal securities dealers should use the foregoing settlement dates for purposes of clearing and settling transactions pursuant to the National Association of Securities Dealers, Inc. (NASD®) Uniform Practice Code, the Municipal Securities Rulemaking Board Rule G-12 on Uniform Practice, and the General and Floor Rules of the Rules of the Board of Governors of the American Stock Exchange®.

Questions regarding the application of those settlement dates to a particular situation may be directed to the NASD Uniform Practice Department at (203) 375-9609.

* Pursuant to Sections 220.8(b)(1) and (4) of Regulation T of the Federal Reserve Board, a broker/dealer must promptly cancel or otherwise liquidate a customer purchase transaction in a cash account if full payment is not received within five business days of the date of purchase or, pursuant to Section 220.8(d)(1), make application to extend the time period specified. The date by which members must take such action is shown in the column titled "Reg. T Date."

INFORMATIONAL

FIPS Changes

Fixed Income Pricing SystemSM Additions, Changes, And Deletions As Of **October 21, 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.

- Corporate Finance
- Legal & Compliance
- Municipal/Government Securities
- Operations
- Senior Management
- Trading & Market Making

KEY TOPICS

- FIPS

As of October 21, 2001, the following bonds were added to the Fixed Income Pricing System (FIPSSM).

Symbol	Name	Coupon	Maturity
ADLA.GS	Adelphia Communications Corp.	10.250	11/01/06
ADTR.GA	Advanstar Inc.	15.000	10/15/11
ARG.GA	Airgas Inc.	9.125	10/01/11
ALWA.GB	Alamosa Delaware Inc.	13.625	08/15/11
AN.GA	AutoNation Inc.	9.000	08/01/08
CWSR.GA	Choctaw Resort Development Enterprises	9.250	04/01/09
DNTC.GA	Del Monte Corp	9.250	05/15/11
DRNC.GA	Dresser Inc.	9.375	04/15/11
ENE.GA	Enron Corp.	8.250	09/15/12
ENE.GB	Enron Corp.	6.750	07/01/05
FMRE.GA	Fresenius Med Cap Tr IV	7.875	06/15/11
GLCS.GA	Global Crossing Hldg Ltd.	8.700	08/01/07
HAZ.GB	Hayes Lemmerz Int'l Inc.	11.875	06/15/06
HRGM.GA	Herbst Gaming Inc.	10.750	08/15/08
HWSV.GB	Hollywood Casino Shreveport	13.000	08/01/06
IM.GA	Ingram Micro Inc.	9.875	08/15/08
KM.GK	K Mart Corp.	9.875	06/15/08
MATR.GA	Matria Healthcare Inc.	11.000	05/01/08
MECU.GC	Mediacom LLC/Cap Corp	9.500	01/15/13
MIKE.GA	Michaels Stores Inc.	9.250	07/01/09
MSNH.GA	Mission Energy Holding Co.	13.500	07/15/08
MHTG.GC	Mohegan Tribal Gaming Authority	8.375	07/01/11
NXTO.GA	NextMedia Operating Inc.	10.750	07/01/11
ODP.GA	Office Depot Inc.	10.000	07/15/08
PRM.GB	Primedia Inc.	8.875	05/15/11
ROIA.GB	Radio One Inc.	8.875	07/01/11
REMG.GB	Remington Product Co. LLC	11.000	05/15/06
LVB.GA	Steinway Musical Instrs. Inc.	8.750	04/15/11
STEI.GC	Stewart Enterprises Inc.	10.750	07/01/08
STLH.GA	Sun International Hotels Ltd.	8.875	08/15/11

NASD Notice to Members 01-83

As of October 21, 2001, the following bonds were deleted from the Fixed Income Pricing System.

Symbol	Name	Coupon	Maturity
CE.GC	Calenergy Co Inc	9.500	09/15/06
CE.GE	Calenergy Co Inc	6.960	09/15/03
CE.GF	Calenergy Co Inc	7.230	09/15/05
CE.GG	Calenergy Co Inc	7.520	09/15/08
CE.GH	Calenergy Co Inc	8.480	09/15/28
CYCL.GA	Centennial Cellular Corp.	8.875	11/01/01
CVXP.GG	Cleveland Elec Illum Co.	7.625	08/01/02
CVXP.GH	Cleveland Elec Illum Co.	9.000	07/01/23
CVXP.GI	Cleveland Elec Illum Co.	7.375	06/01/03
CVXP.GK	Cleveland Elec Illum Co.	9.500	05/15/05
GLCS.GA	Global Crossing Hldg. Ltd.	8.700	08/01/07
ITTD.GA	ITT Industry Inc	6.750	11/15/03
JOIN.GC	Join Intercable Inc	9.625	03/15/02
LENF.GC	Lenfest Communications Inc	7.625	02/15/08
ROV.GA	Rayovac Corp.	10.250	11/01/06
THC.GE	Tenet Healthcare Corp.	8.000	01/15/05
THC.GA	Tenet Healthcare Corp.	9.625	09/01/02
THC.GC	Tenet Healthcare Corp.	8.625	12/01/03
THC.GD	Tenet Healthcare Corp.	7.875	01/15/03
THC.GF	Tenet Healthcare Corp.	8.625	01/15/07
THC.GG	Tenet Healthcare Corp.	7.625	06/01/08
THC.GH	Tenet Healthcare Corp.	8.125	12/02/08
THC.GI	Tenet Healthcare Corp.	9.250	09/01/10

As of October 21, 2001 changes were made to the symbols of the following FIPS bonds:

New Symbol	Old Symbol	New Name/Old Name	Coupon	Maturity
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There were no symbol changes for this time period.

All bonds listed above are subject to trade-reporting requirements. Questions pertaining to FIPS trade-reporting rules should be directed to Patricia Casimates, NASDR Market Regulation, at (240) 386-4994.

Any questions regarding the FIPS master file should be directed to Cheryl Glowacki, Nasdaq Market Operations, at (203) 385-6310.

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Disciplinary Actions

Disciplinary Actions Reported For December

NASD Regulation, Inc. (NASD RegulationSM) has taken disciplinary actions against the following firms and individuals for violations of National Association of Securities Dealers, Inc. (NASD[®]) rules; federal securities laws, rules, and regulations; and the rules of the Municipal Securities Rulemaking Board (MSRB). The information relating to matters contained in this *Notice* is current as of the end of November 2001.

Firms Fined, Individuals Sanctioned

CNS Distributors, Inc. (CRD #43607, San Francisco, California) and John Kenneth Durden, Jr. (CRD #43607, Registered Principal, Livermore, California) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and the firm and Durden were fined \$10,000, jointly and severally. In addition, Durden was suspended from association with any NASD member in any capacity for five business days. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Durden, failed to make a securities record or ledger that reflected accurately all long and short positions held by customers and failed to perform a computation of the amount required to be deposited into a Special Reserve Account for the Exclusive Benefit of Customers. The findings also stated that the firm, acting through Durden, failed to establish a Special Reserve Account for the Exclusive Benefit of Customers and to deposit into the account the required amount, and failed to establish written supervisory procedures reasonably designed to ensure compliance with the SEC's Customer Protection Rule 15c3-3.

Durden's suspension began November 19, 2001, and concluded at the close of business November 26, 2001. **(NASD Case #C01010011)**

First Montauk Securities Corp. (CRD #13755, Red Bank, New Jersey) and Herbert Kurinsky (CRD #276776, Registered Principal, Long Branch, New Jersey) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$50,000, jointly and severally, with Kurinsky. The fine includes the disgorgement of \$460 in connection with commissions received by the firm. Kurinsky was suspended from association with any NASD member in any supervisory capacity for 25 days. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Kurinsky, failed to report to the NASD the existence of "conditions" in accordance with NASD Conduct Rule 3070(b), and failed to report and to timely report to the NASD statistical and summary information regarding customer complaints. The findings also stated that the firm, acting through Kurinsky, permitted individuals to engage in the securities business of the firm as over-the-counter traders while not registered in any capacity. The NASD also found that the firm, acting through Kurinsky, permitted a registered representative to execute public customer securities transactions while his registration was inactive due to his failure to comply with the NASD Continuing Education Regulatory Element.

Kurinsky's suspension began November 19, 2001, and will conclude at the close of business December 13, 2001. **(NASD Case #C10010133)**

Leader Investments, Inc. (CRD #42927, Arlington Heights, Illinois) and Richard Joseph Kapsch, Sr. (CRD #876560, Registered Principal, Palatine, Illinois) submitted a Letter of Acceptance, Waiver, and Consent in which they were fined \$27,500, jointly and severally, which includes restitution of \$10,712.91 to a public customer and disgorgement of \$8,868. The firm agreed to amend its written supervisory procedures relating to its mutual fund business to the satisfaction of the NASD. Kapsch was suspended from association with any NASD member in any principal capacity for 30 days. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Kapsch, failed to supervise a registered representative by failing to promptly detect and take adequate steps to curtail the excessive and unsuitable trading in mutual fund shares by the representative in the individual retirement account (IRA) of a public customer. The findings also stated that the firm, acting through Kapsch, failed to establish, maintain, and enforce adequate written supervisory procedures reasonably designed to achieve compliance with applicable securities laws, regulations, and NASD rules relating to the firm's mutual fund business in that, among other things, the firm's procedures failed to include a sufficiently clear identification of the person(s) responsible for ensuring compliance; a statement as to what steps and reviews will be taken by the responsible person to ensure compliance; a statement as to how often the responsible person will conduct such reviews; and a statement as to how such reviews will be evidenced.

Kapsch's suspension will begin December 17, 2001, and will conclude at the close of business January 15, 2002. **(NASD Case #C8A010079)**

Firms and Individuals Fined

Delta Capital Securities Corporation (CRD #36367, Cordova, Tennessee) and Donald Lee Mundie (CRD #1623710, Registered Principal, Eads, Tennessee) submitted a Letter of Acceptance, Waiver, and Consent in which they were censured and fined \$15,000, jointly and severally. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Mundie, participated in a "part or none" contingency offering and issued a reconfirmation offer to subscribers offering to extend retroactively the original expiration date thus rendering false the representation in the original offering circular that the contingency was being made on a "part or none" contingency basis. The findings also stated that the firm, acting through Mundie, broke escrow in the escrow bank account for an offering of preferred shares when the specified minimum number of shares required to close the issue was met, in part, by the sale of shares to a partner of an affiliate of the firm. **(NASD Case #C05010046)**

First Republic Group, LLC (CRD #39781, New York, New York) and Anthony Robert LaGrega (CRD #2558435, Registered Principal, Aberdeen, New Jersey) submitted a Letter of Acceptance, Waiver, and Consent in which they were censured and fined \$23,500, jointly and severally. The firm was also required to disgorge \$31,902, representing a portion of the financial benefits

obtained by the firm. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through LaGrega, failed to file or timely file with the NASD statistical and summary information regarding written customer complaints received by the firm. The findings also stated that the firm, acting through LaGrega, failed to adopt, implement, and maintain adequate written supervisory procedures reasonably designed to address the reporting of customer complaints to the NASD. In addition, the NASD found that the firm, acting through LaGrega, permitted individuals to act in a capacity requiring registration while their registration status with the NASD was inactive due to their failure to complete the Regulatory Element of NASD's Continuing Education Requirement. **(NASD Case #C10010134)**

Founders Equity Securities, Inc. (CRD #41855, Dallas, Texas), and Thomas James Spackman, Jr., (CRD #2797920, Registered Principal, Dallas, Texas) submitted a Letter of Acceptance, Waiver, and Consent in which they were fined \$11,500, jointly and severally. In addition, the firm was fined \$7,500, jointly and severally, with another individual. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Spackman, failed to deposit funds received in a separate bank account as agent or trustee or to promptly transmit funds received to a bank escrow account in connection with certain contingency offerings. The findings stated that the firm, acting through Spackman, deposited the funds into securities accounts under its control at a clearing firm. The NASD also determined that the

firm, acting through Spackman, held customers' funds in connection with these offerings and during this period, the firm failed to perform reserve computations and to make required deposits into a Special Reserve Bank Account for the Exclusive Benefit of Customers of the respective offerings. In addition, the NASD found that the firm rendered false the representation in an offering memorandum that the offering would terminate on or before a specified date when the firm continued the offerings. Furthermore, the findings stated that the firm failed to establish, maintain, and enforce written supervisory procedures reasonably designed to achieve compliance with applicable securities laws, regulations, and NASD rules. **(NASD Case #C06010033)**

Hunter Securities Corporation (CRD #13134, South Orange, New Jersey) and Stephen Alan Steglitz (CRD #500512, Registered Principal, South Orange, New Jersey) submitted a Letter of Acceptance, Waiver, and Consent in which they were censured and fined \$11,820, jointly and severally, which includes the disgorgement of excess profits of \$1,820. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Steglitz, failed to establish and maintain supervisory procedures reasonably designed to achieve compliance with NASD rules. The findings also stated that the firm, acting through Steglitz, failed to implement written training plans and failed to complete a training needs analysis and to develop written training plans concerning the Firm Element of the Continuing Education Program. The NASD also found that the firm, acting through Steglitz, effected sales of various municipal bonds

to public customers on a principal basis at prices that were unfair and reasonable taking into consideration all relevant factors. **(NASD Case #C9B010091)**

M.S. Farrell & Company, Inc. (CRD #24232, New York, New York) and Thomas Anthony Gallo (CRD #1705791, Registered Principal, Shrewsbury, New Jersey) submitted a Letter of Acceptance, Waiver, and Consent in which they were censured and fined \$25,000, jointly and severally. The firm was required to disgorge \$17,963.39 in commissions. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Gallo, continued to conduct a securities business although the firm's membership had been suspended for failure to pay an arbitration award. The findings also stated that the firm, acting through Gallo, failed to report to the NASD statistical and summary information regarding customer complaints received by the firm, an arbitration that the firm settled for an amount exceeding \$25,000, and customer claims that the firm settled for amounts exceeding \$25,000. The NASD found that the firm, acting through Gallo, permitted individuals associated with the firm to act as registered persons while their registration status with the NASD was inactive due to their failure to complete the Regulatory Element of the NASD's Continuing Education Requirement. In addition, the NASD found that the firm, acting through Gallo, failed to establish and maintain written supervisory procedures reasonably designed to ensure compliance with the Regulatory Element of the Continuing Education Requirements. **(NASD Case #C10010129)**

