

Notice To Members

Notices

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Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Executive Representative
Legal & Compliance
Operations
Senior Management

KEY TOPICS

Investment Banking
Research Reports
Small Firms

REQUEST FOR COMMENT

ACTION REQUESTED BY AUGUST 30, 2002

Research Analysts and Research Reports

NASD Requests Comment on Application of Rule 2711 to Small Firms; **Comment Period Expires on August 30, 2002**

Executive Summary

On May 10, 2002, the Securities and Exchange Commission (SEC) approved new NASD Rule 2711, Research Analysts and Research Reports. The rule is intended to address potential conflicts of interest in the issuance of research reports by members, improve the objectivity of research, and provide investors with more useful and reliable information when making investment decisions. The SEC also approved on that day similar amendments to New York Stock Exchange (NYSE) Rule 472. The rules will be implemented in phases during the period from July 9, 2002 to November 6, 2002.

On July 1, 2002, NASD filed with the SEC a rule change that, among other things, delayed the effectiveness of two provisions of Rule 2711 for small firms. These delaying amendments establish November 6, 2002, as the effective date for Rules 2711(b) and (c) for members that have engaged in a limited number of investment banking transactions over the previous three years. Rules 2711(b) and (c) prohibit a research analyst from being subject to the supervision or control of the member's investment banking department and require compliance personnel to intermediate certain communications between research, investment banking, and the company that is the subject of the research report.

This *Notice* requests comment on whether smaller NASD members should be exempt from certain provisions of Rule 2711. The *Notice* seeks comment on which provisions of Rule 2711 present the greatest challenges for small firms. To the extent NASD determines that it should provide exemptions for small firms, NASD invites comment on which firms should be eligible for these exemptions.

Questions or comments concerning NASD Rule 2711 or this *Notice* may be directed to the NASD Corporate Financing Department at (240) 386-4623.

Request for Comment

NASD requests comment on whether certain small members should be eligible for exemptions from certain provisions of NASD Rule 2711. Comments must be received by August 30, 2002. Members and interested persons can submit their comments using the following methods:

- + mailing in Attachment A—Request for Comment Form—along with written comments
- + mailing in written comments
- + e-mailing written comments to pubcom@nasd.com
- + submitting written comments online on our Web Site (www.nasd.com)

Written comments submitted via hard copy should be mailed to:

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

Important Note: The only comments that will be considered are those submitted in writing by mail, our Web Site, or by e-mail.

Before becoming effective, any rule change developed as a result of responses received to this *Notice* must be approved by the NASD Board of Governors and the SEC.

Background and Discussion

Delaying Amendments for Small Firms

In response to requests from some of our smaller members, on July 1, 2002, NASD filed with the SEC a rule change that, among other things, established November 6, 2002, as the effective date for Rules 2711(b) and (c) for smaller members. These delaying amendments applied to members that over the previous three years, on average each year, have: participated in 10 or fewer investment banking transactions as manager or co-manager; and generated no more than \$5 million in gross investment banking revenues from those transactions.

Regulatory Relief for Small Firms

NASD is soliciting comment during the delay on whether small firms should be eligible for exemptions from certain provisions of Rule 2711 on a permanent basis. Accordingly, NASD requests comment on several questions.

First, NASD requests comment on the potential conflicts of interest faced by smaller firms when they issue research reports. Are the research reports issued by smaller firms any more or less objective than those issued by larger firms? What factors account for any differences in objectivity? To what extent do the conflicts of interest faced by smaller firms differ from those faced by larger firms?

Second, NASD requests comment on whether smaller firms have adopted procedures, other than those required by Rule 2711, to address these conflicts. How effective have any such procedures been?

Third, NASD requests comment on whether any provision of Rule 2711 imposes a burden that is unique to smaller firms. Does any unique burden outweigh any potential benefit to the investing public, and thus justify an exemption for smaller firms?

Fourth, if NASD determined to provide an exemption from certain provisions of the rule to smaller firms, what would be the best method to differentiate between firms that should be eligible for the exemption and those that should not be eligible? Is the transactions and revenues test that was adopted for the delaying amendment appropriate? Are there factors other than the number of investment banking transactions or the amount of investment banking revenues that NASD should consider in determining which members are "small firms"?

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ATTACHMENT A

Request for Comment Form

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

Instructions

Comments must be received by August 30, 2002. Members and interested parties can submit their comments using the following methods:

- + mailing in this form with attached comments
- + mailing in written comments
- + e-mailing written comments to pubcom@nasd.com
- + submitting comments online at our Web Site (www.nasd.com)

This form and/or written comments should be mailed to:

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

Research Analysts and Research Reposts

The staff requests input from members and other interested parties on whether NASD should grant regulatory relief from NASD Rule 2711 for small firms. In particular, the staff seeks comment on the following questions:

1. Are research reports issued by smaller firms more objective than those issued by larger firms?
 Yes No See my attached written comments
2. Do the conflicts of interest faced by smaller NASD firms when they issue research reports differ from those faced by other members?
 Yes No See my attached written comments
3. Have smaller firms adopted procedures, other than those required by Rule 2711, to address conflicts of interest that arise when they issue research reports?
 Yes No See my attached written comments
4. Does any provision of NASD Rule 2711 impose a burden that is unique to smaller firms?
 Yes No See my attached written comments
5. Does any unique burden imposed on smaller firms by a provision of Rule 2711 outweigh the potential benefits to the investing public from the provision, and thus justify an exemption for small firms?
 Yes No See my attached written comments
6. Is the appropriate test for determining which firms qualify for regulatory relief from Rule 2711 a test that includes members that, on average over the past three years, have participated in 10 or fewer investment banking transactions as manager or co-manager and generated \$5 million or less in gross investment banking revenues from those transactions?
 Yes No See my attached written comments
7. Are there factors other than the number of investment banking transactions and amount of investment banking revenues that NASD should consider in determining which firms qualify for regulatory relief?
 Yes No See my attached written comments

Contact Information

Name: _____

Firm: _____

Address: _____

City/State/Zip: _____

Phone: _____

E-Mail: _____

Are you:

An NASD Member

An Investor

A Registered Representative

Other: _____

Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Senior Management
Legal and Compliance
Operations
Trading
Market Making

KEY TOPICS

Alternative Display Facility

Alternative Display Facility (ADF) Nine-Month Pilot
Approved for Trading in Nasdaq Securities

Executive Summary

On July 24, 2002, the Securities and Exchange Commission (SEC) approved amendments to NASD rules that establish, implement, and operate NASD's Alternative Display Facility (ADF) on a pilot basis for nine months.¹ As described in more detail herein, members that choose to participate in the ADF during the pilot may quote and trade Nasdaq-listed securities on or through the ADF, commencing on July 29, 2002. NASD has proposed the permanent establishment and operation of the ADF in a separate rule filing, which would provide market participants the ability to quote and trade Nasdaq and exchange-listed securities.² However, several regulatory issues relating to the trading of exchange-listed securities on the ADF have not been resolved. Because these open issues do not relate to trading Nasdaq securities, NASD has received approval to operate the ADF on a pilot basis with respect to Nasdaq securities only.

The SEC Approval Order, which includes the text of the amendments, is available at <http://www.sec.gov/rules/sro/34-46249.html>. This Notice is intended to provide an overview of how the ADF will operate and member requirements in this regard. For additional information regarding ADF, members should review the SEC Approval Order and other ADF documentation available at http://www.nasd.com/mkt_sys/adf_info.asp.

Questions concerning this Notice related to the rules should be directed to either the Division of Regulatory Policy and Oversight, Office of General Counsel, at (202) 728-8071, or Market Regulation Department, at (240) 386-5126. Questions related to the operation of the ADF or becoming an ADF participant should be directed to the Division of Regulatory Services and Operations, Market Operations and Information Services, at (866) 776-0800 or (212) 858-5178.

02-45

Background

The ADF is a quotation collection, trade comparison, and trade reporting facility developed by NASD in accordance with the SEC's SuperMontage Approval Order³ and in conjunction with The Nasdaq Stock Market, Inc.'s (Nasdaq) anticipated registration as a national securities exchange.⁴ Initially, the ADF will be operated on a pilot basis for nine months. During the pilot, ADF market participants (market makers and ECNs) will be able to post quotations in Nasdaq securities and all members that participate in the ADF will be able to view quotations and report transactions in Nasdaq securities. The facility also will provide for trade reporting and comparison through the Trade Reporting and Comparison Service ("TRACS"), which is described in detail below.

Because the ADF pilot will be operating prior to the approval of Nasdaq's registration as an exchange, NASD will operate both Nasdaq and the ADF during the pilot period. Accordingly, the new rules applicable to quotation and trading requirements for activities through the ADF are separate from the quotation and trading rules relating to Nasdaq. Certain rules applicable to trading on Nasdaq have been amended, but only to reflect that members that choose to participate in both Nasdaq and the ADF may elect to trade report to either facility, except as specifically described herein. Otherwise, rules applicable to trading on Nasdaq have not changed.

The ADF trade reporting rules are consistent with current requirements applicable to Nasdaq market participants and are not intended to require new or different trade reporting responsibilities for parties to transactions. As described

in more detail herein, the new Rule 5400 Series details which party to a transaction has the trade reporting responsibility and where (ADF or Nasdaq) the party with the trade reporting responsibility is required, or has the choice, to trade report.

Market Maker and ECN Registration

Similar to the existing rules applicable to Nasdaq market makers, ADF participants must register as market makers or ECNs to make a market or display orders on the ADF. Market makers will receive approval for registration upon demonstration that they are members in good standing and comply with the net capital and other financial responsibility requirements of the Exchange Act. To ease the administrative burden on NASD members, the pilot ADF rules initially will allow registration as a market maker in the ADF upon proof that a member is a registered Nasdaq market maker.

The ADF rules track Nasdaq requirements that market makers maintain continuous two-sided firm quotations and prescribes market maker obligations when a bid or offer locks or crosses the market. ECNs, however, may post one-sided quotes in the ADF. If an ADF Market Maker that also is a Nasdaq Market Maker is seeking excused withdrawal status, it must obtain such excused withdrawal status in both facilities for the same time period.

The ADF rules also provide that registration as an ADF market maker in a security is voluntarily terminated when the market maker: (1) withdraws its quotations from the ADF and does not re-enter quotations in the security for five minutes; or (2) fails to re-enter quotations within 30 minutes after the end of a trading halt. In either

circumstance, a market maker would be prohibited from participating as an ADF market maker in that security for twenty (20) business days.

Order Access Rule

NASD will not provide an order routing capability. Instead, the pilot ADF Rule 4300A ("order access rule") requires NASD "market participants" to provide "direct electronic access" to other "market participants" and to provide to all other NASD members "direct electronic access" or allow for "indirect electronic access" to the individual market participant's quote ("order access rule"). The rule defines "market participants" as either an ADF Registered Market Maker, or an ADF Registered ECN or ATS. In other words, "market participants" are those members that post quotations in the ADF.

As stated above, the order access rule requires market participants to provide other market participants with direct electronic access to their quotes. "Direct electronic access" is defined in the rule as the ability to deliver an order for execution directly against an individual NASD market participant's best bid or offer without the need for voice communication, with equivalent speed, reliability, availability, and cost, as are made available to NASD market participants' own customers. Therefore, while the linkage must be electronic — telephone access is insufficient — the rule allows market participants flexibility to determine the type and method of linkage. For example, market participants are permitted to link directly among themselves bilaterally using their own technology or to use a provider with multilateral order routing facilities to satisfy the linkage requirements. The rule

requires that a market participant be equally accessible to all other market participants via this electronic link.

The rule also requires market participants to provide all other NASD broker/dealer members (*i.e.*, those members that do not quote in ADF but want to access ADF quotes) with direct electronic access or allow for "indirect electronic access" through their customer broker/dealers. "Indirect electronic access" is defined as the ability to route an order through a market participant's customer broker/dealer for execution against the market participant's best bid and offer, without the need for voice communication, with equivalent speed, reliability, availability, and cost, as are made available to the market participant's customer broker/dealer providing access to the market participant's quotes.

A market participant may not deny indirect access to its quotes by requiring that all broker/dealers link directly to it. The requirement to allow for indirect access also does not permit market participants to refuse direct access to members that would prefer direct connectivity; rather, it creates an additional means for non-market participant broker/dealers to access market participants' quotes.

The order access rule applies only to a market participant's top of book, *i.e.*, the best bid and offer that is displayed in the ADF. Therefore, market participants retain substantial flexibility to negotiate the terms of many other services, such as full book access, placing orders, and use of reserve sizes. ECNs are permitted to charge more for "hit or take" access only — purely a liquidity taking function — than for full subscriber services, provided that the fee is reasonable, based on objective criteria, and not imposed discriminatorily.

Costs of Providing Order Access

Market participants must share equally the costs of providing to each other the direct electronic access required by the rule, unless those market participants agree upon another cost-sharing arrangement. For example, assume the ADF consisted of five market participants and a sixth broker/dealer registered as an ADF market participant. Under this scenario, each of the five existing market participants would be required to split with the new market participant the costs to establish their respective bilateral links with the new market participant, unless the parties agreed upon a different cost allocation.

Market participants also must pay the costs to enable direct electronic access to their quotes by non-market participant broker/dealers seeking access. Thus, a market participant must bear the costs to build, upgrade, or otherwise reconfigure its technology to allow other broker/dealers to connect to it, including the costs to accommodate additional volume resulting from indirect electronic access order flow through customer broker/dealers. Similarly, those non-market participant broker/dealers seeking access to a market participant's quote must bear the line or other costs necessary to connect with a market participant's network.

A customer broker/dealer may charge its customers a fee to provide indirect access to a market participant's quotes. A market participant may not influence or prescribe what a customer broker/dealer may charge its customers for indirect access to the market participant.⁵ Further, a market participant may not preclude or discourage a specific customer broker/dealer from providing indirect access, either through discriminatory pricing or

by degrading its quality of service to its customer broker/dealer. A market participant may, however, offer to provide direct electronic access at a competitive price as part of the services it provides to customers.

Connectivity costs should be distinguished from fees for various other services provided by market participants. NASD recognizes that market participants have a variety of existing business relationships with broker/dealers for which they charge fees for services rendered, e.g., the handling of limit orders, price improvement opportunities, and liquidity enhancement. Market participants may continue to assess fees for these types of services, as permissible under current rules and regulations.

While ECNs may charge to execute against their best bid and offer, the fee must be based on reasonable and objective criteria. And while ECNs are permitted under the proposal to charge more for hit-or-take access than for full service access, they may not impose hit-or-take fees in a way that discriminates against a particular broker/dealer or class of broker/dealers. Thus, in setting its fee schedule, an ECN may not look through its order flow to identify and discriminate against the source of the order flow, e.g., a competitor or a broker/dealer that is accessing the quote indirectly. Rather, an ECN may set a reasonable fee for order flow that takes liquidity – a fee that may be higher than for order flow that provides liquidity — and apply that fee to all such order flow, irrespective of its origin. Similarly, an ECN that offers a volume discount must offer the same terms to all broker/dealers accessing its quote via direct or indirect access, without regard to the identity of the broker/dealer or the source of its order flow.

Minimum Performance Standards

To ensure that ADF quotes are reliable and accessible, order access linkages must meet specified minimum performance standards. Specifically, the pilot ADF rules impose a technological requirement on market participants, mandating that their order linkage system provide them the capability to respond to an order – *i.e.* accept or decline it – from another market participant or customer broker/dealer, within two seconds of receipt. Additionally, market participants are required to have in place a system that can accomplish a “round trip” of an order from another market participant in three or fewer seconds, measured from the time an order is released by a market participant until the time notification of action taken on the order is received back by the market participant that sent the order.

Market participants will be required to certify that their systems can meet these standards at peak capacity, based on reasonable forecasts, before they are authorized to post quotes on the ADF. On an ongoing basis, market participants will be required to re-certify that they can meet these performance standards when volumes exceed those on which the initial certification was based. NASD will review test data to confirm the accuracy of such certifications.

It is important to note that these performance standards are independent of existing firm quote requirements in Exchange Act Rule 11Ac1-1, NASD Rule 3320, and new NASD Rule 4613A(b), which require prompt execution of an order up to the quotation size displayed by the market participant upon receipt of an order to buy or sell. The performance standards ensure that all market participants have adequate technology that will not degrade the

overall accessibility of ADF quotes. By comparison, the firm quote rule addresses market participants’ obligation to honor their quotes when they receive an order. Accordingly, the performance standards do not require market makers to fill orders in two seconds; however, due to their structure, broker/dealers whose business models rely primarily upon electronic executions systems, for example, ECNs, would be expected to fill orders in less than two seconds.

Market Participant Inaccessibility

To further ensure the reliability of linkages and the integrity of the ADF, NASD will have the authority to suspend from quoting or displaying orders for 20 business days any market participant that experiences three unexcused, confirmed system outages during any period of five business days. System outages are defined as an inability to quote or an inability to respond to orders. A review and appeal process is available, whereby the burden will rest with the market participant to establish that a confirmed system outage was attributable to another party. NASD will have discretion to excuse certain outages where the market participant voluntarily brings the matter to the attention of NASD. NASD also will receive and investigate complaints related to failure to provide direct or indirect access. Complaints of this nature can be reported to NASD, Market Operations at (866) 776-0800 or (212) 858-5178.

Reporting of Order Access Data to NASD

To allow NASD to monitor compliance with certain trading rules, such as the firm quote rule and “trade or move” rules, all market participants that display quotations or orders in the ADF must record specified items of information

pertaining to orders they receive from broker/dealers via direct or indirect electronic access and report this information to NASD on a real-time basis. This information must be provided to NASD within 10 seconds of the receipt of an order and, if applicable, when an order is acted upon or responded to.

Trade Reporting and Trade Comparison Service

As described above, TRACS is a trade reporting and comparison service that will operate as part of the ADF pilot. TRACS will collect trade reports for NASD registered market participants, as well as any NASD member that chooses to or is required to report transactions through the ADF. The service will transmit the reports automatically to the Exclusive Securities Information Processor (ESIP), if required, for dissemination to the public and the industry.

TRACS operates similarly to the trade reporting functions of Nasdaq's Automated Confirmation Transaction Service (ACT)⁶ but contains one notable distinguishing feature. TRACS supports a "three party trade report" that will make it easier for ECNs to submit trade reports involving their subscribers and for market makers to submit riskless principal trade reports. A three party trade report is a single last sale trade report that will denote one reporting member – *i.e.*, the party with the trade reporting responsibility as defined in the Rule 4630A Series – and two contra parties. The ADF will split the three party trade report into two separate reports that will then be processed independently in accordance with existing trade reporting rules. Each of these reports will contain its own identifier and a reference to the original three party trade report, so that

the separate reports can be mapped to the same transaction. Therefore, the ADF trade reporting system streamlines the reporting process by reducing from three or two to one the number of trade reports for most ECN and riskless principal transactions.

The TRAC's trade comparison service: (1) compares trade information entered by TRACS participants and submits "locked-in" trades to clearance and settlement; (2) transmits reports of the transactions automatically to the ESIP, if required, for dissemination to the public and the industry; and (3) provides participants with monitoring capabilities to facilitate participation in a "locked-in" trading environment. The trade comparison rules are found in the new Rule 6100A Series.

For those trades where one party is a TRACS subscriber and the other party is an ACT subscriber, both TRACS and ACT will accept one-sided trade reports and submit those trades to the National Securities Clearing Corporation (NSCC). In such cases, NSCC will compare the trade.

Transaction Reporting

The pilot rules adopt the current Nasdaq approach to trade reporting for Nasdaq securities, regardless of whether the member is reporting through TRACS or ACT. The pilot rules adopt a new Rule 5430(b), which designates which party to a transaction has the trade reporting responsibility and where, TRACS or ACT, the party with the trade reporting responsibility is required, or has the choice, to trade report.

Specifically, Rule 5430(b) requires that the seller report trades between two market makers or two non-market makers, the market maker report trades between it and a customer, and an NASD member

report trades between it and a customer. NASD members that are market makers in both the ADF and Nasdaq and have a trade reporting obligation under the rule, have a choice to trade report to ADF or Nasdaq, except for those transactions that are executed or facilitated by a Nasdaq system. If a member is a market maker in either Nasdaq or the ADF, but not the other facility, and has a trade reporting obligation under the rule, the member must report to the facility in which it is a market maker.

For example, if a member is an ADF market maker, but not a Nasdaq market maker, in a security, the member, if it has a trade reporting obligation, must report the transaction in that security to TRACS, unless the trade is executed using ACES, the Nasdaq National Market Execution System (NNMS), the SelectNet Service, the SmallCap Small Order Execution System (SOES), or the Primex Auction System (Primex). A trade executed using ACES must be reported using ACT, and trades executed using NNMS, SelectNet, SOES, or Primex will be reported to ACT automatically. A member that is not a market maker in either facility but is a participant in both facilities and has a trade reporting obligation may trade report to either facility, unless the trade is executed using ACES, NNMS, SelectNet, SOES, or Primex.

With respect to trade reporting by ECNs, ECNs that currently display quotes in Nasdaq have developed different methods of reporting trades. ECNs may continue to report to Nasdaq and/or the ADF in this same manner.

Short Sale Rule

The short sale rule and its accompanying interpretation have been amended for the purposes of the pilot to provide that the current Nasdaq short rule applies to trading in Nasdaq-listed issues on the ADF. Specifically, members trading on the ADF must comply with the short sale rule based on the national best bid, as currently required under Rule 3350, and also includes the current exemption for registered market makers engaged in bona fide market making activity. The short sale rule will continue to apply as it does today to short sale activities on Nasdaq.

Trading Halts

Rule 4120A provides NASD with authority to halt trading through the ADF in Nasdaq securities. ADF will halt trading when another market halts trading in a security for regulatory reasons. If another market halts trading for operational reasons, market participants may continue to trade in the ADF and would be required to meet all applicable trade reporting requirements. In addition, the ADF has the authority to close ADF to quotation activity when the ADF is unable to transmit real-time quotation and trade reporting data to the ESIP. Under such circumstances where the ADF closes due to an inability to transmit quotation or trade reporting data under Rule 4120A(a)(2), members would not be prohibited from trading through, another market, such as Nasdaq, that has not halted trading, or within their own systems.

Any trading halt initiated by NASD would become effective simultaneously with notification via an administrative message sent through the ADF terminal or interface. Trading similarly would resume after an administrative notice has been issued.

Obligations When Quoting in Multiple Market Centers

Existing Rule 2320(g)(2) requires members that display quotations for non-Nasdaq securities in two or more quotation mediums to post the same priced quotations in each medium. Similar to this obligation, new Rule 4613A(e)(1) requires members that display quotations for Nasdaq securities in two or more market centers, including the ADF, to display the same priced quotations in each medium. It does not, however, prohibit displaying different size quotations in two or more mediums or market centers, provided that the price displayed is the same.

Obligation to Have Quotations From Other Market Centers in Close Proximity

New Rule 4613A(e)(2) requires a registered NASD market maker to have in close proximity to the ADF terminal or interface at which it makes a market in a Nasdaq security a quotation service that disseminates quotations in that security from other market centers. A similar rule, Rule 6330(c), currently exists with respect to Consolidated Quotation Service (CQS) market makers. As with the CQS rule, it is NASD's intention for the quotations displayed in the ADF terminals or interfaces to function as a verification mechanism whereby ADF market

participants can monitor their current ADF quotations and ensure that NASD is timely updating and disseminating their quotations. NASD will not disseminate to ADF market participants any consolidated quotation or trade data in a security from securities exchanges and market centers. To ensure that ADF participants have the data necessary to make proper order routing decisions and to satisfy the Vendor Display Rule,⁷ NASD requires ADF market participants to obtain from vendors dynamic quotations and last-sale information on the securities they trade through the ADF, and to display this data in close proximity to the ADF data displayed on their terminals, just as is currently required of CQS market makers in Rule 6330(c).

OATS Requirements

OATS requirements will remain substantially the same as current requirements, with one exception. All NASD members must complete an additional field on the OATS execution report indicating where the order was reported. This requirement will enable NASD to clearly identify which execution reports are associated with ADF trade reports and which are associated with Nasdaq trade reports and, thereby, keep this data separate and confidential, as necessary. This requirement will not be effective until September 27, 2002, to allow time for necessary system changes.

All NASD members must continue to record in electronic form and report to NASD on a daily basis certain information with respect to orders originated, received, transmitted, modified, canceled, or executed ("reportable events") by NASD members relating to equity securities traded on Nasdaq. When the

ADF and Nasdaq are both operating, NASD members, in many cases, will have at least two options as to where they may choose to report their transactions in Nasdaq securities. As such, NASD must "match" OATS execution reports to either TRACS data or ACT data, depending upon where the transaction was reported. By having a field in the OATS execution report indicating where the order was reported, NASD systems will be able to more efficiently compare the execution report to the appropriate trade report.

Fees and Assessments

The fees and assessments applicable to activities through the ADF are contained in the new Rule 7000A Series. The following are fees that will be charged relating to transactions on the ADF: Comparison — \$0.014/side per 100 shares (minimum 400 shares; maximum 7,500 shares); Automated Give-Up — \$0.029/side; Late Report - T+N — \$0.30/side; Browse/query — \$0.28/query; Trade Reporting — \$0.029/side (applicable only to reportable transaction not subject to trade comparison through TRACS); and Corrective Transaction Charge —\$0.25.

Members choosing to participate in the ADF will be charged a minimum of \$5,000 for installation costs associated with connecting to the ADF. Additional reimbursement from members will be required for charges incurred by NASD above \$5,000 due to the installation, removal, relocation, or maintenance of terminal and related equipment. However, the ADF will provide members with a credit of up to \$5,000 toward their trade reporting and comparison charges. Members also will be charged an ADF workstation fee of \$275 per month for

each ADF terminal software license and \$550 per month for each ADF server license.

ADF market participants will be charged a quotation update fee of \$.01 per quotation update in the ADF quotation montage. This quotation update fee, however, will apply only to those quotation updates by the member in the ADF that exceed three times the number of transactions reported by the member through the ADF. This quotation update fee will be determined on a monthly basis. By imposing this fee only where the quotation updates significantly exceed the number of transactions reported, this fee structure fairly imposes costs on those members whose quotation activity creates system capacity demands and, therefore, costs not covered by trade reporting fees.

Fee Waiver and Discount

ADF participants will not be charged for transaction and quotation update fees (Rules 7010A(a) and (b), respectively) for a period of up to three months during the initial six months of operation of the ADF. As a result, during this six-month period, for up to three months starting from the initial transaction by an ADF participant, a participant will not be charged transaction or quotation fees. However, the time period for which the three-month "fee waiver" is available concludes at the end of the six-month period, irrespective of whether the member has participated in the ADF for three months. For example, if the ADF has been operational for four months and a market participant begins trading at that time, it only would be eligible for the "fee waiver" for two months.

Also during the initial six months of operation of the ADF, NASD will adjust its fees imposed on trade reporting and quotation activities through the ADF to provide for volume discounts subsequent to the three month "fee waiver" period, as applicable. Specifically, discounted fees will apply to those members that have greater than 2,000 trades per month and for those members that have greater than 8,000 chargeable quotes per month. The volume discounts would apply to all transaction fees incurred under Rule 7010A(a), except the browse/query fee, and all quotation update fees incurred under Rule 7010A(b). The discounts would apply in the increments per the chart below.

For example, if a member had 5,000 trades and 16,000 quotation updates during a month, the discounted fee structure would apply as follows: no discount would apply to the first 2,000 trades; the fees imposed on trades 2,001 through 4,000 would be discounted by 10%; and the fees imposed on trades 4,001 through 5,000 would be discounted by 25%. The quotation update charge on 1,000 quotations (those quotations that exceed three times the number of trades) would not be discounted because it is less than 8,001.

For additional information regarding requirements related to quoting and/or trading through the ADF, members should review the rule text, SEC Approval Order, and other additional ADF documentation available at http://www.nasd.com/mkt_sys/adf_info.asp.

Trades per Month	Chargeable Quote Updates per Month	Discount
Up to 2,000	Up to 8,000	0%
2,001 to 4,000	8,001 to 15,000	10%
4,001 to 6,000	15,001 to 25,000	25%
6,001 to 8,000	25,001 to 35,000	35%
8,001 or greater	35,001 or greater	50%

Endnotes

- 1 See Securities Exchange Act Release No. 46249 (July 24, 2002), (File No. SR-NASD-2002-97) ("SEC Approval Order").
- 2 See SR-NASD-2001-90. It is possible that the SEC may take action prior the expiration of the pilot period on the proposed rule change to make permanent the ADF for trading both Nasdaq and exchange-listed securities. Fees and assessments applicable to the ADF on a permanent basis are proposed in SR-NASD-2002-28.
- 3 Securities Exchange Act Release No. 43863 (January 19, 2001), 66 Fed. Reg. 8020 (January 26, 2001) (File No. SR-NASD-99-53).
- 4 Securities Exchange Act Release No. 44396 (June 7, 2001), 66 Fed. Reg. 31952 (June 13, 2001) (File No. 10-131).
- 5 The fact that a market participant has an ownership interest in a customer broker/dealer or multilateral linkage provider does not, in itself, constitute influence for the purposes of this rule.
- 6 TRACS will not perform risk management services that are provided by Nasdaq's ACT service.
- 7 Exchange Act Rule 11Ac1-2.

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Special Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Legal & Compliance
Senior Management

KEY TOPICS

National Adjudicatory Council

INFORMATIONAL

NAC Nominations

NASD Announces Nomination Procedures for Regional Industry Member Vacancy on the National Adjudicatory Council; **Nomination Deadline: September 5, 2002**

Executive Summary

The purpose of this *Special Notice to Members* is to advise members of the nomination procedures to fill one upcoming vacancy on the National Adjudicatory Council (NAC). The three-year term of the NAC regional Industry member from the North Region expires in January 2003.

Exhibit I contains information regarding the NAC regional Industry member whose term expires in January 2003. Exhibit II contains a list of all NAC members. The procedures to fill the NAC regional Industry vacancies are outlined in Exhibit III. Also, a Candidate Profile Sheet is included in Exhibit IV.

Nomination Process

Members are encouraged to submit nominations for the upcoming NAC vacancy. To nominate a candidate, members should submit a cover letter and the Candidate Profile Sheet (Exhibit IV) to the appropriate Regional Nominating Committee Chair, the NASD District Director, or NASD Corporate Secretary (listed in Exhibit I) by **September 5, 2002**.

The completed Candidate Profile Sheets will be provided to all Regional Nominating Committee members for review. On or about **September 19, 2002**, the Regional Nominating Committee will provide NASD members with written notice of the NAC candidate that the Committee proposes for nomination to the National Nominating Committee. Pursuant to Article V, Section 5.3(a) of the NASD Regulation By-Laws, the NASD National Nominating Committee shall nominate all candidates for the NAC for subsequent appointment by the Board.

02-46

Questions/Further Information

Questions concerning this *Special Notice to Members* may be directed to the District Directors listed in Exhibit I or to Barbara Z. Sweeney, Senior Vice President and Corporate Secretary, NASD, at (202) 728-8062 or via e-mail at barbara.sweeney@nasd.com.

National Adjudicatory Council Membership and Function

Membership

The NAC consists of 14 members—seven Industry members and seven Non-Industry members. Exhibit II contains a list of all current NAC members. Two Industry members are appointed by the NASD Regulation Board of Directors as at-large members. Five Industry members each represent one of the following geographic regions:

West Region: Hawaii, California, Nevada, Arizona, Colorado, New Mexico, Utah, Wyoming, Alaska, Idaho, Montana, Oregon, and Washington.

South Region: Alabama, Arkansas, Kentucky, Louisiana, Mississippi, Oklahoma, Tennessee, Texas, Florida, Georgia, North Carolina, South Carolina, Puerto Rico, Virginia, Canal Zone, and the Virgin Islands.

Central Region: Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota, Illinois, Indiana, Michigan, Western New York state, and Wisconsin.

North Region: Delaware, Maryland, Pennsylvania, West Virginia, District of Columbia, New Jersey, Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont, and New York (except for New York City, Long Island, and Western New York state).

New York: New York City and Long Island.

We are seeking nominations for the North Region.

Function

According to the NASD By-Laws, the NAC is authorized to act for the NASD Board of Governors in matters concerning:

- ◆ appeals or reviews of disciplinary proceedings, statutory disqualification proceedings, or membership proceedings;
- ◆ the exercise of exemptive authority; and
- ◆ other proceedings or actions authorized by NASD rules.

The NAC also considers and makes recommendations to the Board on enforcement policy and rule changes relating to the business and sales practices of NASD members and associated persons.

EXHIBIT I

NAC Industry Member With A Term Expiring In January 2003

North Region (Districts 9 and 11)

NAC Incumbent: Theodore W. Urban

If you are interested in nominating yourself or a colleague to represent the North Region for a three-year term on the NAC, please submit a cover letter and a completed Candidate Profile Sheet (Exhibit IV) to any of the following individuals by September 5, 2002.

Peter Wheeler

Regional Committee Chair

One University Office Park
29 Sawyer Road
Waltham, MA 02453-3483
(781) 736-0700

John P. Nocella

District 9 Director

NASD
11 Penn Center
1835 Market Street, 19th Floor
Philadelphia, PA 19103
(215) 665-1180

Gary K. Liebowitz

District 9 Director

NASD
581 Main Street, 7th floor
Woodbridge, NJ 07095
(732) 596-2000

Fred McDonald

District 11 Director

NASD
260 Franklin Street, 16th Floor
Boston, MA 02110
(617) 261-0800

Barbara Z. Sweeney

Senior Vice President and Corporate Secretary

NASD
1735 K Street NW
Washington, DC 20006
(202) 728-8062

EXHIBIT II

2002 National Adjudicatory Council

Mary E.T. Beach	Attorney
Herbert H. Brown	Attorney
David A. DeMuro	Lehman Brothers
Alice T. Kane	Blaylock
Douglas L. Kelly	A.G. Edwards & Sons, Inc.
Philip R. Lochner	Director of Public Companies
Mark Madoff	Bernard L. Madoff
Philip V. Oppenheimer	Oppenheimer & Close, Inc.
Mark A. Sargent	Villanova University School of Law
Richard O. Scribner	Recording for the Blind & Dyslexic
William A. Svoboda	Morgan Stanley
Theodore W. Urban	Ferris, Baker Watts, Incorporated
Barbara L. Weaver	Legg Mason Wood Walker, Inc.
Elliott J. Weiss	University of Arizona College of Law

EXHIBIT III

National Adjudicatory Council Nomination Procedures

1. NASD maintains Regional Nominating Committees in the manner specified in Article VI of the By-Laws of NASD Regulation, Inc.
2. Members located in the North Region are hereby notified of the upcoming election of members to the National Adjudicatory Council and are encouraged to submit names of potential candidates to their respective Chair of the Regional Nominating Committee, District Director, or to NASD Corporate Secretary Barbara Z. Sweeney (see Exhibit I) by **September 5, 2002**.
3. Nominees will be asked to complete a Candidate Profile Sheet which will be reviewed by the Regional Nominating Committee.
4. The Regional Nominating Committee shall review the background of the candidates and the description of the NASD membership provided by NASD staff and shall propose one or more candidates for nomination to the National Nominating Committee. In proposing a candidate for nomination, the Regional Nominating Committee shall endeavor to secure appropriate and fair representation of the region.
5. On or about **September 19, 2002**, the Regional Nominating Committee shall notify in writing the Executive Representatives and branch offices of the NASD members in the region the name of the candidate it will propose to the National Nominating Committee for nomination to the National Adjudicatory Council.
6. If an officer, director, or employee of an NASD member in the region is not proposed for nomination by the Regional Nominating Committee and wants to seek the nomination, he or she shall send a written notice to the Regional Nominating Committee Chair or the Secretary of NASD within 14 calendar days after the mailing date of the Regional Nominating Committee's notice (#5 above) and proceed in accordance with the Contested Nomination Procedures found in Article VI of the NASDR By-Laws.
7. If no additional candidate comes forward within 14 calendar days, the Regional Nominating Committees shall certify their candidates to the National Nominating Committee.

Additional information pertaining to the National Adjudicatory Council Election Procedures can be found in Article VI of the By-Laws of NASD Regulation. The By-Laws can be found in the online NASD Manual at www.nasd.com.