SLS Securities Company (CRD #13332, Jersey City, New Jersey) and John William Bruno, Sr. (CRD #2401612, Registered Principal, Staten Island, New York) submitted a Letter of Acceptance, Waiver, and Consent in which they were censured and fined \$12,000, jointly and severally. The firm was fined an additional \$3,000. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Bruno, permitted individuals to engage in the investment banking or securities business and/or function as representatives with the firm, by trading in a proprietary account of the firm, prior to properly qualifying and/or registering in the appropriate capacities. The NASD also found that the firm, acting through Bruno, permitted a registered representative to perform duties as a registered person, by trading in a proprietary account of the firm, while such representative's registration status with the NASD was inactive due to the representative's failure to timely complete the Regulatory Element of the NASD's Continuing Education Rule. In addition, the NASD determined that the firm, acting through Bruno, failed to enforce written supervisory procedures reasonably designed to achieve compliance with the Regulatory Element of the Continuing Education Requirements and registration. The findings also stated that the firm executed short-sale transactions in certain securities and failed to demonstrate that an affirmative determination was annotated for each of the transactions. **(NASD Case #C9B010086)**

Valley Forge Securities, Inc., (BD #20892, Rosemont, Pennsylvania) and Robert Monroe Montani, Jr. (CRD #1284251, Registered Principal, Phoenixville, Pennsylvania) submitted a Letter of Acceptance, Waiver, and Consent in which they were censured and fined \$12,500, jointly and severally. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Montani, failed to respond timely to NASD requests for information. **(NASD Case #C9A010042)**

Firms Fined

ABN AMRO Securities LLC (CRD #6540, New York, New York) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined \$20,000, and required to revise its written supervisory procedures with respect to applicable securities laws and regulations concerning firm quotations. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that, as a registered market maker in securities, orders were presented to the firm at the firm's published bid or published offer in an amount up to its published quotation size. The firm failed to execute the orders upon presentment and thereby failed to honor its published quotations. The findings also stated that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with respect to applicable securities laws and regulations concerning firm quotations. Specifically, the firm's supervisory system did not include written supervisory procedures providing for the

identification of the person responsible at the firm to ensure compliance with the applicable rules; a statement of the steps that such person should take to ensure compliance therewith; a statement as to how often such person should take such steps; and a statement as to how enforcement of such written supervisory procedures should be documented at the firm. **(NASD Case #CMS010150)**

ABN AMRO Incorporated (CRD #15776, New York, New York) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined \$15,000, and required to revise its written supervisory procedures with respect to applicable securities laws and regulations concerning firm quotations. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that as a registered market maker in securities, an order was presented to the firm at the firm's published bid or published offer in an amount up to its published quotation size. The firm failed to execute the orders upon presentment and thereby failed to honor its published quotations. The findings also stated that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with respect to applicable securities laws, and regulations concerning firm quotations. Specifically, the firm's supervisory system did not include written supervisory procedures providing for the identification of the person responsible at the firm to ensure compliance with the applicable rules; a statement of the steps that such person should take to ensure compliance therewith; a statement as to how often such person should take such steps; and a statement as to how enforcement of such written

supervisory procedures should be documented at the firm. **(NASD Case #CMS010152)**

GKN Securities Corporation (CRD #19415, New York, New York) submitted a Letter of Acceptance, Waiver, and Consent in which it was censured and fined \$25,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to timely report to the NASD statistical and summary information regarding written customer complaints received by the firm. The findings also stated that the firm failed to maintain order tickets for transactions executed, failed to show both the time of entry and the time of execution on order tickets, and certain order tickets only contained the time of entry. The NASD also found that the firm incorrectly reported transactions to the Automated Confirmation Transaction ServiceSM (ACTSM) as short sales. **(NASD Case #C10010130)**

Global Capital Securities Corporation f/k/a EBI Securities, Inc. (CRD #16184, Englewood, Colorado) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$15,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it received a customer complaint, an arbitration complaint, and two lawsuits alleging misconduct by a former representative of the firm who was terminated. The NASD found that each of these matters contained information that was required to be disclosed in an amendment to the Uniform Notice of Securities Industry Termination (Form U-5) previously filed by the firm in connection with the representative's

termination. The findings also stated that the Form U-5 was not amended to disclose this information until after the NASD advised the firm of the need for an amendment. **(NASD Case #C3A010041)**

Leonard & Company (CRD #36527, Troy, Michigan) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$12,500, jointly and severally. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it effected transactions in securities when it failed to maintain its minimum required net capital. The NASD also found that the firm failed to prepare accurate trial balances and net capital computations and filed with the NASD a FOCUS Part IIA report that was inaccurate in that, among other things, it overstated the firm's net capital. **(NASD Case #C8A010067)**

Needham & Company, Inc. (CRD #16360, New York, New York) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$32,500. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to execute, contemporaneously or partially, customer limit orders in Nasdaq securities after it traded each subject security for its own market-making account at a price that would have satisfied each customer's limit order. The findings also stated that the firm failed to reflect immediately retail customers' limit orders in its quotations. **(NASD Case #C10010126)**

SunAmerica Securities, Inc. (CRD #20068, Phoenix, Arizona) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$75,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to report customer complaints in quarterly reports, filed a customer complaint late, failed to report matters on accelerated reports, and failed to report terminations for cause. The findings also stated that the firm failed to amend the Forms U-4 and U-5 (Uniform Registration Forms for electronic filing in Web CRD) for registered representatives after becoming aware of information that triggered an obligation to update the forms and was delinquent in amending the Form U-4 for registered representatives. The NASD found that the firm was late in amending the Form U-5 for registered representatives and failed to respond completely to NASD requests for information. In addition, the NASD determined that the firm's written supervisory procedures were not reasonably designed to ensure compliance with NASD Conduct Rule 3070, and to ensure that Forms U-4 and U-5 were promptly amended upon the receipt of information triggering an obligation to update the forms. **(NASD Case #C3A010042)**

Trautman Wasserman & Company, Inc. (CRD #33007, New York, New York) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$17,500. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to show the correct time of execution on the memorandum of broker

orders involving Nasdaq National Market® (NNM®) securities and over-the-counter (OTC) transactions and failed to preserve for a period of not less than three years, the memorandum of a brokerage order involving an OTC transaction. The findings also stated that the firm erroneously reported NNM transactions to ACT, reported transactions to ACT without the required ".SLD" or ".B" modifiers, improperly reported a transaction to ACT with a ".B" modifier, improperly reported a transaction as a principal trade, and improperly reported a transaction to ACT as late. The firm also failed, within 90 seconds after execution, to transmit through ACT last-sale reports of transactions in NNM, SmallCapSM and OTC Equity securities; failed, within 90 seconds after execution, to transmit through ACT last-sale reports of transactions in NNM securities; and failed to designate through ACT such last-sale reports as late. The NASD also found that the firm failed to show the time of execution, or the correct time of execution, on brokerage order memoranda and failed to preserve brokerage order memoranda for a period of not less than three years. **(NASD Case #C10010135)**

Individuals Barred Or Suspended

Jack Asbury Alexander (CRD #2760, Registered Principal, Poway, California) submitted an Offer of Settlement in which he was barred from association with any NASD member in any capacity and required to cooperate with the NASD in any further investigation and hearing relating to his member firm and a speculative security. Without admitting or denying the allegations, Alexander consented to the described sanctions and to

the entry of findings that he recklessly caused his member firm to act as a market maker in, and enter bids for, a speculative security on the Over-the-Counter Bulletin Board® (OTCBB) on a continuous basis when he was aware the firm was engaged in a distribution. The findings also stated that Alexander caused his firm to purchase stocks in the security from both customers and other broker/dealers for the firm's proprietary account, and caused the firm's sales force to recommend the purchase of the stock to retail customers while the distribution was still in progress. In addition, the NASD found that Alexander caused his firm to engage in a series of activities designed to artificially increase the price of the stock while dominating and controlling the market. Furthermore, the NASD found that Alexander recklessly, by the use of the means and instrumentalities of interstate commerce, or of the mails, employed devices, schemes, or artifices to defraud, made untrue statements of material facts or omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or engaged in acts, practices, or courses of business that operated, or would have operated, as a fraud or deceit upon customers in connection with the purchase or sale of securities. **(NASD Case #CAF010016)**

James Warren Anderson (CRD #1060765, Registered Principal, Southlake, Texas) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$20,000 and suspended from association with any NASD member in the capacity of a general securities principal for 20 days. Without admitting or denying the allegations, Anderson consented

to the described sanctions and to the entry of findings that he failed to establish and maintain a system to supervise registered representatives' activities at his member firm that was reasonably designed to achieve compliance with NASD rules. According to the findings, the representatives recommended purchase and sales transactions in the securities accounts of public customers without having reasonable grounds for believing that such recommendations were suitable for the customers in view of the frequency and nature of the recommended transactions and the customers' financial situations, objectives, circumstances, and needs.

Anderson's suspension began November 19, 2001, and concluded December 8, 2001. **(NASD Case #C02010049)**

Keith Gordon Anderson (CRD #1401002, Registered Representative, Atlanta, Georgia) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$2,500 and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the allegations, Anderson consented to the described sanctions and to the entry of findings that he recommended and engaged in a series of purchase and sale transactions in the account of public customers without having reasonable grounds for believing that these recommendations and resultant transactions were suitable for the customers on the basis of their financial situation, investment objectives, and needs.

Anderson's suspension began November 19, 2001, and concluded at the close of business December 3, 2001. **(NASD Case #C05010048)**

Jeffrey Lee Atkinson (CRD #1679474, Registered Representative, Loveland, Ohio) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000, suspended from association with any NASD member in any capacity for 60 days, and required to disgorge \$5,812.03, plus interest, in commissions earned. Payment of the fine and satisfactory proof of payment of the disgorgement, plus interest, is required before Atkinson reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Atkinson consented to the described sanctions and to the entry of findings that he engaged in private securities transactions away from his member firm and failed to provide his firm with detailed written notice of the transactions, his role therein, and to receive permission from the firm to engage in the transactions.

Atkinson's suspension began November 19, 2001, and will conclude at the close of business January 17, 2002. **(NASD Case #C8B010026)**

Arthur Andre Bennett (CRD #4136303, Associated Person, Bronx, New York) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$10,000 and suspended from association with any NASD member in any capacity for 120 days. The fine must be paid before Bennett reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Bennett consented to the described sanctions and to the entry of findings that he failed to disclose material facts on a Form U-4.

Bennett's suspension began November 19, 2001, and will conclude at the close of business March 28, 2002. **(NASD Case #C10010131)**

James Joseph Black, Jr. (CRD #1487059, Registered Representative, Germantown, Tennessee) submitted an Offer of Settlement in which he was barred from association with any NASD member in any capacity and ordered to pay \$57,839.70 in restitution to a public customer. Satisfactory proof of payment of restitution must be made before Black reassociates with any NASD member. Without admitting or denying the allegations, Black consented to the described sanctions and to the entry of findings that he received funds totaling \$57,839.70 belonging to a public customer, deposited the funds into an account under his control, and converted the funds to his own use and benefit, without the knowledge or consent of the customer. The findings also stated that Black failed to respond to an NASD request to appear and provide on-the-record testimony. **(NASD Case #C05010024)**

James Wilton Bowen (CRD #2850154, Registered Representative, Mt. Juliet, Tennessee) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Bowen consented to the described sanction and to the entry of findings that he sent correspondence on his member firm's letterhead to a financial institution for a loan that contained false and misleading information in that the correspondence falsely indicated he was owed \$3,258 in commissions from his member

firm. The findings also stated that Bowen failed to obtain prior approval of the correspondence from a principal of his member firm. **(NASD Case #C05010047)**

Ronald Duane Brouillette (CRD #1689348, Registered Representative, La Jolla, California) was barred from association with any NASD member in any capacity. The sanction was based on findings that Brouillette effected unauthorized trading in the accounts of public customers. Brouillette also failed to respond to NASD requests for information. **(NASD Case #C02010015)**

Wanda Huff Brown (CRD #1877671, Registered Principal, Greenville, South Carolina) was fined \$10,000 and suspended from association with any NASD member in any capacity for one year for failing to file FOCUS reports, and barred from association with any NASD member in any capacity for failing to respond. The fine shall be due and payable upon Brown's re-entry into the securities business. The sanctions were based on findings that Brown, on behalf of her member firm, failed to file FOCUS Part IIA reports with the NASD. In addition, Brown failed to respond to NASD requests for information.

Brown's bar became effective October 29, 2001. **(NASD Case #C07010035)**

Dennis Lane Burgess (CRD #1020157, Registered Representative, Covington, Ohio) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000, suspended from association with any NASD member in any capacity for 60 days, and required to disgorge \$2,100, plus interest, in commissions to public customers.

Payment of the fine and satisfactory proof of payment of the disgorgement, plus interest, is required before Burgess reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Burgess consented to the described sanctions and to the entry of findings that he engaged in private securities transactions away from his member firm and failed to provide his firm with detailed prior written notice of the transactions, his role therein, and to receive permission from the firm to engage in the transactions.

Burgess' suspension began November 19, 2001, and will conclude at the close of business January 17, 2002. **(NASD Case #C8B010025)**

Tom Ray Byerly (CRD #2616833, Registered Representative, Sand Springs, Oklahoma) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$10,000 and suspended from association with any NASD member in any capacity for nine months. The fine must be paid before Byerly reassociates with a member firm following the suspension, or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Byerly consented to the described sanctions and to the entry of findings that he participated in private securities transactions without providing prior written notice to, and receiving permission from, his member firm of his intention to participate.

Byerly's suspension began November 19, 2001, and will conclude August 18, 2002. **(NASD Case #C3A010043)**

Michael John Cambareri (CRD #2070535, Registered Representative, Mount Kisco, New York) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Cambareri consented to the described sanction and to the entry of findings that he engaged in outside business activities related to financial planning for which he received compensation without prior written notice to, or approval from, his member firm. The findings also stated that Cambareri failed to respond to NASD requests for information. **(NASD Case #C11010034)**

John Joseph Carr, Jr. (CRD #2032129, Associated Person, Bayville, New Jersey) was fined \$5,000 and suspended from association with any NASD member in any capacity for 45 days for executing securities transactions when not registered with the NASD, and barred from association with any NASD member in any capacity for failing to respond to NASD requests for information. The fine must be paid upon Carr's reentry into the securities industry. The sanctions were based on findings that Carr actively engaged in the securities business of a member firm by functioning as a registered representative even though he was not registered with the NASD in any capacity. The findings also stated that Carr failed to respond to NASD requests for information.