EXHIBIT IV Candidate Profile Sheet**Current Employment**

Name: _____ CRD#: _____

Firm: _____ #RRs at Firm: _____

Title/Primary Responsibility: _____

Address: _____

City: _____ State: _____ Zip: _____

Phone: _____ Fax: _____

E-mail: _____

Prior Employment (List the most recent first. Feel free to include extra pages if necessary.)

Firm: _____

Title/Primary Responsibility: _____

Firm: _____

Title/Primary Responsibility: _____

General Areas of Expertise (please check all that apply)

- Compliance/Legal
 Corporate Finance
 Financial/Operational
 Institutional Sales
- Investment Advisory
 Retail Sales
 Trading/Market Making
 Other
- _____
- _____

Product Expertise (please check all that apply)

- Corporate Bonds
 Direct Participation Programs
 Equity Securities
 Municipal/Government Securities
- Investment Company
 Options
 Variable Contracts Securities
 Other
- _____
- _____

Memberships/Positions Held in Trade or Business Organizations

Past NASD Experience and Dates of Service (please check all that apply)

Committee Member (Identify committee: _____) Approx. Dates: _____

Arbitrator Approx. Dates: _____

Mediator Approx. Dates: _____

Expert Witness (arbitrations; disciplinary proceedings): _____ Approx. Dates: _____

Other: _____ Approx. Dates: _____

Educational Background

School: _____ Degree: _____

School: _____ Degree: _____

Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Legal and Compliance
Operations
Registration
Senior Management

KEY TOPICS

Money Laundering
Suspicious Activity Reporting

INFORMATIONAL

Anti-Money Laundering

Treasury Issues Final Suspicious Activity Reporting Rule for Broker/Dealers; **Effective Date: Transactions After December 30, 2002**

Draft Form SAR-SF; **Comments Requested by October 4, 2002**

Executive Summary

On October 26, 2001, President Bush signed into law the USA PATRIOT Act (Patriot Act).¹ Title III of the Patriot Act, entitled "International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001," added new provisions to the Bank Secrecy Act (BSA).²

Section 356 of Title III of the Patriot Act required the Department of the Treasury (Treasury), in consultation with the Securities and Exchange Commission (SEC) and the Board of Governors of the Federal Reserve System, to issue rules requiring broker/dealers to file suspicious activity reports (SARs) with the Financial Crimes Enforcement Network (FinCEN), a bureau of Treasury. On July 1, 2002, Treasury published in the *Federal Register* its final rules requiring broker/dealers in securities to file reports that identify and describe transactions that raise suspicions of illegal activity.³ The requirement to file SARs applies to transactions occurring after December 30, 2002.⁴

Specifically, the final rule requires broker/dealers to report to FinCEN any transaction that, alone or in the aggregate, involves at least \$5,000 in funds or other assets, if the broker/dealer knows, suspects, or has reason to suspect that it falls within one of four classes: (1) the transaction involves funds derived from illegal activity or is intended or conducted to hide or disguise funds or assets derived from illegal activity; (2) the transaction is designed, whether through structuring or other means, to evade the requirements of the BSA; (3) the transaction appears to serve no business or apparent lawful purpose or is not the sort of transaction in which the particular customer would be expected to engage and for which the broker/dealer knows of no reasonable explanation after examining the available facts; or (4) the transaction involves the use of the broker/dealer to facilitate criminal activity.

02-47

This *Notice to Members* provides a brief overview of the key provisions of the rule.

Treasury also published, in draft, a new form, "Suspicious Activity Report by the Securities and Futures Industry" (SAR-SF).⁵ While Treasury's final SAR rule indicated that it was developing a suspicious activity reporting form for broker/dealers entitled "Suspicious Activity Report – Brokers or Dealers in Securities" (SAR-BD), Treasury has indicated that the Form could also be used by futures commission merchants (FCMs) registered with the Commodity Futures Trading Commission (CFTC). Accordingly, the draft Form has been revised from SAR-BD to SAR-SF and several fields have been provided on the Form for use by FCMs. Treasury requests comment on draft Form SAR-SF by October 4, 2002.

Questions/Further Information

Questions regarding this *Notice* may be directed to Vicky Berberi-Doumar, Department of Member Regulation, NASD Regulatory Policy and Oversight, at (202) 728-8905, or to Grace Yeh, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-6939.

Discussion

Background

The Patriot Act was enacted to, among other things, deter and punish terrorist acts in the United States and around the world, and to enhance law enforcement investigatory tools. Title III of the Patriot Act — The Money Laundering Abatement Act — imposes significant new obligations on broker/dealers through new anti-money laundering (AML) provisions and amendments to the existing provisions of the BSA.

Among these obligations, broker/dealers are required to have in place as of April 24, 2002, an AML compliance program. NASD Rule 3011, which was approved by the SEC on April 22, 2002, requires that each member develop and implement, by April 24, 2002, a written AML program reasonably designed to achieve and monitor the member's compliance with the requirements of the BSA and the implementing regulations promulgated thereunder by the Treasury, including the obligation to report suspicious activities as set forth in the final SAR Rule. In addition to this *Notice*, members may also refer to *Notice to Members 02-21* (April 2002), which provides guidance to members regarding the development of AML programs and the requirement to report suspicious transactions.

Suspicious Activities Reporting Requirements

Pursuant to the final rule,⁶ a broker/dealer must report a transaction on Form SAR-SF if (a) the transaction is conducted or attempted by, at, or through a broker/dealer, (b) it involves or aggregates funds or other assets of at least \$5,000, and (c) the broker/dealer knows, suspects, or has reason to suspect that the transaction (or a pattern of transactions of which the transaction is a part):

1. involves funds derived from illegal activity or is intended or conducted to hide or disguise funds or assets derived from illegal activity;
2. is designed, whether through structuring or other means, to evade the requirements of the BSA;
3. appears to serve no business or apparent lawful purpose or is not the sort of transactions in which the particular customer would be expected to engage and for which

- the broker/dealer knows of no reasonable explanation after examining the available facts; or
4. involves use of the broker/dealer to facilitate criminal activity.

FinCEN's rule is not limited only to individual transactions, but extends to patterns of transactions. In its release adopting the final rule, FinCEN explicitly clarifies that "if a broker/dealer determines that a series of transactions that would not independently trigger the suspicion of the broker/dealer, but that taken together, form a suspicious pattern of activity, the broker/dealer must file a suspicious transaction report."⁷

The release refers to the "red flags" section of *NASD Notice to Members (NtM) 02-21*⁸ to help determine whether a transaction "appears to serve no business or apparent lawful purpose or is not the sort of transactions in which the particular customer would be expected to engage and for which the broker/dealer knows of no reasonable explanation after examining the available facts."⁹ The release states that broker/dealers should determine whether activities vary substantially from normal practice as to raise suspicions of possible illegality by looking for red flags such as those enumerated in *NtM 02-21*.

Finally, as noted above, the rule requires broker/dealers to disclose transactions that "involves use of the broker/dealer to facilitate criminal activity."¹⁰ The release notes that disclosure under this provision is intended to detect activities that appear to have a criminal purpose but apparently involve legally derived funds. Disclosure protects broker/dealers from being potential or actual victims of criminal violations, or being used to facilitate criminal transactions.

Exceptions from Reporting

The rule contains exceptions from reporting violations otherwise reported to various law enforcement authorities, such as: (1) a robbery or burglary that is reported by the broker/dealer to appropriate law enforcement authorities; (2) lost, missing, counterfeit, or stolen securities that are reported by the broker/dealer pursuant to Rule 17f-1 under the Securities Exchange Act of 1934 (Exchange Act); and (3) a violation of the federal securities laws or rules of a self-regulatory organization (SRO) by the broker/dealer, its officers, directors, employees, or registered representatives, that are reported appropriately to the SEC or an SRO, except for a violation of Exchange Act Rule 17a-8, which must be reported on Form SAR-SF.¹¹

Who Must File

Each broker/dealer involved in a transaction has an independent obligation to monitor for, identify and report suspicious activities. When more than one broker/dealer is involved in a transaction, only one Form SAR-SF is required to be filed, provided the report includes all relevant information. The release uses as an example an introducing and clearing broker, and clarifies that the two broker/dealers may provide each other with copies of the Form SAR-SF that was filed, as well as the underlying documentation.

It is important to note that the release specifies that if the Form SAR-SF relates to the other broker/dealer, then the broker/dealer making the filing is prohibited from notifying the other broker/dealer that a Form SAR-SF has been filed.

In response to several commenters requesting clarification on the application of the rule to certain types of

broker/dealers, the final rule provides that the broker/dealer SAR requirements will not apply to dual registrants (persons registered both with the CFTC as an FCM and with the SEC as a broker/dealer) to the extent their activities are subject to the exclusive jurisdiction of the CFTC, or to broker/dealers registered with the SEC but located outside the United States. However, the final rule will apply to persons registered as a broker/dealer solely to sell variable annuity contracts issued by life insurance companies.

Confidentiality of SAR-SF Filings

The rule also requires that the filing of a Form SAR-SF report must remain confidential. The person involved in the transaction that is subject of the report must not be notified of the Form SAR-SF. In other words, if subpoenaed, the broker/dealer must refuse to provide the information and notify FinCEN of the request, unless the disclosure is required by FinCEN, the SEC, an SRO or other law enforcement authority. Where two or more broker/dealers are filing one Form SAR-SF, the confidentiality provisions apply equally to each broker/dealer participating in a transaction, and not only the broker/dealer that filed the Form SAR-SF.

Filing Procedures

Broker/dealers must file Form SAR-SF within 30 days of becoming aware of the suspicious transaction. If the broker/dealer is unable to identify a suspect, the rule provides an extra 30 days for filing the Form SAR-SF. The Form SAR-SF must be filed within 60 calendar days of initial detection, whether or not the broker/dealer can identify the suspect.

In addition, the rule requires broker/dealers to immediately notify by telephone an appropriate law enforcement authority in situations that require immediate attention, such as terrorist financing or ongoing money laundering schemes, and reminds brokers that they can also report suspicious transactions that may relate to terrorist activity to FinCEN's Financial Institutions Hotline (1-866-556-3974). In both cases, broker/dealers are still required to file a timely Form SAR-SF.

Record Keeping

Broker/dealers must maintain copies of filed Form SAR-SFs and the original related documentation for five years from the date of the filing. Broker/dealers must make the records available to FinCEN as well as to other appropriate law enforcement agencies, federal or state securities regulators, and SROs registered with the SEC.

The rule also requires a broker/dealer to keep records when relying on the rule's exception from reporting, in case FinCEN requests such information.

Form SAR-SF: Request for Comments

As mentioned above, Treasury published draft Form SAR-SF for comments. Treasury has specifically requested that the form not be used until a final version is made available. The draft form contains detailed instructions and guidelines on how to present the information and what to include in order to maximize the benefits of the information to the authorities. Treasury requests comments on, among other things, whether the collection of information is necessary for the proper performance of the functions of the Treasury, and ways to enhance the quality, utility, and clarity of the informa-

tion to be collected. Treasury also requests comments on the estimated burden of collecting the information, ways to minimize the burden, and estimates of start-up costs and costs of operation, maintenance, and purchase of services to provide information. Comments should be submitted to FinCEN by October 4, 2002.

Endnotes

- 1 Public Law 107-56.
- 2 31 U.S.C. 5311, et seq.
- 3 67 Fed. Reg. 44048 (July 1, 2002)
(<http://www.treas.gov/fincen/brokersdealersar/july2002.pdf>).
- 4 Broker/dealers that are affiliates or subsidiaries of banks or bank holding companies must continue to file SARs with FinCEN pursuant to existing BSA reporting and recordkeeping requirements until December 30, 2002. After December 30, 2002, these broker/dealers will have to use the new Form SAR-SF.
- 5 67 Fed. Reg. 50751 (Aug. 5, 2002)
(<http://www.treas.gov/fincen/fedreg08052002.pdf>).
- 6 31 CFR 103.19(a)(2).
- 7 The release also clarifies that the rule is not intended to require broker/dealers to review every transaction that exceeds the reporting threshold. The rule is intended to encourage broker/dealers to evaluate customer activities and relationships and design an appropriate monitoring program; the release suggests that firms use a "risk-based approach" in monitoring for suspicious transactions.
- 8 *NtM 02-21, NASD Provides Guidance To Member Firms Concerning Anti-Money Laundering Compliance Programs Required By Federal Law.*
- 9 31 C.F.R. 103.19(a)(2)(iii).
- 10 31 C.F.R. 103.19(a)(2)(iv).
- 11 The release clarifies that if a broker/dealer does not report a securities violation to the SEC or an SRO because the SEC regulations or SRO rules do not require reporting of such violation, the broker/dealer must nevertheless file a Form SAR-BD to report the violation if otherwise required to be reported under the final SAR Rule.

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Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Executive Representatives
Legal & Compliance
Operations
Senior Management

KEY TOPICS

Central Registration Depository
Fees
Renewal Program

INFORMATIONAL

Annual Renewal Fees

NASD Amends Section 4 of Schedule A to the NASD By-Laws to Establish a Late Fee for Failure to Pay Annual Renewal Fees on a Timely Basis; **Implementation Date: September 1, 2002**

Executive Summary

NASD has adopted an amendment to Section 4(b) of Schedule A to the NASD By-Laws, establishing a fee to be imposed on members that fail timely to pay their annual Renewal Fee as indicated on their Preliminary Renewal Statement. The rule change was filed with the Securities and Exchange Commission (SEC) on July 25, 2002. Pursuant to Section 19(b)(3)(A)(ii) of the Securities Exchange Act of 1934 and SEC Rule 19b-4(f)(2) thereunder, the rule change became effective upon filing. NASD will implement the rule change on September 1, 2002.

Included with this *Notice* is Attachment A, the text of the amendment to Section 4(b) of Schedule A to the NASD By-Laws.

Questions/Further Information

Questions concerning this *Notice* may be directed to Richard E. Pullano, Chief Counsel, Registration and Disclosure, NASD Regulatory Services and Operations, at (240) 386-4821, or Shirley H. Weiss, Associate General Counsel, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-8844.

Discussion

NASD has amended Section 4(b) of Schedule A to the NASD By-Laws to establish a fee if a member fails timely to pay the amount indicated on its Preliminary Renewal Statement. The fee is 10% of a member's final annual renewal assessment or \$100, whichever is greater, with a maximum charge of \$5,000. As further detailed below, NASD will implement this rule change and thus assess the late fee beginning on September 1, 2002.

02-48

NASD administers an annual Renewal Program that simplifies the process of renewing registrations and licenses for member firms and their associated persons by allowing members to pay a single amount to NASD in December of each year. This annual Renewal Fee covers all NASD registration and licensing fees and fees imposed by states and other self-regulatory organizations (SROs). NASD also collects broker/dealer and investment adviser renewal fees on behalf of SROs and state regulators, as applicable, through this program.

Each year, during the first week of November, NASD publishes online, on Web CRD,SM a Preliminary Renewal Statement for each member that advises the member of the total amount of Renewal Fees owed for the following year. The Renewal Fees are generally due to NASD by the end of the first week in December. Members typically pay the amount indicated on their Preliminary Renewal Statement by check or bank wire transfer, and NASD pays the fees to the various regulators by year end. NASD advises its members that their failure to return full payment to NASD by the stated deadline could cause a member to become ineligible to do business in the jurisdictions in which it is registered as of the first business day of the new year. The timely payment of Renewal Fees by NASD members and their subsequent disbursement to appropriate regulators helps to ensure that NASD members will not be precluded from conducting business in the next calendar year as a result of the non-payment of Renewal Fees.

Because of the potential risk to members' ability to conduct business if they fail timely to pay their renewal payments, NASD engages in a comprehensive communications and operational effort

beginning in August of each year that informs members of their obligation to complete the renewals process by the stated deadline and the risk associated with their failure to do so. These communications include an Advance Calendar of Key Dates, a *Notice to Members*, a *Bulletin*, reminder e-mails, and daily reminder Broadcast Messages through Web CRD.

In early January, NASD makes available on-line a Final Renewal Statement that reflects the final status of agent and firm registrations and/or Notice Filings as of December 31 of the previous year. Any adjustments in fees owed as a result of registration terminations or approvals subsequent to the Preliminary Renewal Statement are made in this final reconciled statement on Web CRD. NASD issues a credit/refund to members that paid an amount greater than the final amount based on their Preliminary Renewal Statements. NASD assesses additional fees if a member has paid less than the final reconciled amount.

Notwithstanding NASD's efforts to obtain timely payments of Renewal Fees, a significant percentage of NASD members miss the payment deadline each year, prompting NASD staff to expend additional time and resources to collect these fees after the renewal deadline has passed. NASD staff expends considerable effort to contact delinquent members to prevent them from failing to renew with the jurisdictions with which they are registered. This annual effort is in addition to, and detracts from, NASD's efforts to serve its members in the normal course of business.

NASD has therefore established a late renewal fee that will be assessed against any NASD member that has not paid its Renewal Fees by the published deadline. NASD believes that such a fee serves a

two fold purpose: (1) to provide members with an additional incentive to meet the renewals payment deadline; and (2) to cover the costs of NASD collection activities (*i.e.*, the time and resources expended in contacting and collecting fees from NASD members that miss the deadline). The purpose of the late fee is not to generate significant net revenue, and it should not do so. Instead, the late fee will cover NASD's collection costs and eliminate a significant number of late payments by encouraging members to pay their Renewal Fees by the stated deadline.

Implementation Date

NASD will implement this amendment beginning on September 1, 2002.

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ATTACHMENT A

New language is underlined; deletions are in brackets.

Schedule A to the NASD By-Laws

Assessments and fees pursuant to the provisions of Article VI of the By-Laws of NASD shall be determined on the following basis.

Section 4 - Fees

(a) No change.

(b) NASD shall assess each member a fee of:

(1) through (6) No change.

(7) 10% of a member's final annual renewal assessment or \$100, whichever is greater, with a maximum charge of \$5,000, if the member fails timely to pay the amount indicated on its preliminary annual renewal statement.

(c) through (l) No change.

Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Executive Representatives
Legal & Compliance
Senior Management

KEY TOPICS

IM-8310-2
Release of Disciplinary Information to the Public

INFORMATIONAL

Release of Disciplinary Information

NASD Adopts Amendments to IM-8310-2 Concerning Release of Disciplinary Information to the Public;
Implementation Date: September 1, 2002

Executive Summary

NASD has adopted amendments to NASD Interpretative Material 8310-2 (IM-8310-2), concerning the release of disciplinary information to the public. The amendments (1) clarify the circumstances under which NASD will release redacted information with respect to both Hearing Panel and Extended Hearing Panel decisions issued under the Rule 9200 Series (hereafter referred to as Hearing Panel decisions), and National Adjudicatory Council (NAC) disciplinary decisions issued under the Rule 9300 Series; and (2) conform the timing for the release of unredacted disciplinary information to the timing for the release of redacted disciplinary information with respect to Hearing Panel and NAC decisions.

The amendments were filed with the Securities and Exchange Commission (SEC) on July 31, 2002.¹ Pursuant to Section 19(b)(3)(A) of the Securities Exchange Act of 1934 and SEC Rule 19b-4(f)(6) thereunder, the amendments became effective upon filing. The NASD will implement the amendments to IM-8310-2 on September 1, 2002.

Included with this *Notice* is Attachment A, the text of amended IM-8310-2.

Questions/Further Information

Questions concerning this *Notice* may be directed to Manly Ray, Supervisory Paralegal, Office of Hearing Officers, at (202) 728-8202, or Shirley H. Weiss, Associate General Counsel, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-8844.

02-49

Discussion

IM-8310-2(d)(1) requires NASD to release to the public information with respect to any disciplinary decision that: imposes a suspension, cancellation or expulsion of a member; suspends or revokes an associated person's registration; suspends or bars an associated person; or imposes monetary sanctions of \$10,000 or more. NASD also may release to the public information about disciplinary decisions that involve a significant policy or enforcement determination where the President of NASD Regulatory Policy and Oversight deems the release of such information to be in the public interest. Additionally, IM-8310-2 permits NASD to release in redacted form final, litigated decisions that do not meet any of the criteria for release of information to the public.² As defined in IM-8310-2(d)(1), a redacted decision is one in which the names of the parties and other identifying information (such as the names of employer firms and addresses) are deleted prior to its release.

(1) Permitting the Prompt Release of Decisions in Redacted Form Where the Sanctions Imposed by the Hearing Panel Do Not Meet the Criteria for Release of Disciplinary Information to the Public

Currently, IM-8310-2(d)(1) limits the release of redacted disciplinary decisions that do not meet any of the criteria for release of disciplinary information to the public to "final, litigated, disciplinary decision[s]." This rule language means that NASD cannot release information with respect to such Hearing Panel decisions until the decision is "final," *i.e.* the respondent has appealed to the NAC and the NAC has issued its decision or, in the alternative, the respondent has not appealed and the NAC has determined

not to call the decision for review.³ Additionally, if such a Hearing Panel decision were appealed to, or called for review by, the NAC, the NAC decision would become the "final, litigated, disciplinary decision," and NASD generally would not publish the underlying Hearing Panel decision.

The amendment to IM-8310-2(d)(1) changes "final, litigated, disciplinary decision" to "any disciplinary decision" with respect to the release of redacted decisions. This means that, as of September 1, 2002, NASD will promptly publish on its Web Site "any disciplinary decision" in either redacted or unredacted form, depending upon whether the decision meets any of the criteria for release of disciplinary information to the public. The rule change will allow public investors and other interested persons to get prompt notice of all disciplinary decisions, including those in which the sanctions imposed, if any, did not meet the publication criteria.

(2) Sanctions Imposed by the Hearing Panel Meet the Criteria for Release of Disciplinary Information to the Public, but the Sanctions Imposed by the NAC Do Not Meet the Publication Criteria

The rule change to IM-8310-2(d)(1)(A) will eliminate the current practice in which NASD publishes an unredacted Hearing Panel decision because it meets one or more of the criteria for release of information to the public, but publishes the subsequent NAC decision in redacted form because following an appeal or call for review, the NAC has lowered the sanctions below the minimum criteria for release of information to the public. As of September 1, 2002, NASD will release NAC decisions that do not meet the criteria for release of information to the

public in unredacted form if the underlying Hearing Panel decision meets the criteria for release of information under IM-8210-2 and has been published in unredacted form. This will enable public investors and other interested persons to follow the history of a disciplinary matter on the NASD Web Site in unredacted form even where the NAC has reduced the sanctions imposed by the Hearing Panel to a level that does not meet the publication criteria of IM-8310-2.

(3) Sanctions Imposed on One or More, But Not All, of the Respondents Meet the Criteria for Release of Disciplinary Information to the Public

On occasion, the sanctions imposed on one or more, but not all, of the respondents in Hearing Panel or NAC decisions meet the criteria for release of information to the public. Currently, NASD releases information with respect to both Hearing Panel and NAC decisions in redacted form as to all respondents if the sanctions imposed on one or more, but not all, of the respondents fail to meet any of the criteria for release of information to the public. The amendment to IM-8310-2(d)(1)(B) clarifies that, as of September 1, 2002, NASD will release information in unredacted form as to the respondents whose sanctions meet the publication criteria and in redacted form as to the respondents whose sanctions do not meet the publication criteria; however, consistent with the amendments to IM-8310-2(d)(1)(A) as discussed above, information regarding respondents in NAC decisions that do not meet the criteria for release of inform-

ation to the public will be released in unredacted form if the sanctions imposed on the respondent in the underlying Hearing Panel decision meet one or more of such criteria and the Hearing Panel decision as to that respondent was published in unredacted form.

Implementation Date of Amendments

NASD will implement these amendments on September 1, 2002.

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Endnotes

- 1 See Securities Exchange Act Release No. 46289 (July 31, 2002) (File No. SR-NASD-2002-103).
- 2 See Securities Exchange Act Release No. 42783 (May 15, 2000), 65 FR 32140 (May 22, 2000), effective on July 1, 2002 (amending IM-8310-2 to permit the release of certain disciplinary decisions in redacted form).
- 3 See Rule 9312.

ATTACHMENT A

New language is underlined; deletions are in brackets.

IM-8310-2. Release of Disciplinary Information

(a) through (c) No change

(d)(1) [The Association] NASD shall release to the public information with respect to any disciplinary decision issued pursuant to the Rule 9000 Series imposing a suspension, cancellation or expulsion of a member; or suspension or revocation of the registration of a person associated with a member; or suspension or barring of a member or person associated with a member from association with all members; or imposition of monetary sanctions of \$10,000 or more upon a member or person associated with a member; or containing an allegation of a violation of a Designated Rule; and may also release such information with respect to any disciplinary decision or group of decisions that involve a significant policy or enforcement determination where the release of information is deemed by the President of NASD [Regulation, Inc.] Regulatory Policy and Oversight to be in the public interest. [The Association] NASD also may release to the public information with respect to any disciplinary decision issued pursuant to the Rule 8220 Series imposing a suspension or cancellation of the member or a suspension of the association of a person with a member, unless the National Adjudicatory Council determines otherwise. The National Adjudicatory Council may, in its discretion, determine to waive the requirement to release information with respect to a disciplinary decision under those extraordinary circumstances where the release of such information would violate fundamental notions of fairness or work an injustice. [The Association] NASD may release to the public information on any [other final, litigated,] disciplinary decision issued pursuant to the Rule 8220 Series or Rule 9000 Series, not specifically enumerated in this paragraph, regardless of sanctions imposed, so long as the names of the parties and other identifying information is redacted.

(A) NASD shall release to the public, in unredacted form, information with respect to any disciplinary decision issued pursuant to the Rule 9300 Series that does not meet one or more of the criteria in IM-8310-2(d)(1) for the release of information to the public, provided that the underlying decision issued pursuant to the Rule 9200 Series meets one or more of the criteria in IM-8310-2(d)(1) for the release of information to the public, and information regarding such decision has been released to the public in unredacted form.

(B) In the event there is more than one respondent in a disciplinary decision issued

pursuant to the Rule 9000 Series, and sanctions imposed on one or more, but not all, of the respondents meets one or more of the criteria in Rule IM-8310-2(d)(1) for the release of information to the public, NASD shall release to the public, in unredacted form, information with respect to the respondent(s) who meet such criteria, and may release to the public, in redacted form, information with respect to the respondent(s) who do not meet such criteria. Notwithstanding the foregoing, NASD shall release to the public, in unredacted form, information with respect to any respondent in a disciplinary decision issued pursuant to the Rule 9300 Series if the sanctions imposed on such respondent in the underlying decision issued pursuant to Rule 9200 meet one or more of the criteria for release of information to the public, and information with respect to that respondent has been released in unredacted form.

(2) No change.

(e) through (l) No change.

Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Legal & Compliance
Operations
Registration
Senior Management

KEY TOPICS

Money Laundering Compliance Programs

INFORMATIONAL

Treasury and SEC Request Comment on Proposed Regulation Regarding Broker/Dealer Anti-Money Laundering Customer Identification Requirements; Comment Period Expires September 6, 2002

Executive Summary

On October 26, 2001, President Bush signed into law the USA PATRIOT Act (PATRIOT Act). Title III of the PATRIOT Act, referred to as the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (Money Laundering Abatement Act), imposed obligations on broker/dealers under new anti-money laundering (AML) provisions and amendments to the Bank Secrecy Act (BSA) in an effort to make it easier to prevent, detect, and prosecute money laundering and the financing of terrorism.

Among other things, Section 326 of the Act required the Secretary of the Department of Treasury (Treasury) and the Securities and Exchange Commission (SEC or Commission) jointly to issue a regulation setting forth minimum standards for broker/dealers and their customers regarding customer identification in the account opening process.

On July 23, 2002, the Treasury and SEC published for comment the proposed regulation to implement Section 326.¹ The proposed regulation would require broker/dealers to, at a minimum: (1) adopt and implement reasonable procedures to verify the identity of any person seeking to open an account, to the extent reasonable and practicable; (2) maintain records related to the verification of the person's identity; and (3) determine whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided by any government agency. The release was published in the *Federal Register*;² use this URL to view the text: <http://www.treas.gov/fincen/section326brokerdealers.pdf>.

Questions/Further Information

Questions regarding this *Notice to Members* may be directed to Kyra Armstrong, at (202) 728-6962, or Vicky Berberi-Doumar, at (202) 728-8905, both of the Department of Member Regulation; or Nancy Libin, at (202)-728-8835, or Grace Yeh, at (202) 728-6939, both of the Office of General Counsel, NASD Regulatory Policy and Oversight.

Background

Introduction

The PATRIOT Act is designed to deter and punish terrorists in the United States and abroad and to enhance law enforcement investigation tools by prescribing, among other things, new surveillance procedures, new immigration laws, and new and more stringent AML laws. The Money Laundering Abatement Act strengthens the AML provisions put into place by earlier legislation.

Among these obligations, broker/dealers are required to have in place as of April 24, 2002, an AML compliance program. NASD Rule 3011, which was approved by the SEC on April 22, 2002, requires that each member develop and implement, by April 24, 2002, a written AML program reasonably designed to achieve and monitor the member's compliance with the requirements of the BSA and the implementing regulations promulgated thereunder by the Treasury, including the obligation to establish reasonable customer identification and verification procedures. In addition to this *Notice*, members may also refer to *Notice to Members 02-21* (April 2002), which provides guidance to members regarding the development of AML programs and

procedures for account holder identification and verification.

Description of Proposed Regulation

The proposed regulation provides several definitions, which are briefly reviewed below.

1. Account. The proposed regulation defines "account" to include all types of securities accounts maintained by brokers or dealers.³ These include accounts to purchase, sell, lend, or otherwise hold securities or other assets, cash accounts, margin accounts, prime brokerage accounts that consolidate trading done at a number of firms, and accounts for repurchase and stock loan transactions.

2. Broker/dealer. "Broker/dealer" is defined to include any person registered, or required to be registered, with the Commission as a broker or dealer under the Securities Exchange Act of 1934 (Exchange Act), except persons who register, or are required to be registered, solely because they effect transactions in security futures products.⁴

3. Customer. "Customer" is defined as any person who opens a new account at a broker/dealer or is granted trading authority with respect to an account at a broker/dealer.⁵ Under this definition, a person who has an account at a broker/dealer prior to the effective date of the regulation *would not be* a customer. However, such a person becomes a customer if the person opens a new or different type of account. The proposed regulation also states that a person with trading authority *prior* to the effective date of the regulation *is not* a customer; however, any person who was granted

trading authority *after* the effective date is a customer.

The proposed regulation does not apply to persons seeking information about an account (such as a schedule of transaction fees) if an account is not opened. Transfers of accounts from one broker/dealer to another that are not initiated by the customer are not covered by the proposed regulation.⁶ Examples of an account transfer not initiated by a customer include a merger, acquisition, or purchase of assets or assumption of liabilities.

4. Person. "Person" is defined to include natural persons, corporations, partnerships, trusts or estates, joint stock companies, associations, syndicates, joint ventures, any unincorporated organizations or groups, Indian tribes, and all entities cognizable as legal entities.⁷

5. U.S. person. "U.S. person" is defined as a U.S. citizen, or for persons other than natural persons, an entity established or organized under the laws of a State or the United States.⁸

6. Non-U.S. person. A "Non-U.S. person" is defined as a person that is not a U.S. person as that term is defined in the regulation.⁹

7. Taxpayer Identification number. "Taxpayer identification number" is defined to have the same meaning as determined under the provisions of Section 6109 of the Internal Revenue Code and the regulations of the Internal Revenue Service thereunder.¹⁰

Customer Identification Program

A key aspect of the proposed regulation is the requirement that broker/dealers establish and operate a customer identification program (CIP).¹¹ A CIP must be

part of a firm's overall AML compliance program as required under Section 352 of the PATRIOT Act.¹² It must be approved by the most senior level of the firm, which can be the board of directors, managing partners, board of managers, or other governing body performing similar functions, or by persons authorized to approve such a program.¹³ A CIP's procedures also must enable the firm to form a reasonable belief that it knows the true identity of the customer.

Several factors must be considered in creating and developing CIPs. Firms should consider the types of identifying information available for customers and the methods available to verify that information. The release notes that while the proposed regulation sets forth certain minimum required information and suitable verification methods, firms should consider on an ongoing basis whether additional information and methods are appropriate. In addition, firms should consider the risks associated with their business operations. In considering the risks, firms should consider the following factors:

- (1) the broker/dealer's size;
- (2) the broker/dealer's location;¹⁴
- (3) the method by which customers open accounts at the broker/dealer;¹⁵
- (4) the types of accounts the broker/dealer maintains for customers;¹⁶
- (5) the types of transactions the broker/dealer executes for customers;¹⁷
- (6) the customer base; and
- (7) the broker/dealer's reliance on another broker/dealer with which it shares an account relationship.¹⁸

This last risk factor refers to shared accounts subject to a carrying or clearing agreement governed by NASD Rule 3230 or NYSE Rule 382.¹⁹ The proposed regulation notes that firms sharing accounts may share responsibilities pursuant to their clearing agreements. For example, the correspondent firm may undertake to obtain the identifying information while the clearing firm may undertake the verification. Nonetheless, the proposed regulation makes it clear that both firms are responsible for ensuring that each requirement in the regulation is met with respect to each customer. Therefore, broker/dealers must continually assess whether the other firm can be relied on to perform its responsibilities. A broker/dealer is expected to cease such reliance if it is no longer reasonable.

Required Information

A broker/dealer's CIP must have customers provide, at a minimum, certain identifying information before an account is opened for the customer or the customer is granted trading authority over an account. The firm must obtain from each customer, his or her:

- + Name;
- + Date of birth, for a natural person;
- + Address(es):
 - ◆ Residence and mailing (if different) for a natural person; or
 - ◆ Principal place of business and mailing (if different) for a person other than a natural person; and
- + Documentary Number:
 - ◆ For each customer that is a U.S. person, a taxpayer identification number (such as a Social Security

number or employer identification number); or

- ◆ For each customer that is a non-U.S. person,
 - a U.S. taxpayer identification number;
 - a passport number and country of issuance;
 - an alien identification card number; or
 - the number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.²⁰

Firms should determine whether other identifying information is necessary to form a reasonable belief concerning the true identity of each customer during this process. The proposed regulation notes that there may be certain situations or customers that may cause the firm to obtain additional information. CIPs should have guidelines for such situations to assist in making such determinations.

The Treasury and the SEC have proposed a limited exception to the requirement that a taxpayer identification number be provided prior to opening an account or the granting of trading authority. For new businesses that have applied for, but not received, employer identification numbers (EINs) from the Internal Revenue Service, the CIP may allow the EIN to be provided within a reasonable time after the account is opened. However, CIPs must require the broker/dealer to obtain a copy of the EIN application prior to the account opening or to the grant of trading authority.

Verification Procedures

The procedures for verifying the accuracy of the information must be undertaken within a reasonable time before or after an account is opened or a customer is granted trading authority. There is some flexibility in determining what is a reasonable time. The amount of time may depend on the type of account opened, whether the account was opened in person, and on the type of identifying information available. Although an account is opened, a firm may choose to place limits on the account until the customer's identity is verified. Therefore, firms may use a risk-based approach to determine when the identity of a customer must be verified relative to the opening of an account or the granting of trading authority.

The proposed regulation explains that the verification requirements would apply every time a person opens a new account at a firm or is granted trading authority with respect to an account. However, if a customer whose identification has been verified previously opens a new account or is granted new authority, the firm would not need to verify the customer's identity a second time, provided the broker/dealer (1) previously verified the customer's identity in accordance with procedures consistent with the proposed regulation; and (2) continues to have a reasonable belief that it knows the true identity of the customer.

Verification may occur through two methods: through documents and through non-documentary means. The means of verification may vary based on the type of customer and the method of opening an account. A CIP must discuss both methods and provide guidance on when it is appropriate to use either one or a combination of both.

Documents

CIPs must provide guidance concerning when it is appropriate to use documents to verify a customer's identity. The proposed regulation lists some suitable documents.

They include:

- + For natural persons, an unexpired government-issued identification evidencing nationality or residence and bearing a photograph or similar safeguard.
- + For entities, documents showing existence such as registered articles of incorporation, a government-issued business license, a partnership agreement, or a trust instrument.