Carr's bar became effective October 29, 2001. **(NASD Case #C10010069)**

Robert Anthony Celio (CRD #C05010049, Registered Principal, Broussard, Louisiana) submitted a Letter of Acceptance,

Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Celio consented to the described sanction and to the entry of findings that he received an insurance refund check for \$10,000 made payable to a customer. The findings also stated that Celio failed to mail the check to the customer and, instead, endorsed the customer's name to the check, deposited the check into his personal checking account, and converted the funds to his own use and benefit without the customer's knowledge or consent. **(NASD Case #C05010049)**

Adam Jonathan Cohen (CRD #2164816, Registered Principal, Jericho, New York) submitted an Offer of Settlement in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Cohen consented to the described sanction and to the entry of findings that he failed to testify truthfully, accurately, non-deceptively and/or completely during an NASD on-the-record-interview and caused other individuals to do the same. The findings also stated that member firms, acting through Cohen, filed MC-400 applications with the NASD that contained false, misleading, inaccurate, or incomplete information regarding an individual's job functions with a member firm. The NASD also found that Cohen appeared before an NASD Statutory Disqualification Committee and failed to provide truthful, accurate, non-deceptive, and/or complete information regarding an individual and himself, and permitted the same individual whom he should have known was subject to statutory disqualification to remain associated with a member firm without

approvals from the Securities and Exchange Commission (SEC) or the NASD. In addition, the NASD found that Cohen submitted false, misleading, inaccurate, or incomplete information and written materials to the NASD on an application for a change of ownership and modification of a restriction agreement regarding the supervisory experiences of individuals.

Furthermore, the NASD found that a member firm, acting through Cohen, failed to register an individual with the NASD as a representative or principal when the individual was actively engaged in activities that required registration as a representative or principal. Moreover, the NASD found that a member firm, acting through Cohen, failed to report to the NASD that the firm had become associated in business and/or financial activities with a person subject to statutory disqualification and failed to amend a Form BD to disclose that this person and Cohen had become control persons of the firm. In addition, the NASD found that a member firm, acting through Cohen, failed to establish, maintain, and enforce an effective supervisory system to enable the firm to comply with federal securities laws and NASD rules addressing qualifications of, and registration procedures for, associated persons. Cohen also failed to update his Form U-4 to disclose that he was the subject of an NASD investigation and that he might be named in an NASD disciplinary action. **(NASD Case #C10990158)**

Benjamin Conde (CRD #2397658, Registered Principal, Fairfield, New Jersey) submitted an Offer of Settlement in which he was fined \$7,500, suspended from association with any NASD

member in any capacity for nine months, and required to pay \$11,700, plus interest, in restitution to public customers. The fine and restitution must be paid before Conde reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Conde consented to the described sanctions and to the entry of findings that he purchased and sold shares of stock in the accounts of public customers without the prior knowledge, authorization, or consent of the customers.

Conde's suspension began November 19, 2001, and will conclude August 18, 2002. **(NASD Case #C9B010052)**

Stephen Contino (CRD #2440108, Registered Representative, York, South Carolina) submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$2,500 and suspended from association with any NASD member in any capacity for 30 days. The fine must be paid before Contino reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Contino consented to the described sanctions and to the entry of findings that he failed to disclose his outside business activity to his member firm.

Contino's suspension began November 5, 2001, and concluded at the close of business December 4, 2001. **(NASD Case #C07010071)**

Robin Ramoen Crespo (CRD #4190368, Registered Representative, Paterson, New Jersey) submitted a Letter of

Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 30 business days. Without admitting or denying the allegations, Crespo consented to the described sanctions and to the entry of findings that he failed to disclose material information on a Form U-4.

Crespo's suspension began November 19, 2001, and will conclude at the close of business January 2, 2002. **(NASD Case #C9B010087)**

Robert Nicholas Damato (CRD #1618632, Registered Representative, East Brunswick, New Jersey) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for two months. Without admitting or denying the allegations, Damato consented to the described sanctions and to the entry of findings that he engaged in private securities transactions without prior written notice to, and approval from, his member firm in that he facilitated the investments made by public customers in a private placement offering of common stock.

Damato's suspension began November 1, 2001, and will conclude at the close of business December 31, 2001. **(NASD Case #C9B010084)**

Daniel Guy Danker (CRD #2000099, Registered Principal, Indianapolis, Indiana) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Danker consented to the described sanction and to the entry of findings that he was

responsible for the bookkeeping and daily operations of an investment company that sold investments in common stock to customers. The NASD determined that the funds received were not invested in the company but were commingled with other funds from investors who believed they were investing in other companies. The NASD found that the funds were deposited into bank accounts and distributed for the personal use of Danker and others. The findings also stated that Danker knowingly caused documents, including a stock confirmation statement, to be sent to investors substantiating their purported purchases of investment. **(NASD Case #C8A010077)**

Christian Debiassi (CRD #3002925, Registered Representative, Naples, Florida) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Debiassi consented to the described sanction and to the entry of findings that he effected, or caused to be effected, trades in a public customer's account without obtaining the customer's prior authorization for the trades. The findings also stated that Debiassi failed to respond timely to NASD requests for information. **(NASD Case #C07010077)**

John Michael Donaldson (CRD #1243689, Registered Representative, Basking Ridge, New Jersey) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$20,000 and suspended from association with any NASD member in any capacity for 15 business days. Without admitting or denying the allegations, Donaldson consented to the described sanctions and to the entry of findings that he provided

a public customer with incorrect price quotes on stock prices of positions held within the customer's accounts.

Donaldson's suspension began November 19, 2001, and concluded at the close of business December 10, 2001. **(NASD Case #C10010124)**

Elliott George Downs (CRD #2795169, Registered Representative, Derry, Pennsylvania) was fined \$25,000 and suspended from association with any NASD member in any capacity for two years for unauthorized transactions and failure to execute a sell order, fined \$50,000 and suspended from association with any NASD member in any capacity for one year for unsuitable recommendations, and barred from association with any NASD member in any capacity for material misrepresentations and omissions and failure to respond to NASD requests for information. The fine is due and payable upon Downs' reassociation with an NASD member. The sanctions were based on findings that Downs made material misrepresentations and omissions when making recommendations to public customers, including baseless price predictions, false statements, and inadequate risk disclosure. In addition, Downs made unauthorized transactions and failed to execute a transaction. Furthermore, Downs made unsuitable recommendations to a public customer.

Downs' bar became effective October 15, 2001. **(NASD Case #C07010031)**

Dennis Leroy Dunn (CRD #1606413, Registered Representative, Salem, Oregon) submitted a Letter of Acceptance, Waiver, and Consent in which he

was fined \$10,000 and suspended from association with any NASD member in any capacity for two years. The fine must be paid before Dunn reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Dunn consented to the described sanctions and to the entry of findings that he effected securities transactions for public customers without being registered as a broker or dealer. The findings also stated that Dunn executed securities transactions without first obtaining written advice from his firm stating whether it had approved his participation in the transactions. In addition, the NASD found that Dunn deposited checks from public customers in his law firm operating account where they were commingled with Dunn's own funds until subsequently applied toward the customers' purchases of stock.

Dunn's suspension began November 19, 2001, and will conclude at the close of business November 18, 2003. **(NASD Case #C3B010017)**

Evelyn Freeman (CRD #2665159, Registered Principal, Atlanta, Georgia) submitted a Letter of Acceptance, Waiver, and Consent in which she was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Freeman consented to the described sanction and to the entry of findings that she received \$19,500 from a public customer to be invested, deposited the funds into her personal banking account, and ultimately, only invested \$14,000 for the benefit of the customer. **(NASD Case #C07010076)**

Richard Andrew Gallaher (CRD #1921881, Registered Representative, St. Louis, Missouri) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Gallaher consented to the described sanction and to the entry of findings that he engaged in private securities transactions in connection with the solicitation and sale of securities to investors without providing prior written notice to, and receiving approval from, his member firm. The findings also stated that Gallaher failed to respond completely to NASD requests for information. **(NASD Case #C04010038)**

Melanie Garman-Shaffer (CRD #2062404, Registered Representative, Mt. Pleasant Mills, Pennsylvania) submitted a Letter of Acceptance, Waiver, and Consent in which she was fined \$17,000, which includes disgorgement of \$11,800 in commissions, and suspended from association with any NASD member in any capacity for two months. Without admitting or denying the allegations, Garman-Shaffer consented to the described sanctions and to the entry of findings that she participated in a private securities transaction, failed to give written notice of her intention to engage in such activities to her member firm, and failed to receive written approval from the member firm prior to engaging in such activities.

Garman-Shaffer's suspension began December 3, 2001, and will conclude February 2, 2002. **(NASD Case #C9A010045)**

Charles Evan Giaimo (CRD #2131244, Registered Principal, Westfield, New Jersey) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$7,500 and suspended from association with any NASD member in any capacity for six months. The fine must be paid before Giaimo reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Giaimo consented to the described sanctions and to the entry of findings that he failed to amend his Form U-4 to disclose a customer complaint and an arbitration. The NASD also found that Giaimo willfully failed to disclose material facts on his Form U-4.

Giaimo's suspension began November 19, 2001, and will conclude May 18, 2002. **(NASD Case #C9B010089)**

Jay Alan Gilston (CRD #1802595, Registered Representative, Bridgewater, New Jersey) submitted a Letter of Acceptance, Waiver, and Consent in which he was suspended from association with any NASD member in any capacity for 10 business days. In light of the financial status of Gilston, no monetary sanctions have been imposed. Without admitting or denying the allegations, Gilston consented to the described sanction and to the entry of findings that he engaged in outside business activities and received compensation without prior written notification to, or approval from, his member firm.

Gilston's suspension began November 19, 2001, and concluded at the close of business December 3, 2001. **(NASD Case #C9B010083)**

Thomas Albert Guice (CRD #2425808, Registered Representative, Baltimore, Maryland) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$30,000 and suspended from association with any NASD member in any capacity for two years. The fine must be paid before Guice reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Guice consented to the described sanctions and to the entry of findings that he sold promissory notes worth \$500,000 to investors outside the scope of his employment with his member firms and failed to provide written notice to his member firms describing the proposed transaction, his intentions to engage in such activities, and whether he received, or might receive, selling compensation.

Guice's suspension began December 3, 2001, and will conclude at the close of business December 2, 2003. **(NASD Case #C9A010044)**

Gary Bennett Harkenreader (CRD #2384896, Registered Representative, White Haven, Pennsylvania) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Harkenreader consented to the described sanction and to the entry of findings that he failed to respond to NASD requests to appear and provide testimony. **(NASD Case #C9A010047)**

Donald Lee Heyne (CRD #2444873, Registered Representative, Sioux Falls, South Dakota) submitted a Letter of Acceptance, Waiver, and

Consent in which he was fined \$10,000 and suspended from association with any NASD member in any capacity for 60 days. Without admitting or denying the allegations, Heyne consented to the described sanctions and to the entry of findings that he failed to respond completely to NASD requests for information.

Heyne's suspension began November 5, 2001, and will conclude at the close of business January 3, 2002. **(NASD Case #C04010035)**

Samuel Joseph Iacino (CRD #871012, Registered Representative, Hermitage, Pennsylvania) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$25,000 and suspended from association with any NASD member in any capacity for 60 days. The fine must be paid before Iacino reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Iacino consented to the described sanctions and to the entry of findings that he recommended and sold callable certificates of deposit (CDs) to public customers, made material misrepresentations to the customers that the CDs would be called in a year, that the customers could redeem their CDs a year after purchase without penalty, and that the interest rate the CD paid for the first year would be the sole interest rate applicable to the CD. The findings also stated that Iacino made material misrepresentations and omitted to disclose to the customers that there would be minimal or no risk to their principal when, in fact, there was a risk if the CDs were redeemed prior to the maturity date.

lacino's suspension began December 3, 2001, and will conclude at the close of business January 31, 2002. **(NASD Case #CAF010027)**

Roy Wayne Isom (CRD #1631583, Registered Representative, Jasper, Texas) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Isom consented to the described sanction and to the entry of findings that he served as trustee for trusts that were established for the benefit of minor children and that during this time, he removed \$215,000 from the trusts and converted the funds to his own use and benefit without the authorization, knowledge, or consent of the trust grantor or the trust beneficiaries. The findings also stated that Isom failed to respond to NASD requests for information and documentation. **(NASD Case #C06010030)**

Richard Michael Janicki (CRD #2236373, Registered Representative, Orland Park, Illinois) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity and required to pay \$34,400, plus interest, in restitution. Satisfactory proof of payment of restitution must be made before Janicki reassociates with any NASD member or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Janicki consented to the described sanctions and to the entry of findings that he caused \$34,400 to be withdrawn from the life insurance policies and securities accounts of a public customer and used the proceeds for his own use or benefit, or for purposes other than

for the benefit of the customer. **(NASD Case #C8A010076)**

Jeffrey Arthur Kahn (CRD #263122, Registered Representative, Calabasas, California) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Kahn consented to the described sanction and to the entry of findings that he executed securities transactions in the accounts of public customers without their prior knowledge, authorization, or consent. **(NASD Case #C02010058)**

Gregory Clark Keesecker (CRD #2809959, Registered Representative, Wheeling, West Virginia) submitted a Letter of Acceptance, Waiver, and Consent in which he was suspended from association with any NASD member in any capacity for 30 business days and ordered to pay \$1,000 in disgorgement for commissions received. Satisfactory proof of payment of disgorgement must be made before Keesecker reassociates with any NASD member. Without admitting or denying the allegations, Keesecker consented to the described sanctions and to the entry of findings that he sold shares of initial public offerings (IPOs), and in connection with these alleged shares, negligently misrepresented that he had acquired these shares through agreements with member firms when in fact there were no agreements with these firms and the shares in the IPOs were never acquired.

Keesecker's suspension began November 5, 2001, and will conclude at the close of business December 17, 2001. **(NASD Case #C9A010023)**

Reginald Bernard Knight (CRD #3100095, Registered Representative, West Palm Beach, Florida) was barred from association with any NASD member in any capacity and required to pay \$2,095.75, plus interest, in restitution to a member firm. The sanctions were based on findings that Knight knowingly used funds that were credited to his securities account in error to effect securities transactions for personal profit. **(NASD Case #C07010034)**

Robert Lynn Lasine (CRD #2293715, Registered Representative, Richmond, Virginia) submitted an Offer of Settlement in which he was fined \$2,500 and suspended from association with any NASD member in any capacity for 60 days. The fine must be paid before Lasine reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Lasine consented to the described sanctions and to the entry of findings that he failed to disclose a material fact on his Form U-4.