Non-Documentary Means

A CIP must describe non-documentary verification methods and when these methods will be used in addition to, or instead of relying on, documents. The regulation provides for the exclusive use of non-documentary means (if necessary) due to the number of accounts opened over the Internet, the telephone, and the mail. Suitable non-documentary methods of verification include:

- + contacting a customer after the account is opened (particularly, if the account is opened online or by mail);
- + obtaining a financial statement;
- + comparing the identifying information provided by the customer against fraud and bad check databases to determine whether any of the information is associated with known incidents of fraudulent behavior (negative verification);

- + comparing the identifying information with information available from a trusted third-party source, such as a credit report from a consumer reporting agency (positive verification);²¹ and
- + checking references with other financial institutions.

Other factors to consider include checking whether there is a logical consistency between the identifying information provided such as the customer's name; street address; zip code; telephone number, if provided; the customer's date of birth; and Social Security number.

Non-documentary methods should be used in certain situations, particularly when a firm cannot examine original documents. The following are examples of situations when non-documentary methods should be used:

- + a person is unable to provide an unexpired government-issued identification document with a photograph or similar safeguard;
- + the firm is presented with unfamiliar documents to verify an identity;
- + the firm does not meet the customer face-to-face; or
- + there is a risk that the documents will not enable the firm to verify the customer's identity.

Also, in light of the increase in identity fraud, firms are encouraged to use non-documentary methods, even when a customer has provided documents.

Use of Government Lists

The proposed regulation also requires reasonable procedures for determining whether a customer appears on any list of known or suspected terrorists or terrorist organizations provided by any government agency. This requirement applies only with respect to lists circulated by the federal government such as the list found on Treasury's Office of Foreign Assets Control (OFAC) Web Site (www.treas.gov/fac) and available on www.nasdr.com/money.asp under "OFAC List." Broker/dealers must have procedures for responding to circumstances when a customer is named on a list.²²

Customer Notice

The proposed regulation states that firms must give their customers notice of their identity verification procedures.²³ The CIP must include procedures for providing customers with adequate notice that the broker/dealer is requesting information to verify their identity. This requirement may be satisfied generally by notifying customers about the procedures a firm must comply with to verify their identities. The release also cites, as an example, posting a sign in a firm's lobby or providing customers with any form of written, electronic, or oral notice. Notice must be given before an account is opened or trading authority is granted.

Lack of Verification

As stated above, a broker/dealer should maintain an account for a customer only when it can form a reasonable belief that it knows the customer's true identity. However, a CIP must have procedures for responding to circumstances when a firm cannot form a reasonable belief.²⁴ There

should also be guidelines for when an account will not be opened. Furthermore, a CIP should specify when an account should be closed after attempts have been made to verify a customer's identity. There should also be procedures for determining when a suspicious activity report (SAR) should be filed.²⁵

Recordkeeping

The proposed regulation requires procedures for maintaining records of information used to verify a person's identity, including name, address, and other identifying information.²⁶ Information that must be maintained includes all identifying information provided by a customer. A firm must make a record of each customer's name, date of birth (if applicable), addresses, and tax identification number or other number. Firms also must maintain copies of any documents that were relied on, evidencing the type of document and any identification number it may contain. Firms must make and maintain records of the methods and results of measures undertaken to verify the identity of a customer. These records must be maintained for five years after the date the account is closed or the grant of authority to effect transactions with respect to the account is revoked.

Exemptions

The proposed regulation provides that the Commission, with the concurrence of the Secretary of the Treasury, may exempt any broker/dealer that registers with the Commission from this requirement. Excluded from this exemptive authority are firms that register as broker/dealers solely because they deal in security futures products. In issuing such exemptions,

the Commission and the Secretary will consider whether the exemption is consistent with the purposes of the BSA and in the public interest and may consider other necessary and appropriate factors.²⁷

Comments

Treasury and the SEC seek comment on all aspects of the proposed regulation, and specifically seek comment on the following issues:

1. Whether the proposed definition of "account" (which includes all types of securities accounts maintained by brokers or dealers) is appropriate and whether other examples of accounts should be added to the text of the regulation.
2. How broker/dealers can comply with the requirement to obtain both the address of a person's residence, and, if different, the person's mailing address in situations involving natural persons who lack a permanent address.
3. Whether non-U.S. persons that are not natural persons will be able to provide a broker/dealer with the identifying information required in 31 CFR 103.122(c)(4),²⁸ or whether other categories of identifying information should be added to this section.
4. The extent to which the verification procedures required by the proposed regulation makes use of the information that broker/dealers currently obtain in the account opening process.

5. Whether any of the exemptions from the customer identification requirements contained currently in 31 CFR 103.35(a)(3) should be continued in the proposed regulation. Commenters should address the standards set forth in paragraph (j) of the proposed regulation as well as any other appropriate factors.²⁹

Written comments may be mailed to FinCEN, Section 326 Broker-Dealer Rule Comments, P.O. Box 39, Vienna, Virginia 22183, or sent to e-mail address regcomments@fincen.treas.gov with the caption "Attention: Section 326 Broker/Dealer Rule Comments" in the body of the text.

Written comments should be submitted in triplicate to the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. All submissions should refer to the File No. S7-25-02. Comments may also be submitted electronically at the following e-mail address: rulecomments@sec.gov. The file number should be included on the subject line if e-mail is used.

Written comments must be submitted to Treasury and the SEC on or before September 6, 2002.

Conclusion

NASD will update members when the proposed regulation becomes final. In the interim, NASD reminds members to comply with the provisions of the PATRIOT Act that currently apply to broker/dealers.

Endnotes

- 1 67 Fed. Reg. 48,306 (July 23, 2002).
- 2 Treasury, jointly with other federal financial regulators, also separately issued customer identification requirements for banks and trust companies, savings associations, credit unions, mutual funds, futures commission merchants, and futures introducing brokers.
- 3 67 Fed. Reg. 48,306 at 48,307.
- 4 *Id.*
- 5 *Id.*
- 6 The release notes that there may be times when a broker/dealer may need to verify the identity of customers associated with accounts it is acquiring. Procedures for the transfer of accounts are expected to be part of a firm's AML compliance program required under Section 352 of the PATRIOT Act.
- 7 67 Fed. Reg. 48,306 at 48,307. Broker/dealers that register solely because they effect transactions in security futures products will be subject to separate customer identification regulations issued jointly by Treasury and the Commodity Futures Trading Commission.
- 8 *Id.*
- 9 *Id.*
- 10 *Id.* See also 26 U.S.C. 6109 (2002), which states that, generally speaking, the identifying number of an individual is his or her Social Security account number or employer identification number.
- 11 67 Fed. Reg. 48,306 at 48,307- 48,308.
- 12 31 U.S.C. 5318(h).
- 13 67 Fed. Reg. 48,306 at 48,311.
- 14 Firms located in certain known money laundering areas, for example, may pose a greater risk than firms located in other areas. See 67 Fed. Reg. 48,306 at 48,308.
- 15 This refers to whether the account was opened in person or whether it was opened online, for example. See 67 Fed. Reg. 48,306 at 48,308.

- 16 A firm must determine if the account is a cash, margin, or prime brokerage account, for example. See 67 Fed. Reg. 48,306 at 48,308.
- 17 This could be short sales, block trades, repurchases, and reverse repurchase agreements, for example. See 67 Fed. Reg. 48 306 at 48,308.
- 18 67 Fed. Reg. 48,306 at 48,308.
- 19 NASD Rule 3230 governs clearing agreements. It states, among other things, that all clearing or carrying agreements entered into by a member, except where any party to the agreement is also subject to a comparable rule of a national securities exchange, shall specify the respective functions and responsibilities of each party to the agreement. NYSE 382 also addresses carrying agreements and states, in part, that each carrying agreement shall identify and allocate the respective functions and responsibilities of the introducing and carrying organizations.
- 20 A "similar safeguard" is included in the definition to permit for the use of any biometric identifier that may be used in addition to, or instead of, photographs.
- 21 See *NASD Notice to Members 02-21* at 6, which discusses the use of databases such as Equifax, Exertion and Lexis/Nexis. Please note that NASD is not endorsing any particular product, but offering the names as references.
- 22 67 Fed. Reg. 48,306 at 48,310. See also *NASD Notice to Members 02-21* at 6.
- 23 67 Fed. Reg. 48,306 at 48,310.
- 24 *Id.*
- 25 67 Fed. Reg. 40448 (July, 1, 2002).
- 26 *Id.*
- 27 67 Fed. Reg. 48,306 at 48,311.
- 28 See 67 Fed. Reg. 48,306 at 48,308. Section 103.122(c)(4) requires that a broker/dealer obtain from a customer before an account is opened or trading authority is granted a "documentary number."
- 29 31 CFR 103.35(a)(3) currently provides that a broker/dealer need not obtain a taxpayer identification number with respect to specified categories of persons opening accounts, such as (i) agencies and instrumentalities of Federal, State, local, or foreign governments; (ii) aliens who are ambassadors; ministers, career diplomatic or consular officers; naval, military or other attaches of foreign embassies and legations; and members of their immediate families; (iii) aliens who are accredited representatives of certain international organizations, and their immediate families; (iv) aliens temporarily residing in the United States for a period not to exceed 180 days; (v) aliens not engaged in a trade or business in the United States who are attending a recognized college or university, or any training program supervised or conducted by an agency of the Federal Government; and (vi) unincorporated subordinate units of a tax exempt central organization that are covered by a group exemption letter. The proposed regulation does not contain any exemptions from the Customer Identification Program requirements.

Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Executive Representative
Legal & Compliance
Senior Management

KEY TOPICS

Investment Analysis Tools
Rule 2210

REQUEST FOR COMMENT ACTION REQUESTED BY SEPTEMBER 13, 2002

Investment Analysis Tools

NASD Requests Comment on Proposed Interpretative Material Regarding Investment Analysis Tools.

Comment Period Expires on September 13, 2002.

Executive Summary

NASD Rule 2210(d)(2)(N) prohibits NASD member firms from making predictions or projections of investment results to the public.¹ NASD staff has interpreted the rule to prohibit members from providing customers with access to interactive technological tools that produce simulations and statistical analyses showing a range of probabilities that various investment outcomes might occur. The proposed Interpretive Material to Rule 2210 (Attachment A) would provide a limited exception to Rule 2210(d)(2)(N), allowing members to provide customers direct access to such tools under certain circumstances. NASD seeks comment on whether it should amend Rule 2210(d)(2)(N) to create such an exception and, if so, on the specific provisions of the proposed Interpretive Material.

Action Requested

NASD requests comment from all interested parties on whether and to what extent NASD should amend Rule 2210(d)(2)(N) to allow members to provide investment analysis tools directly to their customers. Comments must be received by **September 13, 2002**. Members and interested persons can submit their comments using the following methods:

- + mailing Attachment B—Request for Comment Form—along with written comments to NASD
- + mailing written comments to NASD
- + e-mailing written comments to pubcom@nasd.com
- + submitting written comments online on the NASD Web Site (www.nasd.com)

02-51

Written comments submitted via hard copy should be mailed to:

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

Important Note: The only comments that will be considered are those submitted in writing or by e-mail.

Before becoming effective, any rule change developed as a result of comments received must be submitted to and approved by the Securities and Exchange Commission (SEC).

Questions/Further Information

Questions or comments concerning the information contained in this *Notice to Members (NtM)* may be directed to Nancy C. Libin, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8835 or nancy.libin@nasd.com, or James S. Wrona, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8270 or jim.wrona@nasd.com, or Joseph P. Savage, Counsel, Investment Companies Regulation, Regulatory Policy and Oversight, at (240) 386-4534 or joe.savage@nasd.com.

Background

In recent years, the public increasingly has sought access to additional investment information and tools to make investment decisions. Technology has been a key component of members' attempts to meet this investor demand.² NASD's proposed Interpretive Material

to Rule 2210 seeks to modernize certain aspects of the rule to keep pace with investor needs and technological developments. In doing so, however, NASD does not want to compromise Rule 2210's general purpose—to ensure that “communications [with the public] are fair, balanced, and not misleading.”³

NASD Rule 2210(d)(2)(N) prohibits members from predicting or projecting investment results in communications to the public. NASD staff has interpreted this provision to prohibit members from providing their customers with access to automated tools that indicate the probability that an investment strategy will produce a desired result. NASD seeks comment on its proposal to modify that interpretation to allow members to provide customers direct access to such tools under certain, limited circumstances.

The proposed Interpretive Material would allow members to make available to their customers “investment analysis tools,” defined as interactive technological tools that produce simulations and statistical analyses showing a range of probabilities that various investment outcomes might occur. In general, these tools express in quantitative terms the likelihood that a specific event—such as meeting a financial goal—might occur. A customer using such a tool usually enters information regarding, for example, his or her age, financial situation, and investment objectives to receive personalized investment advice.

Although NASD staff has not permitted members to provide customers direct access to such tools under NASD's current rules,⁴ other financial advisors and institutions have offered public access to similar automated tools for some time. With appropriate disclosures and other safeguards, NASD believes that investors

could properly use these tools in making judgments about how an investment strategy might perform. Importantly, under the proposed Interpretive Material, the tools could not predict that a particular outcome will in fact occur.

NASD is proposing certain requirements for members' use of the tools with their customers. For instance, among other requirements, members would have to:

- ♦ Disclose the entire range of possible outcomes, giving both downside risk and upside gain.
- ♦ Disclose the universe of investments considered and state that other investments not considered might have characteristics similar to those that the tools analyze.
- ♦ Explain all material assumptions in a clear and understandable manner.
- ♦ Disclose whether the tools search, analyze or in any way favor certain securities within the universe of securities considered and explain the reasons for such selectivity.

Members also would need to provide NASD with access to the tools prior to their use and file with NASD any related sales material for its review. The proposed Interpretive Material, moreover, makes clear that, to the extent that these tools make investment recommendations, NASD's suitability rule, Rule 2310, would apply.⁵

Request For Comment on Proposed Interpretive Material to Rule 2210 Regarding Investment Analysis Tools

NASD is soliciting comments on its proposed Interpretive Material to Rule 2210. NASD requests that members and other interested parties comment on whether Rule 2210(d)(2)(N) should be amended to create an exception that allows members to provide customers direct access to investment analysis tools that indicate probabilities of certain investment outcomes. In addition, NASD seeks comments on the proposed Interpretive Material's specific provisions. NASD also is interested in receiving comments on the benefits and risks associated with customers' use of these tools on members' Web sites.⁶

NASD has found comments from member firms and the public, as well as state and federal regulators, to be a valuable resource in the decision-making process. NASD encourages all interested parties to comment on the concepts discussed above regarding the proposed "investment analysis tools" exception to Rule 2210(d)(2)(N)'s prohibitions. NASD will consider the comments it receives in determining whether to submit the Interpretive Material as a formal rule change to the SEC and, if so, the form that rule change will take. Comments must be submitted by **September 13, 2002**.

Endnotes

- 1 NASD Rule 2210(d)(2)(N) states that:

In communications with the public, investment results cannot be predicted or projected. Investment performance illustrations may not imply that gain or income realized in the past will be repeated in the future. However, for purposes of this Rule, hypothetical illustrations of mathematical principles are not considered projections of performance; e.g., illustrations designed to show the effects of dollar cost averaging, tax-free compounding, or the mechanics of variable annuity contracts or variable life policies.
 - 2 See Commissioner Laura Unger, SEC, *On-Line Brokerage: Keeping Apace of Cyberspace, 1* (Nov. 1999), available at <http://www.sec.gov/pdf/cybrtnd.pdf> (“[I]nvestors can—from the comfort of their own homes—access a wealth of financial information on the same terms as market professionals, including breaking news developments and market data. In addition, on-line brokerage provides investors with tools to analyze this information, such as research reports, calculators, and portfolio analyzers.”); Use of Electronic Media, Release Nos. 33-7856, 34-42728, IC-24426, 65 Fed. Reg. 25843, 25844 (May 4, 2000), 2000 SEC LEXIS 847, at *4 (Apr. 28, 2000) (discussing technology’s impact on the securities industry).
 - 3 SEC Order Approving Proposed Rule Change Relating to Standards for Individual Correspondence, Release No. 34-40365, 63 Fed. Reg. 47062, 47062 (Sept. 3, 1998), 1998 SEC LEXIS 1841, at *3 (Aug. 26, 1998). As the SEC has commented, regulators need to be “sensitive to the regulatory challenges of a changing technological environment” and must “balance the benefits of encouraging innovation and the use of new technologies against the need to protect investors and maintain orderly markets.” SEC Report to the Congress: The Impact of Recent Technological Advances on the Securities Markets (Sept. 1997), available at <http://www.sec.gov/news/studies/techrp97.htm>.
 - 4 As a general matter, members are responsible for hyperlinked information, including any information contained in a hyperlinked Web site that provides an investment analysis tool. However, under certain limited circumstances, members are not responsible for the content and filing of material that appears on independent, third-party Web sites. See Interpretive Letter from Thomas Selman, Director of NASD Advertising/Investment Companies Regulation, to Craig S. Tyle, General Counsel of Investment Company Institute (Nov. 11, 1997), available at http://www.nasdr.com/2910/2210_01.htm (providing guidance regarding members’ regulatory responsibilities for hyperlinks to third-party Web sites). Because the circumstances surrounding hyperlinks will vary, members should file with NASD’s Advertising Regulation Department any Web pages that include hyperlinks to Web sites that contain investment analysis tools to determine the extent to which the member is responsible for the content and filing of such sites.
 - 5 In April 2001, NASD issued its Online Suitability Policy Statement, *Notice to Members 01-23*, 66 Fed. Reg. 20697 (Apr. 24, 2001), 2001 NASD LEXIS 28 (Apr. 2001), available at <http://www.nasdr.com/pdf-text/0123ntm.pdf>. The Policy Statement discusses the circumstances under which “recommendations” are made in the online environment for purposes of the suitability rule. The Policy Statement also states that the suitability rule applies to recommendations made by computer programs.
 - 6 Will access to these products improve investors’ ability to make investment decisions and properly allocate their assets? Are there any risks that investors will rely too heavily on projected returns without recognizing that their actual returns may be different?
- © 2002. NASD. All rights reserved. *Notices to Members* attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.

ATTACHMENT A

Text of Proposed Interpretive Material to Rule 2210

IM-2210- . Requirements for the Use of Investment Analysis Tools

(a) General Considerations

This Interpretive Material provides a limited exception to NASD Rule 2210(d)(2)(N).¹ No member may imply that NASD endorses or approves the use of any investment analysis tool or any recommendation based on such a tool. Members that intend to offer an investment analysis tool under this Interpretive Material must provide NASD's Advertising Regulation Department (Department) with access to the investment analysis tool at least 30 days prior to first use and must file any sales material concerning the tool with the Department at least 30 days prior to use. Members also must provide any supplemental information requested by the Department. If the Department requests changes to the investment analysis tool or sales material, the tool or sales material may not be offered or used until all changes specified by the Department have been made and approved by the Department. In addition, as in all cases, a member's compliance with this Interpretive Material does not mean that the member is acting in conformity with other applicable laws and rules. Members that offer an investment analysis tool under this Interpretive Material are responsible for ensuring that use of the investment analysis tool and all recommendations based on the investment analysis tool comply with NASD's suitability rule, Rule 2310, the other provisions of Rule 2210, and the other applicable federal securities laws and Securities and Exchange Commission and NASD rules.

(b) Definition

For purposes of this Interpretive Material and any interpretation thereof, an "investment analysis tool" is an interactive technological tool that produces simulations and statistical analyses that present a range of probabilities that various investment outcomes might occur thereby enabling investors to evaluate the potential risks of and returns on particular investments.

¹ NASD Rule 2210(d)(2)(N) prohibits NASD member firms from making predictions or projections of investment results to the public. In the past, the rule also had been interpreted as prohibiting members from providing customers with direct access to investment analysis tools. This Interpretive Material allows member firms to offer such tools in certain circumstances.

(c) Use of Investment Analysis Tools and Related Sales Material

Members may provide investment analysis tools and use related sales material only if they:

- (1) present a range of probabilities that various investment outcomes might occur and do not state that a particular investment outcome will, in fact, occur;
- (2) prominently disclose the range of all possible investment outcomes generated by the investment analysis tool;
- (3) use a reproducible mathematical process;
- (4) describe the criteria and methodology used;²
- (5) give investors a fair and balanced presentation of the risks as well as the potential rewards of using the investment analysis tool, including, but not limited to:
 - (A) identification and explanation of the limitations of the methodology employed; and
 - (B) an explanation that it is likely that the analysis will change over time with respect to the same investments.
- (6) disclose the universe of investments considered in the analysis and state that other investments not considered may have characteristics similar to those being analyzed;
- (7) disclose whether the investment analysis tool searches, analyzes or in any way favors certain securities within the universe of securities considered, beyond the criteria and methodology disclosed under paragraph (c)(4), and the reasons for this selectivity;³ and

2 This disclosure should provide detailed information about how the tool conducts its analyses and the principles on which those analyses are based, including, but not limited to, the security- or fund-specific attributes of the recommended securities or mutual funds, transaction costs, tax implications, interest rate and inflationary analysis, historical performance, and the consistency of that performance over time.

3 This disclosure should indicate, among other things, whether the investment analysis tool searches, analyzes or in any way favors certain securities within the universe of securities considered based on revenue received by the member in connection with the sale of those securities or based on relationships or understandings between the member and the entity that created the investment analysis tool. The disclosure also should indicate whether the investment analysis tool is limited to searching, analyzing or in any way favoring securities in which the member makes a market or has any other direct or indirect interest.

(8) explain all material assumptions in a clear and understandable manner.⁴

(d) Disclosures

- (1) The disclosures and other required information discussed in paragraphs (c) and (d)(2) must be in narrative form, may not be contained in footnotes or in a font size that is inconsistent with the tool's overall written presentation, and, where feasible, should be located in areas related to the subject of the disclosure or other required information; and
- (2) members must prominently display the following additional disclosure:
"IMPORTANT: The forecasts or other information generated by [brand name of investment analysis tool] regarding the probabilities that various investment outcomes might occur are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. [Brand name of investment analysis tool] only presents a range of possible outcomes."

⁴ The investment analysis tool should provide the investor with information sufficient to evaluate the tool's analysis and forecast. The tool also should explain fully the differences between the securities or mutual funds previously owned and the securities or mutual funds recommended so that the customer can assess the tool's analysis. If the tool recommends a mutual fund, the tool should provide information about the fund's investment objectives, fees and expenses and other pertinent information, and the fact that these attributes can change.

ATTACHMENT B

Request for Comments Form

Proposed Interpretive Material to Rule 2210 Regarding Members' Ability to Provide Customers Direct Access to Investment Analysis Tools

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

Instructions

Comments must be received by **September 13, 2002**. Members and interested parties can submit their comments using the following methods:

- + mailing Attachment B—Request for Comment Form—along with written comments to NASD
- + mailing written comments to NASD
- + e-mailing written comments to pubcom@nasd.com
- + submitting written comments online on the NASD Web Site (www.nasd.com)

Written comments submitted via hard copy should be mailed to:

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

Proposed Interpretive Material to Rule 2210 Regarding Members' Ability to Provide Customers Direct Access to Investment Analysis Tools

NASD requests comment from all interested parties on whether and to what extent Rule 2210 should be amended to allow members to provide investment analysis tools directly to their customers. In particular, NASD seeks input on the following topics:

1. Should NASD amend Rule 2210(d)(2)(N) to permit members to provide investment analysis tools directly to their customers?

- Yes No See my attached written comments

2. If yes, should members be permitted to provide investment analysis tools directly to their customers and use related sales material only if they present a range of probabilities that various investment outcomes might occur and do not state that a particular investment outcome will, in fact, occur?

Yes No See my attached written comments

3. Should members be permitted to provide investment analysis tools directly to their customers and use related sales material only if they use a reproducible mathematical process?

Yes No See my attached written comments

4. Should firms be required to provide the information listed below?

a. The range of all possible investment outcomes generated by the investment analysis tool.

Yes No See my attached written comments

b. The criteria and methodology used.

Yes No See my attached written comments

c. The risks as well as the potential rewards of using the investment analysis tool, including, but not limited to: identification and explanation of the limitations of the methodology employed; and an explanation that it is likely that the analysis will change over time with respect to the same investments.

Yes No See my attached written comments

d. The universe of investments considered in the analysis and whether other investments not considered may have characteristics similar to those being analyzed.

Yes No See my attached written comments

e. Whether the investment analysis tool searches, analyzes or in any way favors certain securities within the universe of securities considered and the reasons for this selectivity.

Yes No See my attached written comments

5. Should members also be required to display the following additional disclosure?

“IMPORTANT: The forecasts or other information generated by [brand name of investment analysis tool] regarding the probabilities that various investment outcomes might occur are hypothetical in nature, do not reflect actual investment results and are not guarantees of future results. [Brand name of investment analysis tool] only presents a range of possible outcomes.”

Yes No See my attached written comments

6. Will access to these products improve investors' ability to make investment decisions and properly allocate their assets?

Yes No See my attached written comments

7. Are there any risks that investors will rely too heavily on projected returns without recognizing that their actual returns may be different?

Yes No See my attached written comments

Contact Information

Name: _____

Firm: _____

Address: _____

City/State/Zip: _____

Phone: _____

E-Mail: _____

Are you:

An NASD Member

An Investor

A Registered Representative

Other: _____

Notice to Members

AUGUST 2002

SUGGESTED ROUTING

CRD
Legal & Compliance
Member Regulation
Operations
Senior Management

KEY TOPICS

Branch Office Definition
Rule Modernization
Rule 3010(g)(2)

REQUEST FOR COMMENT ACTION REQUESTED BY SEPTEMBER 20, 2002

Branch Office Definition

NASD Requests Comment on Proposed Amendments to NASD Rule 3010(g)(2) ("Branch Office Definition");
Comment Period Expires on September 20, 2002

Executive Summary

NASD requests comment from members, investors, and other interested parties on proposed amendments to NASD Rule 3010(g)(2) ("Branch Office Definition"), which were developed collectively by NASD, the New York Stock Exchange, Inc. (the NYSE) and the North American Securities Administrators Association, Inc. (NASAA), with the intention of creating a uniform definition of the term among regulators. Currently, there is no uniform approach among regulators for classifying locations at which securities operations are conducted. The creation of a uniform branch office definition would allow NASD to pursue registration of branch offices through NASD's Central Registration Depository (CRD) system.

NASD seeks comment on the proposed definition of branch office, including on whether the proposed uniform definition: (1) provides greater clarity on when a location is required to be registered as a branch office; (2) provides a cost savings to firms as a result of centralized registration of locations through NASD's CRD system; (3) minimizes regulatory compliance burdens; (4) significantly affects the number of locations that a firm is required to register; and (5) adequately addresses evolving business practices based on technological innovations. Additionally, NASD seeks comment on whether the proposed exceptions to the branch office are appropriate. Commenters are encouraged to provide empirical data where possible to support their views.

Questions/Further Information

Questions concerning this *Notice* may be directed to Kosha Dalal, Assistant General Counsel, Office of General Counsel, NASD

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Regulatory Policy and Oversight, at (202) 728-6903; or questions concerning NASD coordination with the NYSE and NASAA may be directed to Chip Jones, Associate Vice President, NASD Registration and Disclosure, at (240) 386-4797.

Request for Comment

NASD requests comment on the proposed amendments to Rule 3010(g)(2). Comments must be received by September 20, 2002. Members and interested persons can submit their comments using the following methods:

- + mail Attachment B—Request for Comment Form—along with written comments
- + mail written comments
- + e-mail written comments to pubcom@nasd.com
- + submit written comments online on our Web Site (www.nasd.com)

Written comments submitted via hard copy should be mailed to:

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

Important Note: The only comments that will be considered are those submitted by mail, e-mail, or those submitted to the NASD Web Site.

Before becoming effective, any rule change developed as a result of responses received to this *Notice* must be approved by the Securities and Exchange Commission.

Background

In July 2001, NASD announced in *Notice to Members 01-35* its intention to move forward with an initiative designed to ensure that NASD rules are as streamlined as possible, and impose the least burden to accomplish their objectives while achieving investor protection. In response to *NASD Notice to Members 01-35*, NASD received 37 comment letters identifying rules that should be the focus of our rule modernization effort. After reviewing these comment letters, in *NASD Notice to Members 02-10* (January 2002), NASD requested comment on certain proposals that were under consideration, including establishing a uniform branch office definition. Of the approximately 65 commenters who responded regarding Rule 3010(g)(2), the responses were overwhelmingly in favor of developing a uniform definition that would allow centralized registration through the CRD system.

Current Definition

NASD Rule 3010(g)(2) defines a branch office generally as any location identified by any means to the public or customers as a location at which the member conducts an investment banking or securities business (“holding out”). The current definition excludes certain locations that only are identified in telephone listings, business cards, or letterhead, or referred to in advertising, or identified in a member’s sales literature, provided that the address and telephone number of the branch office or office of supervisory jurisdiction (OSJ) from which the associated person is supervised is given.

NASD designates locations from which associated persons work, other than the main office, as either branch offices or unregistered locations. This designation primarily affects the supervisory responsibilities of, and the fees paid by, members. An office that is designated a "branch office" under NASD rules must pay an annual registration fee and have onsite supervision by a branch manager. A branch office is further classified as an OSJ if any one of the following enumerated activities occurs at the location: order execution, maintenance of customer funds and securities, final approval of new accounts and advertisements, review of customer orders, and supervision of associated persons at other branch offices. An office that is designated an OSJ must have a registered principal onsite. The proposed uniform definition would not affect or change the definition, or responsibilities, of an OSJ.

Need for Uniformity

Currently, there is no uniform approach among regulators for classifying locations at which securities operations are conducted. NASD, the Securities and Exchange Commission (the SEC), the NYSE, and state regulators define the term (or a similar term) differently. The term also has different significance based on who classifies it. Under NASD rules, for example, the term triggers supervisory obligations and fees and, under the SEC rules, the term triggers record keeping requirements. NASD believes that a uniform definition of the term branch office would reduce regulatory burdens on firms because (1) there would be no need to keep track of varying definitions in numerous jurisdictions; (2) the risk of non-

compliance would be reduced; and (3) a centralized registration process would provide efficiencies.

The SEC's books and records rules, Rule 17a-3 and Rule 17a-4 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 proposed branch office definition would not alter or affect the obligations of a firm to comply with the requirements of the Books and Records Rules. The definition proposed here, and agreed upon by representatives of NASAA and the NYSE, largely tracks the definition in the SEC's Books and Records Rules for the term "office."¹

In July 2002, the NASD Board approved publication of this *Notice* seeking comment on the proposed uniform definition. In August 2002, the Board of Directors of the NYSE approved the proposed uniform definition and authorized its staff to file a proposed rule change with the SEC. In addition, NASAA's Broker-Dealer Section Committee has approved the proposed definition. NASAA also has committed to support the adoption of the uniform definition with the various states.

Proposed Definition of "Branch Office"

As proposed, a "branch office" would be any location, other than the main office, where one or more associated persons of a member regularly conduct the business of effecting any transactions in, or inducing or attempting to induce the purchase or sale of, any security, or that is held out as such.

The interpretation of what it means to “regularly conduct the business of effecting transactions in, or inducing or attempting to induce the purchase or sale of any security” under the proposed uniform definition would include activities such as: (1) soliciting new accounts or orders; (2) opening new accounts; (3) accepting or entering orders; and (4) conducting seminars for existing or prospective customers. In addition, “holding out” a location would include references to a location on or in business cards, stationery, advertisements, sales literature, and signage that would lead investors to believe that they are dealing with a branch office of a member firm, regardless of whether the location from which the office is supervised is listed on the communication.

The definition of “branch office” would expressly exclude, subject to the satisfaction of certain conditions:

- (1) a location that operates as a back office;
- (2) a representative’s primary residence, provided the residence is used for securities business for less than 50 days annually and not held out to the public;
- (3) a location, other than a primary residence, provided that it is used for securities business for less than 30 days annually and not held out to the public (e.g., a vacation home);
- (4) a location used by a circuit-rider to meet with customers occasionally and exclusively by appointment;

- (5) a location that is primarily used for non-securities business (e.g., by insurance agents to sell non-securities insurance products) and from which the associated person(s) effects no more than 25 securities transactions in any one calendar year;
- (6) the floor of a registered exchange; and
- (7) a temporary location established in response to implementation of a business continuity plan.

See Attachment A for a full description of the conditions that need to be satisfied for each exception to apply.

Comparison of Current Definition vs. Proposed New Definition

The current NASD branch office definition is based on a “holding out” standard (any location identified to the public or customers as a location at which the member conducts an investment banking or securities business). The definition is broad and is not dependent on the number of associated persons working at any particular location. The current definition excludes certain locations held out to the public so long as the identification of such locations is limited and sets forth the address and telephone number of the branch office or OSJ of the firm from which the associated person is directly supervised (for example, a business card or letterhead can list a non-branch location so long as the address and telephone number of the branch office or OSJ is

also listed). Under the proposed uniform definition, this type of exception would no longer exist.

The proposed uniform definition is intended to provide clarity in application and consistency between self-regulatory organizations (SROs) and state securities administrators. Under the proposed definition, any location where one or more associated persons regularly conduct the business of effecting transactions in, or inducing or attempting to induce the purchase or sale of, any security or that is held out as such is subject to registration as a branch office unless the location meets one of the seven specific exclusions. The exclusions are intended to provide firms with the flexibility that today's business environment demands (for example, many associated persons work from home for some part of the year, or conduct business while on vacation).

The chart on the next page briefly compares the two definitions.

Location	Current Definition	Proposed New Definition
Back Office	Subject to registration if the location is identified to the public in any way, including in a business card, letterhead, or identified in sales literature, etc., unless the address and telephone number of the branch office or OSJ is also identified	Specifically excluded from registration so long as no sales activities occur at the location and it is not held out to the public as a branch office
Primary Residence	Subject to registration if the location is identified to the public in any way, including in a business card, letterhead, or identified in sales literature, etc., unless the address and telephone number of the branch office or OSJ is also identified	Specifically excluded from registration so long as the primary residence is used for securities business for less than 50 business days per year and other conditions are satisfied
Vacation Locations	Subject to registration if the location is identified to the public in any way, including in a business card, letterhead, or identified in sales literature, etc., unless the address and telephone number of the branch office or OSJ is also identified	Specifically excluded from registration so long as the location is used for securities business for less than 30 business days per year and other conditions are satisfied
Bank Circuit Rider	Not subject to registration so long as the address and phone number of the branch office or OSJ are also identified	Not subject to registration so long as not held out (signage required by banking regulations is permitted)
Non-securities Business	Subject to registration if the location is identified to the public in any way, including in a business card, letterhead, or identified in sales literature, etc., unless the address and telephone number of the branch office or OSJ is also identified	Not subject to registration so long as location is used primarily to conduct non-securities business (e.g., sell non-security insurance products) and no more than 25 securities transactions are effected in one year and address and phone number of branch or OSJ is identified
Floor of Registered National Securities Exchange	Potentially subject to registration	Not subject to registration
Temporary Location for Business Continuity	Potentially subject to registration	Not subject to registration

Benefits of Proposed New Definition

NASD believes that a uniform definition would benefit member firms by reducing regulatory burdens and costs, without jeopardizing investor protection. In addition, the potential to use the CRD system for centralized registration of branch offices should provide greater clarity, efficiency, and time and potential liability savings resulting from uniformity. Currently, members with numerous offices must register with each individual state that requires registration; in some jurisdictions, failure to timely register can result in significant sanctions.

NASD, therefore, solicits comment on whether to amend the Branch Office Definition as proposed in Attachment A. NASD also solicits comment specifically on whether the proposed uniform definition: (1) provides greater clarity on when a location is required to be registered as a branch office; (2) provides a cost savings to firms as a result of centralized registration of locations through CRD; (3) minimizes regulatory compliance burdens; (4) significantly affects the number of locations that a firm is required to register; and (5) adequately addresses evolving business practices based on technological innovations. Additionally, NASD seeks comment on whether the proposed exceptions to the branch office definition are appropriate. Commenters are encouraged to provide empirical data where possible to support their views.

Endnote

¹ Rule 17a-3(g)(1) under the Exchange Act defines the term “office” to mean 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.