Lasine's suspension began November 19, 2001, and will conclude at the close of business January 18, 2002. **(NASD Case #C07010027)**

Edward Linzer (CRD #1050490, Registered Representative, Mineola, New York) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 15 days. Without admitting or denying the allegations, Linzer consented to the described sanctions and to the entry of findings that he actively engaged in the

management of his member firm without being registered as a principal with the NASD.

Linzer's suspension began November 19, 2001, and will conclude at the close of business December 3, 2001. **(NASD Case #C10010120)**

Debra Janet Lyles (CRD #2308720, Registered Representative, Washington, DC) was barred from association with any NASD member in any capacity. The sanction was based on findings that Lyles failed to disclose material information on her Form U-4 and failed to respond to NASD requests for information. **(NASD Case #C07010028)**

Anthony John Marchiano (CRD #1205721, Registered Principal, Naples, Florida) submitted an Offer of Settlement in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Marchiano consented to the described sanction and to the entry of findings that he failed to respond to an NASD request to appear and give testimony. **(NASD Case #CAF990048)**

Allan Watkins Matthews (CRD #3111519, Registered Representative, Galveston, Texas) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Matthews consented to the described sanction and to the entry of findings that, without prior authorization, knowledge, or consent from insurance customers, he deposited customer checks totaling \$1,090 into his personal bank account. The findings stated that Matthews forwarded checks

totaling \$310 to the insurance company to pay portions of the customers' homeowners insurance premiums, retaining the difference of \$780 for his personal use and benefit. **(NASD Case #C06010032)**

Thomas Vincent Meaglia (CRD #862483, Registered Representative, Monrovia, California) and Richard Steven Meza (CRD #2570853, Registered Representative, Lancaster, California) submitted Offers of Settlement in which Meaglia was fined \$37,803.57 and suspended from association with any NASD member in any capacity for one year. Meza was fined \$2,500 and suspended from association with any NASD member in any capacity for 10 days. Meaglia and Meza must pay the fines before they reassociate with any NASD member following the suspensions or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that Meaglia and Meza exercised discretion in the accounts of public customers without having obtained prior written authorization from the customers and prior written acceptance of the accounts as discretionary by their member firm. The findings also stated that Meaglia and Meza recommended and engaged in purchase and sale transactions in the account of public customers without having reasonable grounds for believing that the recommendations and resultant transactions were suitable for the customers on the basis of their financial situations, investment objectives, and needs.

Meaglia's suspension began November 5, 2001, and will conclude at the close of business

November 4, 2002. Meza's suspension began November 5, 2001, and concluded at the close of business November 14, 2001. **(NASD Case #C02010002)**

Albert Medina (CRD #2730223, Registered Representative, Brooklyn, New York) submitted an Offer of Settlement in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Medina consented to the described sanction and to the entry of findings that he executed unauthorized transactions in the accounts of public customers without obtaining prior authorization from the customers. The NASD also found that Medina failed to respond timely to an NASD request for information. **(NASD Case #C07000086)**

Jaffna V. More (CRD #2843698, Registered Representative, Mill Valley, California) submitted a Letter of Acceptance, Waiver, and Consent in which she was fined \$5,000 and suspended from association with any NASD member in any capacity for 10 business days. The fine must be paid before More reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, More consented to the described sanctions and to the entry of findings that she signed the names of public customers to an option client information form without the knowledge and consent of the customers and submitted it to her member firm.

More's suspension began November 19, 2001, and concluded at the close of business December 3, 2001. **(NASD Case #C01010010)**

Alex Hung Nguyen (CRD #2843949, Registered Representative, San Jose, California) submitted an Offer of Settlement in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 90 days. Without admitting or denying the allegations, Nguyen consented to the described sanctions and to the entry of findings that he created a letter purportedly from a public customer and signed the customer's name to the letter without her knowledge or consent, had the signature guaranteed, and provided the letter to a complex of mutual funds for the purpose of obtaining a commission.

Nguyen's suspension began December 3, 2001, and will conclude March 2, 2002. **(NASD Case #C01010007)**

Erik Robert Olufson (CRD #2875845, Registered Representative, Miami, Florida) was barred from association with any NASD member in any capacity. The sanction was based on findings that Olufson engaged in fraudulent sales practices to induce public customers to purchase securities. The findings also stated that Olufson made baseless price predictions and failed to provide adequate risk disclosure to the customers. The NASD also found that Olufson acted as a registered representative with a member firm without being registered with the NASD and failed to respond to NASD requests for information. **(NASD Case #C07010039)**

Khashayar Mehdi Pashakhan (CRD #2670228, Registered Representative, Irvine, California) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$15,000 and suspended from association with

any NASD member in any capacity for six months. The fine must be paid before Pashakhan reassociates with any NASD member firm. Without admitting or denying the allegations, Pashakhan consented to the described sanctions and to the entry of findings that he participated in an outside business activity and failed to provide prompt written notification to his member firm of such activity. The findings also stated that Pashakhan engaged in a private securities transaction without prior written notice to, and approval from, his member firm.

Pashakhan's suspension began November 19, 2001, and will conclude at the close of business May 18, 2002. **(NASD Case #C02010059)**

Shashin J. Patel (CRD #1043487, Registered Principal, Chicago, Illinois) was barred from association with any NASD member in any capacity and ordered to pay \$325,000 in restitution to public customers. The sanction was based on findings that Patel participated in private securities transactions without providing prior oral or written notification to, and receiving permission from, his member firm. **(NASD Case #C8A010033)**

Michael Dale Peay (CRD #2915288, Registered Representative, Allen, Texas) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Peay consented to the described sanction and to the entry of findings that without prior authorization, knowledge, or consent from the trustee of a customer account, he caused checks totaling \$29,833 to be drawn on the account, deposited

the checks into his personal securities account at his member firm, and utilized the funds for his personal use and benefit. **(NASD Case #C06010031)**

LaRissa Lee Peltola (CRD #3254951, Registered Representative, Eagan, Minnesota) submitted an Offer of Settlement in which she was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Peltola consented to the described sanction and to the entry of findings that she willfully failed to disclose a material fact on her Form U-4. The findings also stated that Peltola failed to respond to NASD requests for information. **(NASD Case #C04010026)**

John Lawton Phillips (CRD #2500981, Registered Representative, San Diego, California) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Phillips consented to the described sanction and to the entry of findings that he failed to establish and maintain a system to supervise a registered representative's activities that was reasonably designed to achieve compliance with certain NASD rules and failed to supervise the individual with respect to unsuitable recommendations. The findings also stated that Phillips recommended purchase and sale transactions for the account of a public customer without having reasonable grounds for believing that such recommendations were suitable for the customer in view of the frequency and nature of the recommended transactions and the customer's financial situation, objectives, circumstances, and needs. **(NASD Case #C02010048)**

Mary Marie Price (CRD #3130830, Associated Person, Stacy, Minnesota) submitted a Letter of Acceptance, Waiver, and Consent in which she was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Price consented to the described sanction and to the entry of findings that, without a public customer's knowledge or consent, she deposited a \$36,183.35 check made payable to the customer into an account over which she had control with the intention of using the funds for her own benefit or for some purpose other than the customer's benefit. The findings also stated that Price failed to respond to NASD requests for information. **(NASD Case #C04010039)**

Lawrence Gerald Redmond (CRD #2663849, Registered Representative, Staten Island, New York) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$7,500 and suspended from association with any NASD member in any capacity for one year. The fine must be paid before Redmond reassociates with any NASD member following the suspension. Without admitting or denying the allegations, Redmond consented to the described sanctions and to the entry of findings that while registered with a member firm, he purchased options in his personal account for which he knew he could not pay, willfully causing credit to be extended to him in contravention of Regulation T of the Interpretation of the Board of Governors of the Federal Reserve System. The findings also stated that Redmond entered false information into his firm's computer system indicating that he had deposited funds into his account for the option

purchases when, in fact, such deposits were never made.

Redmond's suspension began November 5, 2001, and will conclude at the close of business November 4, 2002. **(NASD Case #C10010119)**

Raymon Salinas (CRD #2017792, Registered Representative, San Francisco, California) was barred from association with any NASD member in any capacity. The sanction was based on finding that Salinas willfully failed to disclose a material fact on a Form U-4. **(NASD Case #C01000017)**

James Andrew Sitter (CRD #2791924, Registered Representative, Pittsburgh, Pennsylvania) submitted a Letter of Acceptance, Waiver, and Consent in which he was suspended from association with any NASD member in any capacity for 30 business days and ordered to pay disgorgement of \$8,000, representing commissions received. Without admitting or denying the allegations, Sitter consented to the described sanctions and to the entry of findings that while associated with a member firm, he sold shares of IPOs to public customers offered through another firm. The findings stated that Sitter negligently misrepresented that the firm had agreements with member firms to acquire shares in the IPOs and that through these agreements had acquired the shares. The NASD determined that there were no agreements between these firms and the shares in the IPOs were never acquired.

Sitter's suspension began December 3, 2001, and will conclude at the close of business January 14, 2002. **(NASD Case #C9A010027)**

Samuel Thomas Southard (CRD #2390261, Registered Representative, Bayonet Point, Florida) submitted an Offer of Settlement in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Southard consented to the described sanction and to the entry of findings that he forged the signature of an insurance customer on credit card applications and a check. The findings also stated that Southard added himself as an additional cardholder and effected purchases and cash advances without authorization. In addition, the NASD found that Southard willfully failed to amend his Form U-4 to disclose a material fact. **(NASD Case #C07010057)**

Darrin Duane Spencer (CRD #2267888, Registered Principal, Chesterfield, Missouri) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Spencer consented to the described sanction and to the entry of findings that he engaged in inappropriate trading irregularities that resulted in profits and the subsequent payment of \$596,334.13 in restitution to his member firm. According to the findings, Spencer bought shares of stock from his member firm's inventory account, sold it to his personal account at the firm at a price that was below the current market price, and sold the stock from his personal account back to the firm's inventory account at a price that was higher than the closing bid price. The findings also stated that after shares of stock were canceled from his member firm's inventory account, Spencer purchased the stock in his

personal account at a price that was below the current market price and subsequently sold the stock from his personal account to the firm's inventory account at a price that was higher than the closing bid price. In addition, the NASD found that Spencer failed to respond to an NASD request for information. **(NASD Case #C04010036)**

Gina M. Stevens (CRD #4264673, Registered Representative, Plainfield, Illinois) submitted a Letter of Acceptance, Waiver, and Consent in which she was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Stevens consented to the described sanction and to the entry of finding that she willfully failed to update her Form U-4, in that she failed to disclose material information. **(NASD Case #C8A010071)**

Frank William Sullivan (CRD #2734333, Registered Representative, Fairfield, Connecticut) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member firm in any capacity. Without admitting or denying the allegations, Sullivan consented to the described sanction and to the entry of findings that he entered into an agreement in which he agreed to pay bribes and kick-backs to individuals in return for his selection as the investment consultant and/or broker of record for public employee pension accounts. The NASD also found that Sullivan agreed to pay the individuals a percentage of any commissions or other fees he received as the investment consultant and/or broker of record. The findings stated that as a result of the agreement, Sullivan was selected as the broker of record

and his member firm was selected as the investment consultant in connection with the pension plans. **(NASD Case #C11010035)**

Eileen Marie Torrillo (CRD #1477895, Registered Principal, Dix Hills, New York) submitted a Letter of Acceptance, Waiver, and Consent in which she was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Torrillo consented to the described sanction and to the entry of findings that she filed, or caused to be filed, with the NASD FOCUS reports that she knew contained false and misleading information. **(NASD Case #C10010128)**

Thomas Arthur Turnure (CRD #1316278, Registered Principal, Wyckoff, New Jersey) submitted an Offer of Settlement in which he was fined \$20,000, suspended from association with any NASD member in any capacity for 15 months, and required to appear and testify truthfully at any NASD disciplinary hearing with respect to this proceeding. The fine must be paid before Turnure reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Turnure consented to the described sanctions and to the entry of findings that he failed to implement, maintain, and enforce effective supervisory systems and procedures that would have enabled his member firm to comply with federal securities laws and NASD rules regarding underwriting and retail brokerage activities and the qualifications of, and registration process for, associated persons. The findings also stated that Turnure failed to take sufficient supervisory steps in response to red flags generated by customer

complaints. In addition, the NASD found that Turnure failed to establish, maintain, and enforce written supervisory procedures that would have enabled his member firm to prevent and detect the violations alleged in customer complaints.

Turnure's suspension began December 3, 2001, and will conclude March 2, 2003. **(NASD Case #C10010004)**

Samuel Elias Urquidez (CRD #2915736, Registered Representative, Gonzales, California) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Urquidez consented to the described sanction and to the entry of findings that he exercised discretionary power in the account of a public customer without the customer giving him prior written authorization and without the account having been accepted by the firm. The findings also stated that Urquidez misappropriated \$14,500 from his member firm by improperly entering customer service credits and promotional credits to a customer's account. **(NASD Case #C01010012)**

Anthony Martin Westonsmart (CRD #2046085, Registered Representative, Columbus, Georgia) was barred from association with any NASD member in any capacity and required to pay \$9,127.50, plus interest, in restitution to a public customer. The sanctions are based on findings that Westonsmart converted customer's funds to his own use and benefit and forged a customer's endorsement on a check drawn to the customer's order, cashed the check, and converted a portion of the

proceeds to his own use and benefit. The findings also stated that Westonsmart failed to respond to NASD requests for information. **(NASD Case #C07010036)**

Mark Richard Wozniak (CRD#1321641, Registered Representative, Granger, Indianapolis) submitted an Offer of Settlement in which he was fined \$5,000, required to pay \$20,000 plus interest in restitution to public customers, and suspended from association with any NASD member in any capacity for three months. The fine must be paid and proof of restitution provided before Wozniak reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Wozniak consented to the described sanctions and to the entry of finding that he participated, for compensation, in private securities transactions and failed to provide written notice to, and obtain written authorization from, his member firm prior to engaging in such transaction.

Wozniak's suspension began November 19, 2001, and will conclude at the close of business February 18, 2002. **(NASD Case #C8A010029)**

Mark Abraham Zborowski (CRD #1325328, Registered Principal, New York, New York) was fined \$10,000 and suspended from association with any NASD member in any principal capacity for six months for net capital violations, and barred from association with any NASD member in any capacity for failure to respond. The fine must be paid when and if Zborowski seeks to reenter the securities industry. The sanctions are based on findings

that Zborowski operated a member firm while failing to maintain the minimum required net capital. The findings also stated that Zborowski failed to respond to NASD requests for information.

Zborowski's bar became effective October 23, 2001. **(NASD Case #C10010076)**

Individuals Fined

James Charles Green (CRD #1776913, Registered Principal, Brooklyn, New York) submitted a Letter of Acceptance, Waiver, and Consent in which he was censured and fined \$12,500. Without admitting or denying the allegations, Green consented to the described sanctions and to the entry of findings that he caused his member firm to violate its NASD Membership Agreement in that he allowed the owner of the firm to act as a de facto principal and control person of the firm, and allowed the owner to function in a principal capacity although he was not registered with the NASD as a principal. The findings also stated that Green failed to maintain and enforce supervisory procedures at the firm regarding compliance with applicable SEC and NASD rules regarding marking customer order tickets and short sales. **(NASD Case #C10010122)**

Lawrence Howard Harris (CRD #4039551, Registered Representative, Rohnert Park, California) submitted a Letter of Acceptance, Waiver, and Consent in which he was censured and fined \$41,832.81, which includes the disgorgement of a transaction profit of \$39,832.81. Without admitting or denying the allegations, Harris consented to the described sanctions and to the entry of findings that he purchased, or allowed to be purchased, shares of common stock for his account

held at a member firm at the public offering price per share. The NASD also found that Harris engaged in such activities while failing to give written notice to his member firm that he had opened and was maintaining the account, and failing to give written notice to the member firm at which he opened the account that he had become associated and then registered with his member firm. **(NASD Case #C8A010073)**

Ezra Pascal Mager (CRD #316853, Registered Representative, New York, New York) submitted a Letter of Acceptance, Waiver, and Consent in which he was censured and fined \$14,360.66, which includes the disgorgement of a transaction profit of \$12,360.66. Without admitting or denying the allegations, Mager consented to the described sanctions and to the entry of findings that he purchased, or allowed to be purchased, shares of common stock for his account held at a member firm at the public offering price per share. The NASD also found that Mager engaged in such activities while failing and neglecting to give written notice to his member firm that he had opened and was maintaining the account, and failed and neglected to give written notice to the member firm at which he opened the account that he had become associated and then registered with his member firm. **(NASD Case #C8A010074)**

Edward Arnold Moos (CRD #339448, Registered Principal, Short Hills, New Jersey) submitted a Letter of Acceptance, Waiver, and Consent in which he was censured and fined \$20,500, which includes the disgorgement of a transaction profit of \$19,500. Without admitting or denying the allegations, Moos consented to the described sanctions and to

the entry of findings that, in contravention of the NASD Free-Riding and Withholding Rule, he purchased, or allowed to be purchased, shares of a common stock for the trust account he opened and held at a member firm at the public offering price. **(NASD Case #C8A010075)**

Robert John Richmeier, Jr. (CRD #710982, Registered Representative, Littleton, Colorado) submitted a Letter of Acceptance, Waiver, and Consent in which he was censured and fined \$10,848 which includes the disgorgement of commissions received of \$2,848. Without admitting or denying the allegations, Richmeier consented to the described sanctions and to the entry of findings that he failed to take all necessary steps to establish the availability of an exemption from registration for shares of securities that were purchased and resold, resulting in the sale of unregistered securities. **(NASD Case #C3A010044)**

Warren Joseph Sulmasy (CRD #2352071, Associated Person, Nesconset, New York) submitted a Letter of Acceptance, Waiver, and Consent in which he was censured and fined \$10,000. Without admitting or denying the allegations, Sulmasy consented to the described sanctions and to the entry of findings that he caused his member firm to violate the terms of its NASD Membership Agreement by acting as a de facto principal and control person of the firm when the Agreement required him to have no involvement in the firm's business or operations or to act in any capacity requiring him to become a registered person. The findings also stated that Sulmasy acted in a principal capacity without being registered with the NASD as a principal. **(NASD Case #C10010121)**

Complaints Filed

The following complaints were issued by the NASD. Issuance of a disciplinary complaint represents the initiation of a formal proceeding by the NASD in which findings as to the allegations in the complaint have not been made, and does not represent a decision as to any of the allegations contained in the complaint. Because these complaints are unadjudicated, you may wish to contact the respondents before drawing any conclusions regarding the allegations in the complaint.

Savas Zafer Alkoc (CRD #2019226, Registered Representative, Lakewood, New Jersey) was named as a respondent in an NASD complaint alleging that he settled a customer complaint away from his member firm for losses suffered by the customer totaling \$4,000 without the knowledge or consent of his member firm. The complaint also alleges that Alkoc received cash and checks from public customers totaling \$65,261.98 for investment purposes, and, instead, had treasurer's checks issued and deposited a portion of the funds in his personal securities account without the customer's authorization or consent to use their funds in this manner. **(NASD Case #C9A010043)**

John Robert Bacon (CRD #4064268, Registered Representative, Deerfield Beach, Florida) was named as respondent in an NASD complaint alleging that he received checks totaling \$5,000 from a public customer to be invested and received a new account form to establish a securities account. The allegations state that, instead of establishing the account and making the investment as instructed, Bacon converted the funds for his own use and benefit. The complaint

further alleges that Bacon failed to respond to NASD requests for information. **(NASD Case #C07010074)**

Brian Coleman Barge (CRD #3243595, Registered Representative, Detroit, Michigan) was named as a respondent in an NASD complaint alleging that he received \$1,225 from public customers to purchase automobile insurance policies and failed to apply the funds as directed and, without the knowledge or authorization of the customers, used the funds for his own benefit or for some purpose other than the benefit of the customers. The complaint also alleges that he affixed the signature of a public customer to an automobile insurance application without the knowledge or consent of the customer and failed to respond to NASD requests for information and documents. **(NASD Case #C8A010078)**

Sheila Marie Cali (CRD #3082147, Registered Representative, Columbia, South Carolina) was named as a respondent in an NASD complaint alleging that she received insurance premium payments from her public customers totaling \$1,698.15, failed to remit these payments to her member firm, and converted the funds to her own use and benefit. **(NASD Case #C07010075)**

Anthony Francis DeCarlo (CRD #2568723, Registered Representative, Woodbridge, New Jersey) was named as a respondent in an NASD complaint alleging that he reimbursed a public customer for a surrender charge without the knowledge or approval of his member firm. The NASD further alleges that DeCarlo failed to respond truthfully to the NASD during an on-the-record

interview. **(NASD Case #C9B010085)**

George Patrick Ford, Jr. (CRD #2335245, Registered Principal, Rye, New York) was named as a respondent in an NASD complaint alleging that he effected a transaction in the account of a public customer without the customer's prior knowledge, authorization, or consent. **(NASD Case #C10010132)**

Lewis Douglas Hanchell (CRD #3025649, Registered Representative, Miami, Florida) was named as a respondent in an NASD complaint alleging that he effected trades in a public customer's account without authorization from the customer. The complaint further alleges that Hanchell failed to respond to NASD requests for information. **(NASD Case #C07010078)**

Shannon Mae McDermott (CRD #4129251, Registered Representative, Granby, Missouri) was named as a respondent in an NASD complaint alleging that, without the knowledge or consent of a public customer, she initiated cash withdrawals totaling \$4,500 from the customer's bank account, deposited the cash funds into an account she controlled, and used the funds for her own benefit or for some purpose other than the benefit of the customer. The complaint also alleges that McDermott failed to respond to NASD requests for information. **(NASD Case #C04010037)**

Thomas Daniel Roskin (CRD #2267315, Registered Representative, New York, New York) was named as a respondent in an NASD complaint alleging that he executed transactions in the accounts of public customers without their prior knowledge, authorization, or consent. The

complaint also alleges that Roskin, through means or instrumentalities of interstate commerce or of the mails, intentionally, knowingly or recklessly employed a device, scheme, and artifice to defraud and manipulative, deceptive, or other fraudulent device or contrivance; omitted to state material facts necessary to make the statements made, in light of the circumstances under which they were made, not misleading; and engaged in acts, practices, or courses of business that operated as a fraud or deceit upon public customers. The complaint further alleges that Roskin made material, misleading, and/or false representations to public customers concerning securities that were without a reasonable basis and failed to disclose material information including, but not limited to, negative information about the companies and investment risks. In addition, the complaint alleges that Roskin exercised discretionary authority in the accounts of public customers without prior effective written authorization from public customers and without having his member firm's written acceptance of the account as discretionary. **(NASD Case #C10010140)**

Stonebriar Securities, Inc. (CRD #19193, North Palm Beach, Florida) and Matthew James Fitzgibbon (CRD #4112304, Registered Principal, Columbus, Indiana) were named as respondents in an NASD complaint alleging that the firm, acting through Fitzgibbon, recommended the purchase of common stock and made price predictions to public customers without having a reasonable basis for the representations and predictions. The complaint also alleges that the firm, acting through Fitzgibbon, failed to disclose to customers that the stock was a speculative investment, had flat revenues and

suffered losses, and had limited operating capital and needed additional funds to grow. The complaint further alleges that the firm failed to disclose the ownership of the stock and the sale of shares by accounts affiliated with and/or controlled by a representative of the firm. In addition, the complaint alleges that the firm failed to obtain information to timely approve accounts for penny stock trading, and to obtain written agreements for transactions involving penny stocks. The complaint alleges that Fitzgibbon guaranteed a public customer against loss in his account in connection with the recommendation to purchase a common stock and made unsuitable recommendations to public customers based on their trading inexperience and financial situations. Furthermore, the complaint alleges that Fitzgibbon failed to execute customer sell orders. **(NASD Case #C07010072)**

Firm Suspended For Failure To Supply Financial Information

The following firm was suspended from membership in the NASD for failure to comply with formal written requests to submit financial information to the NASD. The actions were based on the provisions of NASD Rule 8210 and Article VII, Section 2 of the NASD By-Laws. The date the suspension commenced is listed after the entry. If the firm has complied with the requests for information, the listing also includes the date the suspension concluded.

The Sunnoor Corporation,
Lockwood, California
(November 1, 2001)

Individual Barred Pursuant To NASD Rule 9544 For Failure To Provide Information Requested Under NASD Rule 8210. (The date the bar became effective is listed after the entry.)

Kesslak, Anthony J.,
Stephens City, Virginia
(October 11, 2001)

Individuals Suspended Pursuant To NASD Rule 9541(b) For Failure To Provide Information Requested Under NASD Rule 8210. (The date the suspension began is listed after the entry.)

Armenta, Joseph E.,
Phoenix, Arizona
(October 11, 2001)

Baylor, Ky Nigel,
Columbus, Ohio
(November 2, 2001)

Benelli, Rosemary,
Sun City Center, Florida
(October 25, 2001)

Deane, Robert,
Albany, New York
(October 26, 2001)

Ferguson, Philip L.,
Fowlerton, Indiana
(October 31, 2001)

Grau, Steven A.,
Lighthouse Point, Florida
(October 23, 2001)

Hathaway, II, William,
Virginia Beach, Virginia
(October 11, 2001)

Humphreys, Kyle Wade,
Mesa, Arizona
(October 11, 2001)

Lowe, Anthony,
Cumming, Georgia
(October 11, 2001)

Individual Suspended Pursuant To NASD Rule Series 9510 For Failure To Comply With An Arbitration Award Or A Settlement Agreement

The date the registration was suspended is included after the entry. If the individual has complied, the listing also includes the date the suspension was lifted.

Roche, Estelle Alexandria,
Boca Raton, Florida
(October 24, 2001 –
November 15, 2001)

NASD Regulation Hearing Panel Fines Ko Securities And Its President For Illegal Short Selling

NASD Regulation announced that a disciplinary Hearing Panel has fined Ko Securities, Inc., together with its president, Terrance Yoshikawa, nearly \$150,000 for short-selling more than 46,000 shares of EntreMed, Inc., on May 4, 1998, without first ascertaining that the stock in question could be borrowed or delivered. The panel also fined Ko Securities \$15,000 for other violations of federal securities laws and NASD rules. Ko Securities is located in Seattle, Washington.

NASD's Affirmative Determination Rule requires that before a firm executes a short sale in a security in which it is not a bona fide market maker, it must make an affirmative determination that it can borrow or provide the securities for delivery by settlement date. The rule also requires that a member firm maintain a written record of such an affirmative determination.

On Sunday, May 3, 1998, *The New York Times* published an article stating that EntreMed had successfully completed clinical

trials for two new drugs that appeared to cure cancer in mice. The following morning, May 4, EntreMed's share price soared, opening at \$85, compared to a closing price of \$12 on the preceding Friday. EntreMed stock traded over 23 million shares on May 4, closing at \$51.823. This compares to just 19,150 shares on the previous trading day.

The Hearing Panel found that Ko Securities and Yoshikawa violated NASD's rules by selling short over 46,000 shares of EntreMed for the firm's account on May 4 without first determining that it could borrow EntreMed stock. The Panel's decision emphasized that the rule requires an NASD member to make and document an affirmative determination to protect the selling firm, the clearing firm, and the buyer. The panel rejected the claim that Ko had met the rule's requirements merely by covering the relevant short sales by day's end, and stated that Yoshikawa's defense was "wholly inconsistent with the underlying goals of 'additional discipline on short selling' and protecting marketplace integrity."

In assessing sanctions for the short-sale violations, the panel ordered Ko Securities and Yoshikawa to jointly pay a fine of \$147,450, which includes the profits earned from the illegal short sales. The panel also fined Ko Securities \$15,000 for violations of the Securities and Exchange Commission's record keeping rule and NASD's rule governing just and equitable principles of trade.

Ko Securities appealed the charges on November 5, and a cross appeal was filed by NASD Regulation's Enforcement Department on December 14.

NASD Regulation Sanctions Seven For Trade Or Move Violations

NASD Regulation has settled seven separate disciplinary actions against firms for violations of the NASD's Trade or Move Rule. The seven firms involved in these actions were censured and fined a total of \$120,000.

The Trade or Move Rule applies to all securities listed on The Nasdaq Stock Market, and is designed to ensure that the markets for Nasdaq stocks open in a fair and orderly manner. Markets become locked and crossed when a market maker enters or maintains an "ask" price for a security that is the same or lower than the "bid" price of another market maker. Locked or crossed quotations may occur in fast-moving markets and can have significant impact on the opening of trading in newly offered securities. The rule requires firms that lock or cross the market during the time period between 9:20 a.m. to 9:30 a.m. EST to immediately send Trade or Move messages to the parties with whom it has locked or crossed. Firms receiving Trade or Move messages during this time period must, within 30 seconds of receipt, either execute the trade in full or move their quote to an unlocking price.