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ATTACHMENT A

Proposed New Text of Rule 3010(g)(2) - "Branch Office" Definition

A "branch office" is any location, other than the main office, where one or more associated persons of a member regularly conduct the business of effecting any transactions in, or inducing or attempting to induce the purchase or sale of, any security, or that is held out as such, excluding:

- (A) any location that is established solely for customer service and/or back office type functions where no sales activities are conducted and that is not held out to the public as a branch office;
- (B) any location that is the associated person's primary residence; provided that (i) the location is used for securities business for less than 50 business days in any one calendar year; (ii) only one person, or multiple associated persons who reside at that location and are members of the same immediate family, conduct business at the location; (iii) the location is not held out to the public as an office and the associated person does not meet with customers at the location; (iv) neither customer funds nor securities are handled at that location; (v) the associated person is assigned to a designated branch office, and such designated branch office is reflected on all business cards, stationery, advertisements and other communications to the public by such associated person; (vi) the associated person's correspondence and communications with the public are subject to the firm's supervision; (vii) electronic communications (*i.e.*, e-mail) are made through the member's electronic system; (viii) all orders are entered through the designated branch office; (ix) written supervisory procedures pertaining to supervision of sales activities conducted at the residence are maintained by the member; and (x) a list of the residence locations are maintained by the member;

-
- (C) any location, other than a primary residence, that is used for securities business for less than 30 business days in any one calendar year, provided the member complies with the provisions of paragraph (B) above;
 - (D) any office of convenience, where associated persons occasionally and exclusively by appointment meet with customers, which is not held out to the public as a branch office (Where such location is on bank premises, only signage required by the Interagency Statement (Statement on Retail Sales of Nondeposit Investment Products required under Banking Regulations) may be displayed);
 - (E) any location that is used primarily to engage in non-securities activities and from which the associated person(s) effects no more than 25 securities transactions in any one calendar year; provided that any advertisements or sales literature identifying such location also sets forth the address and telephone number of the location from which the associated person(s) conducting business at the non-branch locations are directly supervised; or
 - (F) the Floor of a registered national securities exchange where a member conducts a direct access business with public customers; and
 - (G) a temporary location established in response to the implementation of a business continuity plan.

The term "business day" as used herein shall not include any partial business day provided that the associated person spends at least four hours on such business day at his or her designated branch office during the hours that such office is normally open for business.

ATTACHMENT B

Request for Comment Form

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

Instructions

Comments must be received by September 20, 2002. Members and interested parties can submit their comments using the following methods:

- + mail Attachment B—Request for Comment Form—along with written comments
- + mail written comments
- + e-mail written comments to *pubcom@nasd.com*
- + submit written comments online on our Web Site (*www.nasd.com*)

This form and/or written comments should be mailed to:

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

Proposed Amendments to Rule 3010(g)(2) - "Branch Office" Definition

1. Should NASD adopt the proposed uniform branch office definition?
 Yes No See my attached written comments

2. Should NASD provide for the centralized registration of branch offices for NASD and other regulators through the CRD system?
 Yes No See my attached written comments

3. Are the exceptions to branch office definition appropriate?
 Yes No See my attached written comments

4. How many registered branch offices do you currently have?

5. How many registered branch offices would you have under the proposed uniform definition?

6. In how many states do you register branch offices?

- 7 a. How much of a cost savings or increase will you have as a result of the proposed uniform definition?
\$ _____

- b. If you expect the proposed definition would increase your costs, then would the efficiencies created by the ability to register branch offices through CRD offset such increased costs?
 Yes No See my attached written comments

Contact Information

Name: _____

Firm: _____

Address: _____

City/State/Zip: _____

Phone: _____

E-Mail: _____

Are you:

An NASD Member

An Investor

A Registered Representative

Other: _____

Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Legal and Compliance
Operations
Senior Management

NASD Rule 3070

NASD Files Proposal to Amend Rule 3070 to Require Filing of Criminal and Civil Complaints and Arbitration Claims with NASD; Revises Letters Sent When Determination Made to Close an Investigation Without Further Action

KEY TOPICS

NASD Rule 3070
NASD Rule 2110

Executive Summary

NASD has undertaken two initiatives to improve the quality and flow of information to it about allegations of broker misconduct. First, on August 14, 2002, NASD filed with the Securities and Exchange Commission (SEC) a rule proposal to amend NASD Rule 3070 to require members promptly to file with NASD copies of certain criminal and civil complaints and arbitration claims that name a member or an associated person as defendant or respondent. Specifically, the proposed rule change would require members to file with NASD copies of (1) any criminal complaints filed against the member or plea agreements entered into by the member that are covered by the rule; (2) any securities or commodities-related private civil complaints filed against the member; (3) any arbitration claim against the member; and (4) any criminal complaint or plea agreement, private civil complaint or arbitration claim against an associated person that is reportable under Question 14 on Form U-4, irrespective of any dollar threshold requirements that question imposes for notification. Members would not be required to file copies of any arbitration claims filed in the NASD Dispute Resolution forum. NASD recently began to review copies of claims filed in that forum for possible regulatory response.

Second, NASD has revised the letters it sends to customers and members when a determination is made to close an investigation without disciplinary action. The revised letters state that a determination by NASD not to take action against a member or a member's associated person has no evidentiary weight in any mediation, arbitration, or judicial proceeding. Further, NASD considers it inconsistent with just and equitable principles of trade (Rule 2110) for a member or a member's associated person to attempt to introduce such a determination into evidence in any of those proceedings.

02-53

The text of the proposed amendments to Rule 3070 is attached. Comments on the proposal should be directed in writing to the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549.

Questions concerning this Notice should be directed to Philip Shaikun, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8451.

Background and Discussion

Rule 3070

Rule 3070 currently requires, among other things, that a member report to NASD when it is a defendant or respondent in felony criminal proceedings, certain misdemeanor criminal proceedings, or in certain civil or arbitration actions. As to the latter, Rule 3070(a)(7) requires that a member report to NASD when the member or a person associated with the member is a defendant or respondent in securities or commodities-related civil litigation or arbitration only when the proceeding has been disposed of by a judgment, award or settlement in an amount exceeding either \$15,000 (if the defendant or respondent is an associated person) or \$25,000 (if the defendant or respondent is the member). No existing rules require a member routinely to file copies with NASD of complaints filed against it in any legal proceedings.

Similar to Rule 3070, Question 14 on Form U-4 requires notice that an associated person has been **charged** or convicted of a felony or certain misdemeanors. It further requires notice that an associated person has been named as a respondent or defendant in a

consumer-initiated arbitration or civil litigation involving a sales practice violation that is pending, resulted in a judgment, settled for \$10,000 or more, or contains a claim for compensatory damages of at least \$5,000. However, Form U-4 does not require that the member or associated person file with NASD a copy of the complaint that initiates such proceedings or any plea agreements to resolve reportable criminal charges.

By requiring members to file with NASD copies of certain criminal and civil complaints and arbitration claims, the proposed amendments to Rule 3070 will provide NASD with additional sources of pertinent information regarding broker misconduct. As a result, NASD can enhance investor protection efforts by promptly taking appropriate regulatory action to address specific allegations and to prevent similar or related misconduct in the future. Moreover, the information can be combined with other sources of regulatory intelligence to identify patterns and trends at the earliest possible stage, thereby deploying resources to higher risk areas that better protect investors. With respect to associated persons, it is important to receive copies of complaints and claims reportable under Question 14 on Form U-4, even when they fall below specified dollar thresholds, as such matters may also point to trends or otherwise flag conduct where regulatory action might be warranted.

NASD now makes copies, at its own expense, of all arbitration claims filed in the NASD Dispute Resolution forum. Those claims are forwarded after copying to a unit within NASD that reviews the allegations in the claims for possible regulatory action.

NASD would treat similarly copies of other complaints, claims and plea agreements required to be filed with NASD under the rule proposal.

The rule proposal minimizes the burden on members in that the rule requires only the filing of those complaints and claims most likely to reveal information to assist NASD's regulatory mission. For example, members would not be required to file private civil litigation complaints or arbitration claims that do not relate to securities or commodities-related conduct. Furthermore, as discussed above, the proposal would not require members to file with NASD any arbitration claims that are originally filed in the NASD Dispute Resolution forum. NASD is already incurring the cost to make copies of those claims and will continue to do so under the proposal.

Content and Use of Close-Out Letters

In a related initiative, NASD recently revised the letters that are sent to customers and members when a determination is made to close an investigation without further disciplinary action. This step was taken after NASD learned that some customers chose not to bring allegations to the attention of NASD out of concern that a letter declining further action would be offered as exculpatory evidence in an arbitration, mediation, or judicial proceeding.

NASD is not litigating a private arbitration claim when it conducts a regulatory review. As a result, the revised letters now state NASD's contention that a determination not to take action

against a member has no evidentiary weight in a subsequent proceeding, such as mediation, arbitration, or a judicial action. In addition, NASD now gives the customer the option not to receive a close-out letter. To opt out, a customer must notify NASD of this decision in writing or by e-mail. In the event a customer does opt out, NASD will not issue a final close-out letter.

Furthermore, the revised letters warn that NASD considers it inconsistent with just and equitable principles of trade (Rule 2110) for a member or associated person to attempt to introduce the letter, or the fact that NASD declined further action, as evidence in a subsequent legal proceeding. NASD's decision to close an investigation without further action can result from many factors unrelated to the merits of a complaint, such as jurisdictional limitations or the existence of an ongoing or completed enforcement action by another law enforcement or regulatory agency. As such, NASD considers it unethical and potentially misleading to suggest to an adjudicator or mediator that NASD's determination is probative evidence in a dispute on the merits of a related claim.

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ATTACHMENT A

Proposed Amendment to NASD Rule 3070

Additions are underlined. Deletions are in brackets.

3070. Reporting Requirements

(a) through (c) No change.

(d) Nothing contained in [paragraphs (a), (b) and (c) of] this Rule shall eliminate, reduce, or otherwise abrogate the responsibilities of a member or person associated with a member to promptly file with full disclosure, required amendments to Form BD, Forms U-4 and U-5, or other required filings, and to respond to [the Association] NASD with respect to any customer complaint, examination, or inquiry.

(e) Any member subject to substantially similar reporting requirements of another self-regulatory organization of which it is a member is exempt from [the provisions] paragraphs (a), (b) and (c) of this Rule.

(f) Each member shall promptly file with NASD copies of:

(1) any indictment, information or other criminal complaint or plea agreement for conduct reportable under paragraph (a)(5) of this Rule;

(2) any complaint in which a member is named as a defendant or respondent in any securities or commodities-related private civil litigation;

(3) any securities or commodities-related arbitration claim filed against a member in any forum other than the NASD Dispute Resolution forum;

(4) any indictment, information or other criminal complaint, any plea agreement, or any private civil complaint or arbitration claim against a person associated with a member that is reportable under question 14 on Form U-4, irrespective of any dollar thresholds Form U-4 imposes for notification, unless, in the case of an arbitration claim, the claim has been filed in the NASD Dispute Resolution forum.

Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Legal & Compliance
Senior Management

REQUEST FOR COMMENT ACTION REQUESTED BY SEPTEMBER 20, 2002

Membership Application Rules

NASD Requests Comment on Proposed Amendments to Rules 1014 and 1017; **Comment Period Expires September 20, 2002**

KEY TOPICS

Membership Application Process
Membership Continuation Process
Rule 1014
Rule 1017

Executive Summary

NASD requests comment on proposed amendments to Rules 1014 and 1017. Rule 1017(a) sets forth certain events relating to changes in a member's ownership, control, or business operations, which require a member to apply and obtain approval from NASD staff.¹ Rule 1014 establishes the standards for approval of both new member applications under Rule 1013 and "continuing member applications" under Rule 1017. NASD is proposing amendments to Rules 1014 and 1017 to clarify and further strengthen NASD's authority under these rules in an effort to stay abreast of market developments.

Specifically, NASD has experienced an increase in member consolidations, business restructurings, and asset sales. NASD has reviewed proposed transactions that could have an adverse effect on the payment of arbitration awards and satisfaction of other customer claims. To address concerns raised in such transactions, NASD seeks comment on amendments to Rules 1014 and 1017 that would: (1) expand NASD's authority to review asset transfers to include any transfer involving a material amount of assets and/or revenues that contribute materially to earnings; (2) require that any seller that is not a member of the New York Stock Exchange (NYSE) file an application for asset transfers covered by the rule even in the case where the buyer to the transaction is an NYSE member (which currently is a situation excluded from review under Rule 1017); and (3) create a new standard of admission explicitly identifying as decisional criteria unpaid arbitration awards or other adjudicated customer awards, as well as pending arbitration claims by an applicant, its controlling persons, principals, registered representatives, any lender of 5% or more of the applicant's net capital, and any other member with respect to which these persons were a controlling person or a 5% lender of its net capital.

02-54

In addition, former members or their associated persons with a significant disciplinary history, including a history of unpaid arbitrations, may later seek to re-enter the securities industry. NASD is concerned about the investor protection issues and the potential adverse impact on the integrity of the marketplace posed by these persons. In this regard, as further outlined below, NASD is requesting comments on an amendment that would place the burden on applicants to demonstrate that their applications should be approved notwithstanding that the applicant has a history of certain regulatory events.

NASD further seeks comment on whether Rule 1014 should be amended to include reference to entities as controlling persons in light of the fact that NASD's current definition of "associated persons" does not include non-natural persons.

Questions/Further Information

Questions regarding this *Notice to Members* may be directed to the NASD Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8071; or the NASD Member Regulation Department, Regulatory Policy and Oversight, at (202) 728-8221.

Request for Comment

NASD requests comment on the proposed amendments to Rules 1014 and 1017 described in this *Notice*. For your convenience, we have provided a checklist (see Attachment B) that offers a convenient method to participate in the comment process concerning the proposed amendments.

Comments must be received by **September 20, 2002**. Members and interested persons can submit their comments using the following methods:

- ▶ mail Attachment B—Request for Comment Form—along with written comments
- ▶ mail written comments
- ▶ e-mail written comments to pubcom@nasd.com
- ▶ submit written comments online on our Web Site (www.nasd.com)

Written comments submitted via hard copy should be mailed to:

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

Important Note: The only comments that will be considered are those submitted by mail, e-mail, or those submitted to the NASD Web Site.

Before becoming effective, any rule change developed as a result of responses received to this *Notice* must be approved by the Securities and Exchange Commission.

Background

The membership application and membership continuation processes have played an important role in investor protection by helping to ensure that new members and members that make a material change to their business comply and continue to comply with

rigorous standards. Rule 1014, which sets forth the standards used when reviewing new member and continuing member applications, specifically requires NASD to consider the public interest and protection of investors when reviewing applications.

Recently, there has been an increase in company restructurings, including the selling of company assets. Asset transfer applications filed pursuant to Rule 1017 are often time-sensitive and may be the first step in a member's withdrawal from the securities business. While asset transfers often serve legitimate business purposes, they also can raise customer protection issues. NASD has encountered several instances where the effect of a member attempting to restructure by transferring assets is to insulate the member and its owners from responsibility for payment of pending or unpaid arbitrations. In some cases, the member will transfer its assets without a corresponding transfer of its liabilities. Because the corporate format used by many members seeks to insulate the owners from liabilities of the member, a customer with an award or judgment against the member may only be able to be paid from the member's assets. Thus, an asset transfer may transform the member from an operating business that can generate value over time to a shell holding the firm's liquidated value, leaving behind customers with arbitration claims pending against, or arbitration awards unsatisfied by, a member.

Discussion

Based on NASD's experience in applying the membership application procedures, especially in light of increasing concerns

regarding the potentially negative effects of asset transfers on former and current customers, NASD believes that Rules 1014 and 1017 should be amended to allow NASD to better identify and respond to applications that may leave pending arbitrations and customer claims unaccounted for.

1. Review of Material Transfer of Member's Assets

NASD believes it is important that it has the opportunity to review all member transactions that can materially adversely affect current and former customers. Rule 1017(a)(3) requires a member to submit an application only upon the transfer of substantially all of the member's assets. However, this may potentially eliminate from NASD's review a member's piecemeal transfer of its assets that, while not "substantially all" in amount, may nevertheless have a material impact on the operations or profitability of the selling member. In this regard, NASD proposes broadening the scope of Rule 1017(a)(3) to require members to submit applications prior to the transfer of a material amount of the member's assets or prior to the transfer of any asset, business or line of operation that generates revenues comprising a material portion of the selling member's earnings.² NASD further seeks comment on whether "material" should be more specifically defined in the Rule and, if so, the appropriate standard of materiality. For example, should NASD define "material" for these purposes to be 25% or more of the member's assets or any asset, business or line of operation that generates revenues of 25% or greater of the selling member's earnings. NASD seeks comment on whether some other standard is more appropriate.

2. Clarification of Members Required to Submit Applications

Because of concerns that a selling member's customers may be left unprotected following an asset transfer, NASD believes that the seller's situation should be reviewed in connection with all such transactions. Rule 1017(a) currently exempts selling members from the requirement to submit applications if the acquiring firm is a member of the NYSE. The proposed amendments would require all non-NYSE selling members to submit an application regardless of whether the buyer is an NYSE member. NASD does not intend to put applicants through duplicative approval processes where the transaction is otherwise subject to adequate customer protection safeguards. Rather, in requiring an application regardless of whether the acquirer is a member of the NYSE, NASD will be assured of receiving notice and will be in a position to target particular aspects of the transaction for additional review, if necessary.

3. Consideration of Arbitrations in Application Process

Comporting with NASD's attempts to foster compliance with the terms of arbitration and other adjudicated customer awards, NASD proposes to amend Rule 1014(a)(3) explicitly to include as factors in the consideration of both new and continuing member applications the unpaid arbitration awards or other adjudicated customer awards, as well as pending arbitration claims against an applicant and other persons that may have significant control or influence over the applicant, including its controlling persons, principals, registered representatives, any lender of 5% or more of the applicant's net capital,

and any other member with respect to which these persons were a controlling person or a 5% lender of its net capital.³

4. Burden of Proof

NASD has seen instances where an applicant (both new member and change of ownership/control) has a disciplinary history of some concern that falls short of a statutory disqualification. Many of these cases involve applications from closely held firms where, even if the broker/dealer establishes heightened supervisory procedures, the influence of the control person on the small broker/dealer may overcome the supervisory structures. Rule 1014(a)(3) requires NASD to determine whether an applicant and its associated persons "are capable of complying with" federal securities laws and the rules of NASD. A variety of specific events, including past and current disciplinary actions and customer claims, are among the considerations referenced in the rule. However, there is little case precedent to guide NASD in applying this standard, particularly in the context of the key principals and control persons of smaller firms.