Compliance with the Trade or Move Rule is critically important to ensuring accurate pricing at the open of The Nasdaq Stock Market. The rule generally has been viewed, since its adoption in 2000, as having increased the ability of investors to get fair prices, increased market transparency, and improved price discovery in The Nasdaq Stock Market at the open.

The following firms were censured and fined a total of \$120,000 by NASD Regulation for violations of the Trade or Move Rule:

- National Financial Services, L.L.C., \$30,000 (includes a fine for locked and crossed violation during normal business hours);
- Windsor Capital Advisors, Inc., \$20,000;
- Prudential Securities Incorporated, \$20,000 (includes a fine for locked and crossed violation during normal business hours);
- Pershing Trading Company, L.P., \$20,000;
- Gerard Klauer Mattison & Co., Inc., \$10,000;
- BancBoston Robertson Stephens, \$10,000; and
- J.P. Morgan Securities, Inc., \$10,000.

These actions are the result of reviews conducted by the Trading Practices Section within NASD Regulation's Market Regulation Department. These firms have neither admitted nor denied the allegations, but have consented to the entry of findings pursuant to the settlements.

These disciplinary actions highlight NASD Regulation's commitment to enforce member compliance with trading rules essential to market quality and customer protection. NASD Regulation notes that industry-wide compliance with the Trade or Move Rule has improved considerably in recent periods of potential volatility, such as the September 2001 Expiration when equity, futures, and index options expired on the same date.

For Your Information

Filing Due Dates For Web-Based FOCUS, Annual Audits, Customer Complaint Information, And Short Interest Reporting

NASD Regulation, Inc. reminds member firms of their obligation to file the appropriate Web-Based FOCUS reports, Annual Audits, Customer Complaint information, and Short Interest Reporting by the specified due dates. The following schedules outline due dates for 2002. Questions regarding the information to be filed can be directed to the appropriate District Office. Business questions as to how to file reports, resetting passwords, and technical questions concerning system requirements, file uploads, submission problems for Web-Based FOCUS and Customer Complaints can all be directed to (800) 321-NASD. Business questions regarding the Short Interest Reporting deadlines should be directed to Yvonne Huber at (240) 386-5034 or Jocelyn Rena at (240) 386-5091.

Web-Base FOCUS Due Dates

Monthly And Fifth FOCUS

<i>Period Ending</i>	<i>Due Date</i>
January 31, 2002	February 26, 2002
February 28, 2002	March 25, 2002
April 30, 2002	May 23, 2002
May 31, 2002	June 25, 2002
July 31, 2002	August 23, 2002
August 31, 2002	September 25, 2002
October 31, 2002	November 25, 2002
November 30, 2002	December 24, 2002

Quarterly FOCUS Part II/IIA

<i>Quarter Ending</i>	<i>Due Date</i>
December 31, 2001	January 25, 2002
March 31, 2002	April 23, 2002
June 30, 2002	July 24, 2002
September 30, 2002	October 23, 2002
December 31, 2002	January 27, 2003

Annual Schedule I Due Date

2001 Annual FOCUS Schedule I	January 25, 2002
2002 Annual FOCUS Schedule I	January 27, 2003

2002 Annual Audit Filings Due Dates

<i>Period End</i>	<i>Due Date</i>
January 31, 2002	April 1, 2002
February 28, 2002	April 29, 2002
March 31, 2002	May 30, 2002
April 30, 2002	June 29, 2002
May 31, 2002	July 30, 2002
June 30, 2002	August 29, 2002
July 31, 2002	September 29, 2002
August 31, 2002	October 30, 2002
September 30, 2002	November 29, 2002
October 31, 2002	December 30, 2002
November 30, 2002	January 29, 2003
December 31, 2002	March 1, 2003

2002 Customer Complaints/3070 Due Dates

4th quarter 2001:	1/15/02 (Tuesday)
1st quarter 2002:	4/15/02 (Monday)
2nd quarter 2002:	7/15/02 (Monday)
3rd quarter 2002:	10/15/02 (Tuesday)
4th quarter 2002:	1/15/03 (Wednesday)

2002 Short Interest Reporting Deadlines

Trade Date	Settlement Date	Exchange-Listed Short Interest Due*	Nasdaq Short Interest Due*
January 10 Thursday	January 15 Tuesday	January 17 1:00 p.m. Thursday	January 17 6:00 p.m. Thursday
February 12 Tuesday	February 15 Friday	February 20 1:00 p.m. Wednesday	February 20 6:00 p.m. Wednesday
March 12 Tuesday	March 15 Friday	March 19 1:00 p.m. Tuesday	March 19 6:00 p.m. Tuesday
April 10 Wednesday	April 15 Monday	April 17 1:00 p.m. Wednesday	April 17 6:00 p.m. Wednesday
May 10 Friday	May 15 Wednesday	May 17 1:00 p.m. Friday	May 17 6:00 p.m. Friday
June 11 Tuesday	June 14 Friday	June 18 1:00 p.m. Tuesday	June 18 6:00 p.m. Tuesday
July 10 Wednesday	July 15 Monday	July 17 1:00 p.m. Wednesday	July 17 6:00 p.m. Wednesday
August 12 Monday	August 15 Thursday	August 19 1:00 p.m. Monday	August 19 6:00 p.m. Monday
September 10 Tuesday	September 13 Friday	September 17 1:00 p.m. Tuesday	September 17 6:00 p.m. Tuesday
October 9 Wednesday	October 15 Tuesday	October 17 1:00 p.m. Thursday	October 17 6:00 p.m. Thursday
November 12 Tuesday	November 15 Friday	November 19 1:00 p.m. Tuesday	November 19 6:00 p.m. Tuesday
December 10 Tuesday	December 13 Friday	December 17 1:00 p.m. Tuesday	December 17 6:00 p.m. Tuesday

***Eastern Standard Time**

INFORMATIONAL

**INSITE
Reporting
Requirements**

**SEC Approves NASD
Rule Proposal Requiring
Member Clearing And
Self-Clearing Firms To
Report Prescribed Data;
Effective Date:
December 10, 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.

- Executive Representatives
- Legal & Compliance
- Operations
- Senior Management

KEY TOPICS

- INSITE
- Reporting Requirements

Executive Summary

On November 27, 2001, the Securities and Exchange Commission (SEC) approved proposed National Association of Securities Dealers, Inc. (NASD®) Rule 3150, "Reporting Requirements for Clearing Firms." Rule 3150 requires each member that is a clearing firm or self-clearing firm to report to the NASD in such format as the NASD may require prescribed data pertaining to itself and any member for which it clears.¹ This data will be used to facilitate the surveillance component of NASD Regulation's INSITE program. Through the use of INSITE's technology, NASD Regulation will enhance investor protection by identifying potentially high-risk situations as they develop.

The text of the amendments as provided in Attachment A became effective on December 10, 2001.

Questions/Further Information

Questions concerning this Notice may be directed to Frank J. McAuliffe, Member Regulation, NASD Regulation, at (240) 386-4670; Elizabeth A. Wollin, Member Regulation, NASD Regulation, at (240) 386-5156; or Shirley H. Weiss, Office of General Counsel, NASD Regulation, at (202) 728-8844.

The INSITE Program

The data gathered by NASD Regulation under Rule 3150 will be used to facilitate the surveillance component of INSITE (an acronym for Integrated National Surveillance and Information Technology Enhancements), a new business model that will permit NASD Regulation to use sophisticated

statistical analysis techniques to detect emerging risk patterns at member firms. Through INSITE, NASD Regulation will collect and analyze information about members and produce reports that identify "exceptions" based on historical and current comparisons of member data. The exceptions will trigger follow-up reviews and possible examinations. INSITE will permit NASD Regulation to concentrate its examinations on the higher-risk segments of the industry, focus the content of each examination on higher-risk topics, streamline the examination process for examiners and members, and better coordinate regulatory findings with other NASD Regulation departments.

Who Is Subject To The Requirements Of Rule 3150

Rule 3150 requires each member clearing and self-clearing firm to report prescribed data to NASD Regulation. Members may enter into an agreement with a third party, such as a service bureau, pursuant to which the third party agrees to fulfill the clearing or self-clearing firm's obligations under proposed Rule 3150. Notwithstanding the existence of such an agreement, each member that is a clearing or self-clearing firm will be responsible for complying with the reporting requirements of Rule 3150.

What Must Be Reported Under Rule 3150

The text of Rule 3150 does not specify the data that must be reported to NASD Regulation, but members may review the reporting requirements on the NASD Regulation Web Site at <http://www.nasdr.com/insite.asp> (INSITE Firm Data Filing Technical Specifications). The reporting

requirements have been designed to require firms to provide summaries of information that they are already collecting, including, among other things, aggregate net liquidating equity in each clearing firm's correspondents' proprietary accounts, exchange and non-exchange transactions, options transactions, debt transactions, customer accounts, short interest, unsecured customer debits, trade cancellations (T+1 forward), and as-of trades summaries. These data elements may change over time, and NASD Regulation will continue to work with its members and their service bureaus to identify the data that is needed to operate the surveillance component of INSITE and to modify the reporting requirements as necessary. The initial data elements will be reported daily. NASD Regulation will provide clearing and self-clearing firm members with advance notice (in an *NASD Notice to Members* or by other means of communication, such as the NASD Regulation Web Site) of any changes to the required data elements or filing frequency.

What Are The Technical Reporting Requirements Under Rule 3150

Rule 3150 does not specify the method to be used by members in reporting prescribed data. The technical requirements associated with all of the processes necessary for transmitting the required data to NASD Regulation can be found on NASD Regulation's Web Site at <http://www.nasdr.com/insite.asp> (INSITE Firm Data Filing Technical Specifications). Firms may report data via NASD Regulation's Form Filing Web Site or, for firms with connectivity to the NASD OATS private network, through that file transfer protocol. Members may

obtain additional information about reporting responsibilities, technical specifications, compliance issues, and more by contacting NASD Business and Technology Support Services at (800) 321-NASD, or by sending an e-mail to nasdregfilling@nasd.com.

As with any new program or technology, systems failures may arise. When that happens, NASD Regulation expects members to report these failures, correct them as expeditiously as possible, and restart the reporting process. Generally, NASD Regulation will not view a system failure as a disciplinary matter if it has occurred in the normal course of doing business, is not part of a series of systems failures, and the member is attempting to correct it.

The NASD Regulation Web Site also features information that will aid members in making programming changes that will enable them to create the daily summaries required by INSITE. NASD Regulation is also committed to developing a system on its Web Site that will permit members to review the information that they or their service bureaus have reported.

When Will NASD Regulation Require Clearing And Self-Clearing Firms To Report Data Under Rule 3150

NASD Regulation will implement Rule 3150 reporting requirements in phases. The three clearing firms that have been part of an ongoing pilot program will be phased in first, as soon after December 10, 2001, as possible. NASD Regulation will phase in all other members in several stages. NASD Regulation will publish the schedule of phase ins as soon as it has been established, but in no event will NASD Regulation give

member firms less than six months' notice of their start-up date. NASD Regulation will take into account broker/dealers' relationships with service bureaus in establishing the phase-in schedules. NASD Regulation expects Rule 3150 to be fully implemented by the end of 2002.²

Effective Date Of Amendments

These amendments became effective on December 10, 2001.

Endnotes

- 1 See Securities Exchange Act Release No. 45109 (Nov. 27, 2001), 66 FR 63271 (Dec. 5, 2001) (File No. SR-NASD-2001-19) (SEC Approval Order).
- 2 Rule 3150 includes a provision that permits members to request an exemption from Rule 3150's reporting requirements pursuant to the Rule 9600 Series. As stated in Rule 3150(b), exemptions from any or all of the Rule 3150 reporting requirements will be granted only under exceptional and unusual circumstances.

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ATTACHMENT A—RULE TEXT

New language is underlined.

3100. BOOKS AND RECORDS, AND FINANCIAL CONDITION

3150. Reporting Requirements for Clearing Firms

(a) Each member that is a clearing firm or self-clearing firm shall be required to report to the Association in such format as the Association may require, prescribed data pertaining to the member and any member broker-dealer for which it clears. A clearing firm or self-clearing firm may enter into an agreement with a third party pursuant to which the third party agrees to fulfill the obligations of a clearing firm or self-clearing firm under this Rule. Notwithstanding the existence of such an agreement, each clearing firm or self-clearing firm remains responsible for complying with the requirements of this Rule.

(b) Pursuant to the Rule 9600 Series, the Association may in exceptional and unusual circumstances, taking into consideration all relevant factors, exempt a member or class of members unconditionally or on specified terms from any or all of the provisions of this Rule that it deems appropriate.

* * *

PROCEDURES FOR EXEMPTIONS**9610. Application****(a) Where to File**

A member seeking exemptive relief as permitted under Rules 1021, 1070, 2210, 2320, 2340, 2520, 2710, 2720, 2850, 2851, 2860, Interpretive Material 2860-1, 3010(b)(2), 3020, 3150, 3210, 3230, 3350, 8211, 8212, 8213, 11870, or 11900, Interpretive Material 2110-1, or Municipal Securities Rulemaking Board Rule G-37 shall file a written application with the appropriate department or staff of the Association and provide a copy of the application to the Office of General Counsel of NASD Regulation.

(b) and (c) No change

INFORMATIONAL

**Compensation
and Mixed
Capacity
Trading**

**Guidance on
Compensation and
Mixed Capacity Trading****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.

- Executive Representatives
- Legal & Compliance
- Registered Representatives
- Senior Management
- Training

KEY TOPICS

- Disciplinary Information

Executive Summary

The Nasdaq Stock Market, Inc. (Nasdaq®) and NASD Regulation, Inc. (NASD Regulation) believe that market rules should enhance investor protection and promote competition among market participants. The advent of decimal pricing in the Nasdaq market has caused many Nasdaq market makers to re-evaluate methods of charging for their services, as well as the manner in which they represent customer orders in the marketplace. Consequently, firms have questioned whether Nasdaq rules accommodate different methods of compensation for a market maker's services. In turn, firms have approached Nasdaq and NASD Regulation for interpretive advice concerning their regulatory obligations when executing transactions on a commission or commission-equivalent basis. In response to these and other inquiries, Nasdaq and NASD Regulation have prepared this *Notice to Members*.

The guidance relating to mixed capacity trades and the capability to change the Automated Confirmation Transaction ServiceSM (ACTSM) report capacity indicator on a post-execution basis, which are discussed below, relate principally to Nasdaq securities (Nasdaq National Market and SmallCap). Nasdaq continues to evaluate whether there is a need for similar guidance regarding securities traded in the OTC Bulletin Board, and will provide information regarding this issue in a separate document at a future date.

**Questions/Further
Information**

Questions regarding this *Notice* may be directed to the Nasdaq

Office of General Counsel at (202) 728-8088, and the Legal Section, Market Regulation Department, NASD Regulation at (240) 386-5126.

Discussion/Background

Traditionally, the business model of Nasdaq market makers has been based on the difference between the price at which market makers were willing to buy and sell securities. The difference, or "spread," typically makes up a component of a market maker's compensation for the risk it assumes and the liquidity it supplies to the market. As a result of changes to the Nasdaq market resulting from decimalization, some market participants are seeking to alter their methods of charging and paying for market services. In many cases, this means expanding the use of a commission-based fee model.

At the outset, Nasdaq wishes to emphasize that decisions about methods of compensation should be made in arm's length negotiations between broker/dealers and their customers. Each firm and its customers must make individual, independent determinations about the fee and payment structures that are appropriate for their business relationships. Therefore, the issuance of this *Notice* does **not** obligate any market participant to impose, or accept, any particular compensation model, nor does it suggest the appropriate level of compensation. Instead, this *Notice* seeks to provide interpretive advice and guidance to firms to assist them in meeting their regulatory obligations arising from whichever manner they choose to participate (and pay or receive compensation for that participation) in Nasdaq.

I. Trade Capacity

Q. 1. What is a principal trade?

A. A principal trade is a trade in which the broker/dealer buys or sells for an account in which the broker/dealer has a beneficial ownership interest (e.g., a proprietary account). When executing transactions from this account, the broker/dealer typically charges its customer a markup, markdown, or commission equivalent, and may also trade on a "net" basis (see Question 4).

Q. 2. What is an agency trade?

A. An agency trade is a trade in which a broker/dealer, authorized to act as an intermediary for the account of its customer, buys (sells) a security from (to) a third party (e.g., another customer or broker/dealer). Such a trade is not executed in, or does not otherwise pass through, the broker/dealer's proprietary account. When executing an agency trade, the broker/dealer generally charges the customer a commission for its services.

Q. 3. What is a riskless principal trade?

A. In Nasdaq, a riskless principal trade is one in which a broker/dealer, after having received an order to buy (sell) a security, purchases (sells) the security as principal, **at the same price**, to satisfy that order. The broker/dealer generally charges its customer a markup, markdown, or commission equivalent for its services, which is disclosed on the confirmation required by

Securities Exchange Act (Exchange Act) Rule 10b-10. For further guidance on riskless principal trade reporting obligations for Nasdaq securities, please see *Notice to Members 99-65*, *Notice to Members 99-66*, and *Notice to Members 00-79*.

Q. 4. What is a net trade?

A. A net trade takes place when a market maker, at the request of a customer, while holding a customer order to buy (sell), executes a buy (sell) as principal at one price (from the street or another customer) and then executes an offsetting sell to (buy from) the customer at a different price. The difference between the price of the market maker's transaction and the price of the offsetting transaction to the customer is the market maker's compensation, and such compensation generally is not separately disclosed on the customer confirmation. To the extent that the market maker executes a transaction to facilitate the execution of the customer order it holds, such a transaction appears to be a riskless principal transaction. However, because the two transactions are effected at two different prices, the market maker is required under NASD trade reporting rules to report both legs (i.e., the street (or another customer) side and the customer side) of the transaction to the tape. The market maker's capacity for both transactions in ACT is principal (P). See *Notices to Members 95-67*, *96-10*, *99-65* and *00-79* for further guidance on net trading.¹

II. Fees In General

Q. 5. Do NASD/Nasdaq rules prohibit a member firm from charging its customer a commission or commission equivalent?

A. No. There are no NASD/Nasdaq rules or interpretations that prohibit a member firm from charging its customers either a commission when acting as agent, or a commission equivalent when acting in a principal or riskless principal capacity. It is up to each individual NASD member firm, consistent with its regulatory obligations, to reach an independent determination as to the manner in which it seeks to be paid by its customers for services rendered.

Q. 6. Can a member firm charge its customer a commission when acting in a principal or riskless principal capacity?

A. The NASD rules do not specifically address this issue. Members should, however, refer to Securities and Exchange Commission (SEC) guidance and interpretations on this issue.

III. Handling Orders in Mixed Capacities

7. Q. Can a market maker that handles orders at the same price but in different capacities (e.g., as agent, riskless principal and/or principal) combine these orders and represent them in a single quote?

- A. Yes. A market maker can combine agency, riskless principal and/or principal orders and represent them in a single quote. When a market maker is displaying trading interest in its quotation in Nasdaq and that quote is accessed by another participant through a Nasdaq system, Nasdaq systems currently assume that the market maker traded on a principal basis, and consequently default the execution report in ACT to a principal capacity indicator. Nasdaq and NASD Regulation understand that it is possible that the accessed quote represents an agency order or a combination of agency interest and proprietary (principal or riskless principal) interest. Nasdaq and NASD Regulation also understand that a firm may wish to adjust its Nasdaq system-generated ACT report to indicate that the market maker handled all or a portion of the execution of a mixed capacity quote as agent.

As an accommodation, Nasdaq is providing a voluntary option that will allow firms to break out the agency and/or riskless principal components of a "mixed" capacity execution through an ACT Regulatory Report – similar to "Alternative 2" under

NASD riskless principal trade reporting rules. Specifically, a market maker would submit a non-clearing/non-tape report or a clearing only report (collectively, ACT Regulatory Report) to ACT for the agency and/or riskless principal portion(s) of the larger, system-reported execution. The market maker would be required to submit the ACT Regulatory Report within 15 minutes of the original mixed capacity execution. Additionally, the ACT Regulatory Report would have to include: 1) in the memo field, the ACT control number for the original trade report generated by the Nasdaq system;² and 2) in the execution time field, the time the order was **allocated** to the agency and/or principal account. As discussed in more detail below,³ the presumption is that the entire amount of such a mixed capacity execution has been done on a principal basis unless allocated to an agency account within a general time parameter of 60 seconds.⁴

Q. 8. Can a market maker handling orders at the same price in different capacities (e.g., as agent, riskless principal and/or principal) combine these orders for entry into a Nasdaq system (i.e., SelectNet or the National Market Execution System (NNMS or SuperSOES)) for execution?

- A. Yes. While it would be preferable for such orders to be entered separately into a Nasdaq system whenever possible, a market maker can combine such orders for entry into SuperSOES or SelectNet

as a single mixed capacity order.⁵ Similar to the procedure for the execution against mixed capacity quotes that is described in Question 7, Nasdaq will provide a voluntary option for firms to allocate the agency and/or riskless principal components of a "mixed" capacity execution resulting from the submission of a single "mixed order" into SuperSOES or SelectNet. As described in Question 7, this will be accomplished by the submission of an ACT Regulatory Report that identifies the agency and/or riskless principal order(s) that make up any or all of the executed mixed capacity order that was entered into the Nasdaq system.

Q. 9. Is a member required to use the ACT Regulatory Report to break out executions of agency and/or riskless principal orders, as outlined in Questions 7 and 8?

- A. No. Member firms are not required to use this voluntary option to allocate the execution of a mixed capacity quote that is accessed via a Nasdaq system to its capacity component parts. Similarly, member firms that choose to aggregate multiple orders of differing capacities into a single mixed capacity order, for entry into SuperSOES or SelectNet, or into an Electronic Communications Network (ECN) or Alternative Trading System (ATS), are not required to use this voluntary option to allocate the execution of such orders to their capacity component parts. The above-described

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approach is one, but not the only, way for firms to document the capacity in which they traded.⁶

Please see Section V for further guidance on record keeping obligations.

Additional information on this functionality will be provided in a separate Technical Update. Until that time, we have included below an example illustrating the type of reports that can be submitted to adjust portions of a mixed capacity execution.

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Example 1: MMA is at the inside offer of \$20.00 for 15,000 shares. MMA's quote is composed of a 7,500 share principal order and a 7,500 share agency order (both to sell). MMB enters a market order to buy 15,000 into SuperSOES. At 10:00:00 a.m., SuperSOES executes the incoming buy order for 15,000 shares against MMA's quote, and ACT reports the 15,000

share execution to the tape on behalf of MMA (ACT control number = 1150111111). MMA allocates the order to the agency account for a customer that is a non-NASD member (e.g., institution) within 30 seconds of execution at 10:00:30 a.m. If MMA wishes to use the ACT Regulatory Report to break out executions of the mixed capacity order, MMA

would be required to submit an ACT Regulatory Report for 7,500 shares sold, with an allocation time of 10:00:30 a.m. (in the execution time field) and an ACT control number of 1150111111 in the memo field, as set forth below, within 15 minutes of the original mixed capacity execution:⁷

Tape/Media Report Sent to ACT by SuperSOES

MMID	OEID	Volume	Price	MMA Capacity	ACT Control #	Memo	Execution Time	Tape Rpt.	Clrg
MMA	MMB	15,000	20.00	P	1150111111		10:00:00	Yes	Yes

MMA's ACT Regulatory Report

MMID	OEID	Volume	Price	MMA Capacity	ACT Control #	Memo	Execution Time	Tape Rpt.	Clrg
MMA	MMB	7,500	20.00	A	1150222222	1150111111	10:00:30	No	No

The categories in the above-referenced trade reports are for illustrative purposes only

MMID	Executing Reporting Party
OEID	Order Entry (Contra) Party
Volume	Shares executed
Price	Transaction price
MMA Capacity	Capacity indicator for Market Maker A: P = principal, A = agency, R = riskless principal
ACT Control #	Unique ACT identifier attached to each ACT report
Memo	ACT field for input of miscellaneous information. Must be used to indicate original ACT control #
Execution Time	Time of order execution. On the ACT Regulatory Report, indicated time represents the time of allocation.
Tape Rpt.	Indicates whether the ACT record is reported to the tape. For ACT Regulatory Reports, this should always be "No."
Clrg	Indicates whether the ACT record is cleared through the ACT system

Example 2: MMA is holding an agency order to buy 10,000 shares at a price not to exceed \$20.00, plus an agreed upon, separately disclosed commission. MMA then receives another agency order to sell 10,000 shares at \$20.00. MMA's system is programmed to match agency orders and report the agency crosses to ACT.

Q. 10. Can MMA cross two customer agency orders internally and report the transaction to ACT as agent?

- A. Yes, provided that the orders are not run through the market maker's proprietary account. Here, MMA would submit one trade report to ACT indicating that MMA acted as agent and effected an agency cross.
-

Q. 11. Is it permissible for a market maker to use an omnibus account to allocate executions among agency, principal, and riskless principal accounts?

- A. Yes. A firm can maintain an omnibus account, which **cannot** be the firm's proprietary account (*i.e.*, the firm cannot hold proprietary positions in the account), from which it allocates executions to sub-accounts. When allocating to an agency or riskless principal sub-account, the firm must have record keeping and supervisory systems in place that can demonstrate, on an order-by-order basis, that, prior to execution, the firm had in hand the agency or riskless principal order to which the execution in the omnibus account relates.

IV. Trade Reporting Mixed Executions

As stated previously, Nasdaq and NASD Regulation recognize that in today's market environment market makers may be representing multiple customers in multiple capacities in a single transaction. In order to assist those market participants in properly categorizing their activities for regulatory and business purposes, Nasdaq has determined to provide a voluntary mechanism for firms to break out larger mixed capacity executions into their appropriate component parts. The following questions and examples illustrate how this mechanism will work.⁸

Example 3: Assume MMA is displaying 15,000 shares to buy at \$20.00. This quotation represents two agency institutional orders of 5,000 each, along with an additional 5,000 of proprietary interest for the purpose of trading with retail customers. The market maker has been given discretion by the agency customer, subject to available best execution opportunities, to fill the customer's agency orders, or any part of them, on a principal basis. MMB accesses MMA's entire quote of 15,000 shares through SuperSOES, which automatically reports the trade to ACT with MMA's capacity as principal.

Q. 12. How does MMA split out the mixed components of the execution?

- A. MMA would submit an ACT Regulatory Report for each agency portion of the trade it desired to split out from the original execution. Individual reports can be submitted for each order executed on an agency basis (*i.e.*, two ACT Regulatory Reports of 5,000 shares each), or all orders executed in the same capacity can be combined in a single report (*i.e.*, one ACT Regulatory Report for 10,000 shares). Assuming that the initial transaction report to ACT disclosed MMA's capacity as principal, there will be no additional report required to indicate that 5,000 shares of the original 15,000 share execution were effected on a principal basis, and Nasdaq and NASD Regulation will assume, for regulatory purposes, that the remaining portion was executed as principal.

Example 4:

Market is **\$12.95 - \$13.00**

MMA
is quoting **\$12.95 - \$13.10**

MMB
is quoting **\$12.70 - \$13.00**

MMA receives an institutional order to buy 10,000 shares at a price not to exceed \$13.00, plus an agreed upon, disclosed commission. The customer requests, and MMA agrees, to handle the order on an agency basis. MMA sends an order through SuperSOES, which executes all 10,000 shares against MMB at \$13.00.

Q. 13. MMA acted as agent and wishes to confirm the trade to the customer as agent. Is it permissible to change MMA's capacity to agency after the fact if MMA clearly documents the capacity in which it acted?

A. Yes. Although Nasdaq and NASD Regulation are of the view that, wherever possible, orders should be marked correctly for capacity purposes at the time of entry into a Nasdaq system, if a market maker is unable to accurately designate its trading capacity at that time (because, for example, it is acting in a mixed capacity), it may voluntarily adjust its capacity post-execution by using Nasdaq's new functionality.

However such a change may not be necessary in the above scenario. As the party that entered the SuperSOES order, MMA already possesses the capability of designating through SuperSOES its capacity as principal, riskless principal or agent when it enters the order that is executed against MMB.⁹ Note that, as of the date of this *Notice*, market participants cannot enter orders into SelectNet with a riskless principal capacity indicator.

Example 5: MMA receives an institutional order to buy 10,000 shares at a price not to exceed \$13.00, plus an agreed upon, disclosed commission. The customer instructs MMA to handle the order on an agency basis. MMA sends multiple SelectNet messages to fill the customer order. ECN 1 executes 9,000 shares and

ECN 2 executes 5,000 shares resulting in two executions totaling 14,000 shares at a price of \$13.00.

Q. 14. What happens to the "overbought" portion?

A. MMA must take the "overbought" portion into inventory. Because all 14,000 shares were executed at a price of \$13.00, it makes no difference which "portion" is allocated to the agency order, provided that the agency order is filled in its entirety. As the sender of the SelectNet orders, MMA may indicate agency (A) or principal (P) at the time of order entry. If MMA does not indicate agency at the time of order entry, it can change the capacity indicator to agency (A) for the order(s) by submitting an ACT Regulatory Report for those shares that are handled as agent. In the above scenario, therefore, the capacity indicator on the 9,000 shares that were purchased from ECN 1 would be changed to agency (A), and the 5,000 shares that were purchased from ECN 2 would be changed to reflect that only 1,000 shares were purchased as agent (with the remaining 4,000 shares of the 5,000 share execution having been purchased as principal).¹⁰

Firms should be mindful of their best execution obligations when receiving better-priced executions from ECNs at prices superior to their displayed quotations (*i.e.*, any price improvement received in such instances should be passed along to the customer).

Example 6: Assume MMA receives from Customer #1 a not held buy order for 10,000 shares at a price not to exceed \$13.00. MMA contemporaneously receives from Customer #2 a not held agency buy order for 10,000 shares at a price of \$13.00. MMA sends a SelectNet message to ECN 1 to buy 20,000 shares at \$13.00. ECN 1 executes 15,000 and moves to \$13.10.

Q. 15. How does MMA identify which portion of the execution goes to Customer #1 and which portion is allocated to Customer #2?

A. Neither Nasdaq nor NASD Regulation has mandated any particular order handling and execution priority procedures among orders. In this Example, MMA may, therefore, allocate executions among its accounts as long as it employs a reasonable methodology for allocating shares, which is adequately and properly disclosed to its customers, is fair, consistently applied, and does not unfairly discriminate against any particular class of accounts or types of orders. For example, a member could use a FIFO method for all orders, allocate to accounts on a pro-rata or an "even split" basis, or use other objective methodologies or formulae. It would be inappropriate, however, for a member's methodology to allocate shares to institutional orders over retail orders or to the orders of certain preferred accounts. To the extent a member elects to implement such an allocation methodology, the firm

must describe it in firm documentation on both a current and an historical basis.

The member must further ensure that its written supervisory procedures and supervisory system review the extent to which its chosen methodology allocates shares in a manner consistent with the duty of best execution.¹¹ Member firms should also understand that simply because they employ a methodology for allocating shares, and that methodology is followed in a particular circumstance, that it does not automatically mean that any or all customer orders executed pursuant to such a methodology received best execution. Lastly, firms are reminded that they must always treat limit orders that they have accepted in compliance with NASD Rule IM-2110-2 (the Limit Order Protection Interpretation, a.k.a. "Manning obligations").

Q. 16. In a mixed capacity trade that is, upon execution, originally allocated to an omnibus account, do Manning obligations arise at the time of execution or allocation?

- A. The presumption is that the entire amount of an execution effected in an omnibus account is effected as a principal or riskless principal transaction, and is therefore a triggering trade for the purposes of Manning obligations, at the time of execution. For mixed capacity executions, however, this presumption may be rebutted, and the amount of shares

subject to Manning protection reduced if, within a general time parameter of 60 seconds after the mixed capacity execution, all or a portion of the execution is allocated to an agency account. Allocations to an agency account more than 60 seconds after the original mixed capacity execution do not relieve a market maker of its Manning obligations to any protectable customer limit orders that it holds.

For example, MMA is displaying 10,000 shares to buy at \$20.00 in its quote. SuperSOES executes the full 10,000 shares, and MMA allocates those shares immediately to its omnibus account. Within 60 seconds of the SuperSOES executions, MMA, pursuant to its established allocation methodology, allocates 3,000 shares to an agency account for a 3,000 share not held agency order it is holding. In this hypothetical, MMA would, within a general time parameter of 60 seconds after the original mixed capacity execution, owe Manning fills up to 7,000 shares for any protectable limit orders that it was holding on its book to buy at \$20.00 or higher. In addition, any shares remaining in the omnibus account within 15 minutes of the original mixed capacity execution will be deemed to be a proprietary position of MMA and must therefore immediately be allocated by MMA from its omnibus account to its proprietary trading account (see Question 11).

V. Record Keeping Obligations

Q. 17. Does a member firm have record keeping obligations when trading in a mixed capacity basis?

- A. Yes. In addition to any applicable record keeping obligations under SEC Rules 17a-3 and 17a-4 and NASD Conduct Rule 3110, any member firm trading in a mixed capacity basis, regardless of whether they are voluntarily submitting ACT Regulatory Reports or not, must have in place systems and controls that produce records that enable the firm and NASD Regulation accurately to reconstruct, in a time-sequenced manner, the activity in accounts used to engage in mixed capacity trading. Accordingly, for any given period of time throughout the trading day, and for all accounts used to engage in mixed capacity trading, firms must be able readily to reconstruct for NASD Regulation the details of all orders worked on an agency or riskless principal basis, all trades that could have been attributed to an agency or riskless principal order and whether those trades were executed on an agency or riskless principal basis (using ACT Regulatory Reports or otherwise), or on a principal basis.

NASD Regulation will examine this activity to determine whether post-execution capacity adjustments were properly done and supported by the orders held by the firm at the time of the execution of the agency or riskless principal

quote or order. Conversely, NASD Regulation will examine this activity to determine whether the firm improperly refrained from post-execution capacity adjustments due these orders.

Failure to record and retain such information could result in disciplinary action. The inability to substantiate the capacity of a trade will also cause NASD Regulation to assume that the original (and potentially incorrect) capacity that it reported to ACT is its actual capacity and assess compliance with related regulatory obligations on that basis. Moreover, NASD Regulation will examine post-execution capacity adjustments (and failures to make adjustments) for possible best execution violations.

Q. 18. How can a member demonstrate that a trade was executed as “riskless principal” where the member executes both principal and riskless principal transactions?

A: The member must have written policies and procedures to assure that orders executed and reported as “riskless principal” comply with NASD Rules 4632, 4642, and 6420, which require that the transactions offsetting a customer order executed as riskless principal occur **after** the customer order is received **to satisfy** that order. At a minimum, these policies and procedures must require that the customer order was received prior to the offsetting transactions, and that the offsetting transactions are

allocated to the riskless principal account in a consistent manner and on a prompt basis. Members must have supervisory systems in place that can demonstrate order-by-order compliance with this requirement. The above standard would apply to agency transactions allocated to an omnibus account as well.

VI. Order Audit Trail Obligations (OATS)

The ability to allocate, on a voluntary basis, the components of a mixed capacity execution into its individual parts requires members to provide certain additional information to OATS. The following questions and answers have been prepared by NASD Regulation to assist member firms in this regard.

Q. 19. Are there any OATS requirements if a firm submits an ACT Regulatory Report to allocate the components of a mixed capacity execution?

A: Yes. If a firm chooses to allocate, on a voluntary basis, the components of a mixed capacity execution in ACT into its individual parts, then that firm’s OATS obligations are as follows:

For Orders Entered on Behalf of a Customer for Execution

Under current OATS requirements, a firm that enters an order into a Nasdaq system for execution must submit to OATS a Route Report indicating that the order was routed to a Nasdaq

system. However, if a member chooses to allocate, on a voluntary basis, the components of a mixed capacity execution in ACT into its individual parts, such an allocation will take place after the time of the original execution. In addition, given the post-trade allocation process envisioned by the use of ACT Regulatory Reports, which may involve allocations among several agency orders and/or principal and riskless principal accounts, it may be that a firm has executed an order before it has had an opportunity to create a Route Report for submission to OATS. Accordingly, in this instance, a firm must submit an Execution Report to OATS rather than a Route Report. If a firm is representing multiple customer orders in the same ACT Regulatory Report, it must ensure that each OATS Execution Report contains the same branch/sequence number as reported on the ACT Regulatory Report. Alternatively, the firm may submit an ACT Regulatory Report for each separate customer order that comprises the mixed capacity execution and each such entry must contain the necessary information to ensure that the OATS Execution Report(s) can be matched to the related ACT Regulatory Report(s).¹²

For Orders Displayed for Execution

Under current OATS requirements, a firm must submit to OATS a New Order Report and an Execution Report when an order it is displaying is executed against.¹³ This will still be the

case if a member chooses to allocate, on a voluntary basis, the components of a mixed capacity execution that resulted from a mixed capacity displayed order. However, if the firm does a voluntary allocation, it will be required to match the OATS Execution Report to the second ACT report (the ACT Regulatory Report) by entering a branch/sequence number in both the ACT Regulatory Report and the OATS Execution Report and omitting the Reporting Exception Code of "M" from the OATS Execution Report. If a firm is representing multiple customer orders in the same ACT Regulatory Report, it must ensure that each OATS Execution Report contains the same branch/sequence number as reported on the ACT Regulatory Report. Alternatively, the firm may submit an ACT Regulatory Report to ACT for each separate customer order that comprises the mixed capacity execution and each such entry must contain the necessary information to ensure that the OATS Execution Report(s) can be matched to the related ACT Regulatory Report(s).¹⁴

Q. 20. If a firm elects not to use the voluntary ACT Regulatory Report to break out the executions of agency orders, as outlined in Questions 7 and 8, above, but rather relies on another approach, are there any additional OATS reporting requirements for that firm?

A. Yes. If a firm chooses to allocate, through an approach other than the use of a voluntary ACT Regulatory

Report, the components of a mixed capacity execution into its individual parts, then that firm's OATS obligations are as follows:

For Orders Entered On Behalf Of A Customer For Execution

Because such allocations will take place after the time of the original execution, it may be that the firm has executed an order before it has had an opportunity to create a Route Report for submission to OATS. In this instance, a firm must submit an Execution Report to OATS rather than a Route Report. However, unlike the case where a voluntary ACT Regulatory Report is used, there will be no related ACT report submitted that reflects the post-execution allocation. Consequently, a firm electing not to use the voluntary ACT Regulatory Report to allocate the components of a mixed capacity execution must append a Reporting Exception Code of "M" to any Execution Report(s) submitted to OATS for post-execution allocation.

For Orders Displayed On Behalf Of A Customer For Execution

The firm's OATS reporting obligations in this situation are the same as its current OATS reporting obligations when an order that is displayed in a quotation is executed. That is, an Execution Report must be submitted to OATS with a Reporting Exception Code of "M" to indicate that no ACT match will take place because the firm did not have the ability, at the time its quote was accessed, to enter a

branch/sequence number into the Nasdaq system-generated ACT report.

Q. 21. When allocating the components of a mixed capacity execution, what time should be submitted in the execution time field of an OATS Execution Report, the time of the execution or the time of allocation?

A. The time of allocation, regardless of whether the member is using the voluntary (or any other) approach to track and record subsequent capacity adjustments to portions of mixed capacity executions.

Q. 22. Do my OATS obligations change if I am using the Update feature in ACT to change the capacity of the entire execution rather than using the ACT Regulatory Report option?

A. Yes. The Update feature not only allows the capacity indicator to be changed in ACT, but it also allows a change to, or the addition of, the branch/sequence number field. Therefore, if a branch/sequence number was not entered by the firm at the time of order entry, the firm must enter a branch/sequence number in the ACT Regulatory Report and include that same branch/sequence number on the related OATS Execution Report. In this case, the execution time on the OATS Execution Report must be the same as the execution time on the corresponding ACT Regulatory Report.

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Endnote(s)

- 1 Nothing in this *Notice to Members* is intended to change the rules applicable to markups, fair prices, and commissions. See, e.g., NASD Conduct Rule 2440, Interpretive Memorandum (IM) 2440, and *Notice to Members 92-16*.
- 2 The "Memo" field is available through all Nasdaq trade reporting mediums, including Computer-to-Computer Interface (CTCI), the ACT Trade Report Entry Screen on the NWII™ workstation, and the Application Program Interface (API). ACT assigns a control number to each trade report submitted to ACT. Nasdaq provides users with several methods for identifying the ACT control numbers assigned to trade reports, which will be discussed in greater detail in a later Technical Update.
- 3 See Section IV of this *Notice*.
- 4 See *Notice to Members 95-67*, at Question 5.
- 5 Nothing in this *Notice to Members* is intended to change the rules relating to the trading of Nasdaq SmallCap securities on Nasdaq's Small Order Execution System (SOES). See NASD Rules 4750-4756.
- 6 Firms may use the ACT Regulatory Report to break out the actual capacities of a mixed capacity execution in a variety of circumstances, including when they are: acting as the order sender or receiver (order-entry firm) through SuperSOES; acting as the order sender or receiver through SelectNet; and transacting through another execution venue, such as an ECN or ATS. In other words, members will have the ability to correct their capacity to a particular execution in ACT regardless of whether they are on the reporting side or the contra side to the execution and regardless of whether they received an execution through a Nasdaq system. Additionally, firms may use an ACT Regulatory Report to change the capacity on the entire original execution.
- 7 Submission of such reports is discussed in greater detail in Section IV of this *Notice*.
- 8 Nothing in this *Notice to Members* is intended to change the trade reporting requirements under the riskless principal trade reporting rules. See *NASD Notices to Members 99-65, 99-66, and 00-79*.
- 9 See Technical Update #2001-22, September 24, 2001, regarding specifications, enhancements, and modifications related to riskless principal transactions through API and CTCI. The ability to enter riskless principal transactions through NW II will go into effect first quarter 2002.
- 10 The allocation(s) to the agency account must occur within a general time parameter of 60 seconds in order to avoid potential Manning violations. Overbought shares in the proprietary account would trigger Manning obligations for any protectable limit orders the market maker was holding to buy at \$13 or higher. See Question 17.
- 11 See *Notices to Members 98-96 and 99-45*.
- 12 In order for OATS to electronically "match" the OATS Execution Report to the related ACT Regulatory Report, the MPID, Issue Symbol, Execution Date, Execution Time Stamp to the second, and the Branch/Sequence number must match exactly on both reports. For purposes of the ACT Regulatory Reports and related OATS Execution Reports, the time of allocation is entered into the time of execution field.
- 13 For these trades, the Execution Report must be submitted with a Reporting Exception Code of "M" to indicate that no ACT match will take place because the firm did not have the ability, at the time its quote was accessed, to enter a branch/sequence number into the ACT Regulatory Report.
- 14 See footnote 12 as to which elements of the OATS Execution Report and the related ACT Regulatory Report must match.

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