NASD is proposing to further enhance its authority under Rule 1014(a), for all categories of applications, to consider the impact of an applicant's past behavior by creating a rebuttable presumption that the presence of any of the events enumerated in Rule 1014(a)(3)(A) and (C) through (E), places the burden on the applicant to demonstrate that the application should be approved notwithstanding the presence of that regulatory history. The rebuttable presumption does not create new standards for admission, but merely shifts the burden of proof to applicants to

show that they should be allowed admission. NASD believes that investor protection and service of the public interest demands that applicants with a regulatory history bear the burden of overcoming the rebuttable presumption that their application should be denied.

Additional Issue for Comment

Finally, NASD proposes to amend Rule 1014 to include reference to non-natural controlling persons in light of the fact that NASD's current definition of "associated persons" does not encompass non-natural persons.

Endnotes

- 1 The changes requiring application and approval are: mergers, the acquisition of a member, the acquisition of substantially all of a member's assets, a change in ownership or control of a member, and a material change in a member's business operations.
 - 2 As with other Rule 1017 applications, Rule 1017(c)(1) allows NASD to place interim restrictions on any asset transfer if NASD believes that the application does not meet Rule 1014 standards. These interim restrictions are meant for the protection of investors and ordinarily would not prevent a transaction from moving forward. However, there may be some instances where the protection of investors will require that interim restrictions will prohibit or delay a transaction from closing.
 - 3 NASD further notes that Rule 2110 applies to efforts by a firm and its owners to unfairly prejudice customers seeking relief in arbitration proceedings.
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ATTACHMENT A

New language is underlined; deletions are in brackets.

1014. Department Decision

(a) Standards for Admission

After considering the application, the membership interview, other information and documents provided by the Applicant, other information and documents obtained by the Department, and the public interest and the protection of investors, the Department shall determine whether the Applicant meets each of the following standards:

(1) – (2) No Change.

(3) The Applicant and its Associated Persons are capable of complying with the federal securities laws, the rules and regulations thereunder, and the Rules of the Association, including observing high standards of commercial honor and just and equitable principles of trade. In determining whether this standard is met, the Department may take into consideration whether:

(A) – (B) No Change.

(C) an Applicant or Associated Person is the subject of a pending, adjudicated, or settled regulatory action or investigation by the Commission, the Commodity Futures Trading Commission, a federal, state, or foreign regulatory agency, or a self-regulatory organization; a pending, adjudicated, or settled investment-related civil action for damages or an injunction; or a criminal action (other than a minor traffic violation) that is pending, adjudicated, or that has resulted in a guilty or no contest plea; or an Applicant, its control persons, principals, registered representatives, any lender of 5% or more of the Applicant's net capital, and any other member with respect to which these persons were a control person or a 5% lender of its net capital is subject to unpaid arbitration awards, other adjudicated customer awards, unpaid arbitration settlements, or pending arbitrations;

(D) – (F) No Change.

(4) – (14) No Change.

(b) Granting or Denying Application

(1) In reviewing an application for membership, the Department shall consider whether the applicant meets each of the standards in paragraph (a), provided the Applicant overcomes the presumption that the application should be denied where one or more of the circumstances identified in Rule 1014(a)(3)(A) and (C) through (E) exist.

(2) [(1)] If the Department determines that the Applicant meets each of the standards in paragraph (a), the Department shall grant the application for membership.

(3) [(2)] If the Department determines that the Applicant does not meet one or more of the standards in paragraph (a) in whole or in part, the Department shall:

(A) grant the application subject to one or more restrictions reasonably designed to address a specific financial, operational, supervisory, disciplinary, investor protection, or other regulatory concern based on the standards for admission in Rule 1014(a); or

(B) deny the application.

(c) – (g) No Change.

(h) Definition of Associated Person

For purposes of this Rule 1014, the term “Associated Person” shall mean (1) a natural person registered under the Rules of NASD; or (2) a sole proprietor, partner, officer, director, branch manager, or other natural person, company, government, or political subdivision, agency, or instrumentality of a government occupying a similar status or performing similar functions who will be or is anticipated to be associated with the Applicant, or a natural person or company, government, or political subdivision, agency, or instrumentality of a government engaged in the investment banking or securities business who will be or is anticipated to be directly or indirectly controlling or controlled by the Applicant, whether or not any such person or company, government, or political subdivision, agency, or instrumentality of a government is registered or exempt from registration under the NASD By-Laws or the Rules of NASD.

1017. Application for Approval of Change in Ownership, Control, or Business Operations

(a) Events Requiring Application

A member shall file an application for approval of any of the following changes to its ownership, control, or business operations:

(1) a merger of the member with another member, unless both are members of the New York Stock Exchange, Inc. or the surviving entity will continue to be a member of the New York Stock Exchange, Inc.;

(2) a direct or indirect acquisition by the member of another member, unless the acquiring member is a member of the New York Stock Exchange, Inc.;

(3) a direct or indirect acquisition of [substantially all] a material amount of the member's assets or any asset, business or line of operation that generates revenues comprising a material portion of the member's earnings, unless [the acquirer is a member] both the seller and acquirer are members of the New York Stock Exchange, Inc.;

(4) a change in the equity ownership or partnership capital of the member that results in one person or entity directly or indirectly owning or controlling 25 percent or more of the equity or partnership capital; or

(5) a material change in business operations as defined in Rule 1011(i).

(b) – (f) No Change.

(g) Department Decision

(1) The Department shall consider the application, the membership interview, other information and documents provided by the Applicant or obtained by the Department, the public interest, and the protection of investors. In rendering a decision on an application submitted under Rule 1017(a), the Department shall consider whether the applicant meets each of the standards in Rule 1014(a), provided the Applicant overcomes the presumption that the application should be denied where one or more of the circumstances identified in Rule 1014(a)(3)(A) and (C) through (E) exist.

(A) In rendering a decision on an application for approval of a change in ownership or control, or an application for approval of a material change in business operations that does not involve modification or removal of a membership agreement restriction, the Department shall determine if the Applicant would continue to meet the standards in Rule 1014(a) upon approval of the application.

(B) In rendering a decision on an application requesting the modification or removal of a membership agreement restriction, the Department shall consider whether the maintenance of the restriction is appropriate in light of:

- (i) the standards set forth in Rule 1014;
- (ii) the circumstances that gave rise to the imposition of the restriction;
- (iii) the Applicant's operations since the restriction was imposed;
- (iv) any change in ownership or control or supervisors and principals; and
- (v) any new evidence submitted in connection with the application.

(2) – (4) No Change.

(h) – (k) No Change.

ATTACHMENT B

Request For Comment Form

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

Instructions

Comments must be received by **September 20, 2002**. Members and interested parties can submit their comments using the following methods:

- ▶ mail Attachment B—Request for Comment Form—
along with written comments
- ▶ mail written comments
- ▶ e-mail written comments to *pubcom@nasd.com*
- ▶ submit written comments online on our Web Site
(*www.nasd.com*)

Written comments submitted via hard copy should be mailed to:

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

Proposed Amendments to Rules 1014 and 1017

1. Is it appropriate for NASD to review transfers of a material amount of a member's assets or transfers of any asset, business or line of operation that generates revenues comprising a material portion of the selling member's earnings?
 Yes No See my attached written comments

2. In connection with the proposed expanded review of asset transfers, should NASD include a more specific standard of materiality in the Rules?
 Yes No See my attached written comments

3. Should NASD review other types of transactions that are not currently included in the Rules?
 Yes No See my attached written comments

4. Should NASD require all non-NYSE selling members to submit applications to NASD for approval prior to the transfer of assets?
 Yes No See my attached written comments

5. (a) Is it appropriate for applicants to bear the burden of proof to demonstrate that they should be approved for membership despite the presence of a regulatory history and,
 Yes No See my attached written comments

(b) if so, is it appropriate to impose this burden for pending matters such as pending investigations and arbitrations?
 Yes No See my attached written comments

6. Should the scope of Rule 1014 be expanded to include non-natural persons?
 Yes No See my attached written comments

Contact Information

Name: _____

Firm: _____

Address: _____

City/State/Zip: _____

Phone: _____

E-Mail: _____

Are you:

An NASD Member

An Investor

A Registered Representative

Other: _____

Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Corporate Financing
Legal & Compliance
Registered Representatives
Senior Management
Trading & Market Making

KEY TOPICS

Flipping
IPO Allocations
NASD Rule 2710
NASD Rule 2712
Penalty Bids
Spinning
Underwriting Compensation

REQUEST FOR COMMENT ACTION REQUESTED BY SEPTEMBER 9, 2002

Regulation of IPO Allocations and Distributions

NASD Requests Comment on Proposed New Rule 2712 (IPO Allocations and Distributions) and on an Amendment to Rule 2710 (Corporate Financing Rule); Comment Period Expires September 9, 2002.

Executive Summary

NASD is proposing to create new Rule 2712 and amend existing Rule 2710 to prohibit certain IPO allocation abuses. The federal securities laws¹ and existing NASD rules² already prohibit certain IPO allocation abuses. These laws and rules would continue to apply if NASD adopts proposed new Rule 2712. Nevertheless, new, specifically targeted provisions in Rule 2712 would aid member compliance efforts and help to maintain investor confidence in the capital markets. In particular, the proposal would expressly prohibit the following types of conduct:

- ♦ the allocation of IPO shares as consideration or inducement for the payment of excessive compensation for other services provided by the member;
- ♦ the solicitation of aftermarket orders for the allocation of IPO shares;
- ♦ the allocation of IPO shares to an executive officer or director of a company on the condition that the officer or director send the company's investment banking business to the member, or as consideration for investment banking services previously rendered; and
- ♦ the imposition of a penalty on registered representatives whose retail customers have "flipped" IPO shares when similar penalties have not been imposed with respect to syndicate members.

The proposal would require members to adopt procedures reasonably designed to ensure that the requirements and prohibitions in Rule 2712 are followed. The proposal also would amend Rule 2710 to allow NASD to collect certain data on potential “spinning” abuses from members. See Exhibits A and B for rule language.

Action Requested

NASD encourages all interested parties to comment on the proposal. Comments must be received by September 9, 2002. Comments should be mailed to:

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

Important Note: The only comments that will be considered are those submitted via e-mail or in writing.

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

Questions/Further Information

As noted, written comment should be submitted to Barbara Z. Sweeney. Questions concerning this *Notice to Members — Request for Comment* may be directed to Joseph E. Price, Director, Corporate Financing Department, NASD Regulatory Policy and Oversight, at (240) 386-4623, or Gary Goldsholle, Associate

General Counsel, NASD, Regulatory Policy and Oversight, at (202) 728-8104.

Background

NASD is proposing new Rule 2712 and an amendment to Rule 2710. These rule changes will better ensure that members avoid unacceptable conduct when they engage in the allocation and distribution of IPOs. In addition, these rule changes are intended to sustain public confidence in the IPO process, which is critical to the continued success of the capital markets.

Members are reminded that each provision in proposed Rule 2712 would apply independently. Compliance with one provision would not provide a safe harbor with respect to the other provisions of the rule. Moreover, members would have to ensure that their participation in the allocation and distribution of IPOs complies not only with Rule 2712, but with applicable federal securities laws and other NASD rules, including those referred to above.

1. Prohibition of Abusive Allocation Arrangements

Rule 2712(a) would expressly prohibit a member and its associated persons from offering or threatening to withhold an IPO allocation as consideration or inducement for the receipt of compensation that is excessive in relation to the services provided by the member. This provision would prohibit this activity not only with respect to services, but any service offered by the member.

NASD does not intend that this prohibition interfere with legitimate customer relationships. For example, the prohibition is not intended to prohibit

a member from allocating IPO shares to a customer because the customer has separately retained the member for other services, when the customer has not paid excessive compensation in relation to those services. NASD requests comment on whether this provision appropriately balances the need to protect the integrity of the IPO allocation process with the desire to avoid undue interference with legitimate customer relationships.

2. Prohibition of Aftermarket Tie-in Agreements

Rule 2712(b) would expressly prohibit a member or an associated person that is participating in an IPO from requesting that a customer purchase shares in the aftermarket as a condition to being allocated shares in the IPO. In August 2000, the SEC's Division of Market Regulation issued *Staff Legal Bulletin No. 10*, in which it stated that requiring a customer to agree to buy additional shares in the aftermarket as a condition to being allocated shares in the distribution violates Rules 101 and 102 of Regulation M and may violate other anti-fraud and anti-manipulation provisions of the federal securities laws. The *Staff Legal Bulletin* explained that aftermarket tie-in agreements are a particularly egregious form of solicited transaction prohibited by Regulation M. The SEC staff wrote that "solicitations and tie-in agreements for aftermarket purchases are manipulative because they undermine the integrity of the market as an independent pricing mechanism." Rule 2712(b) would expressly prohibit these types of aftermarket tie-in agreements, thereby supplementing existing prohibitions in Regulation M and Rule 2110.

The proposed rule would prohibit discussions in which after-market

purchases are requested as a condition for the receipt of an IPO allocation. We request comment on this provision.

3. Prohibition of Spinning

Rule 2712(c) would expressly prohibit a member and its associated persons from allocating IPO shares to an executive officer or director of a company on the condition that the executive officer or director, on behalf of the company, direct future investment banking business to the member. The rule also would prohibit IPO allocations to an executive officer or director as consideration for directing investment banking services previously rendered by the member to the company.

"Spinning" or awarding IPO shares to the executive officers and directors of the company divides the loyalty of the agents of the company (i.e., the executive officers and directors) from the principal (i.e., the company) on whose behalf they must act. This practice is inconsistent with just and equitable principles of trade.

Rule 2712(c) would prohibit the allocation of IPO shares on the condition that the executive officer or director send investment banking business to the member, or as consideration for previously directed investment banking business. The provision is not intended to prohibit a member from allocating IPO shares to a customer merely because the customer is an executive officer or director of a company.

NASD also is proposing to amend Rule 2710, the Corporate Financing Rule, to require that members file information regarding the allocation of IPO shares to executive officers and directors of a company that hires a member to be the book-running managing underwriter of the company's IPO. This information would assist the staff in monitoring the

possibility that improper allocations to executive officers or directors may have occurred. This information also may alert the staff to allocations that could violate Rule 2712(a).

4. Restrictions on Penalty Bids

Rule 2712(d) would prohibit members from penalizing registered representatives whose customers have “flipped” IPO shares that they have purchased through the member, unless a penalty bid, as defined in Regulation M Rule 101 has been imposed. Rule 101 defines a penalty bid as “an arrangement that permits the managing underwriter to reclaim a selling concession from a syndicate member in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions.”

Regulation M and Nasdaq Stock Market Rule 4624 provide notice and recordkeeping requirements for penalty bids. Penalty bids typically are used in the aftermarket of an offering that is under downward price pressure from an imbalance of sell orders relative to purchase orders. NASD does not oppose this use of penalty bids. However, some members have penalized their registered representatives in connection with flipping by retail customers, even when the managing underwriter has not imposed a penalty bid on the syndicate members. For example, members have penalized their registered representatives by recouping the commission or credits previously granted for the sale of IPO shares.

The practical consequence of this practice is that registered representatives are penalized, and their retail customers may be pressured to retain their long position in the IPO shares, while representatives for institutional customers generally are not penalized at all for their flipping activity. The inequity of this selective penalization is most difficult to justify in light of the fact that most IPO shares are typically allocated to institutional customers, and the need to encourage institutional customers to remain committed to the issuer may therefore be greater. The proposed rule would effectively prohibit this selective practice by permitting members to impose internal penalties on their registered representatives only when the managing underwriter has imposed a penalty bid on the syndicate members. The provision would not place any limit on syndicate penalty bids, however.

5. Requirement for Procedures

Rule 2712(d) would require members to adopt procedures reasonably designed to ensure that the requirements and prohibitions in Rule 2712 are followed. The proposal would not mandate specific procedures that would apply to all members. Instead, it would permit members to tailor the required procedures to their particular corporate structure and the nature of their underwriting and distribution activities. Accordingly, members that do not engage in the allocation or distribution of IPOs would not be required to adopt procedures under Rule 2712.

Endnote

- 1 *E.g.*, Rules 10b-5 (Employment of Manipulative and Deceptive Devices) and Rule 100 (Regulation M).
- 2 *E.g.*, Rules 2110 (Standards of Commercial Honor and Principles of Trade), 2710 (Corporate Financing Rule), 2330 (Customers' Securities or Funds), 3010 (Supervision), and 3060 (Influencing or Rewarding Employees of Others).

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EXHIBIT A

Rule 2712. IPO Allocations and Distribution

(a) **Abusive Allocations.** No member or person associated with a member may offer or threaten to withhold shares it allocates in an initial public offering (“IPO”) as consideration or inducement for the receipt of compensation that is excessive in relation to the services provided by the member.

(b) **Aftermarket Tie-in Agreements.** No member or person associated with a member that is participating in an IPO may request that a customer purchase shares in the aftermarket as a condition to being allocated shares in the IPO distribution.

(c) **Spinning.** No member or person associated with a member may allocate IPO shares to an executive officer or director of a company:

(1) on the condition that the executive officer or director, on behalf of the company, direct future investment banking business to the member, or

(2) as consideration for directing investment banking services previously rendered by the member to the company.

(d) **Policies Concerning Flipping.** No member or person associated with a member may directly or indirectly recoup, or attempt to recoup, any portion of a commission or credit paid or awarded to an associated person for selling shares in an IPO as a penalty or disincentive for selling the shares to a customer that engaged in flipping, unless the managing underwriter has assessed a penalty bid on the member.

(1) In connection with its obligation to maintain records relating to penalty bids under SEC Rule 17a-2(c)(1), a member must promptly record and maintain information regarding any penalty or disincentive assessed on its associated persons in connection with a penalty bid.

(2) Definitions

For purposes of this Rule, the following terms shall have the meanings stated below.

(A) "Flipping," means the initial sale of IPO shares purchased in an offering within 30 days following the effective date of such offering.

(B) "Penalty bid" means an arrangement that permits the managing underwriter to reclaim a selling concession from a syndicate member in connection with an offering when the securities originally sold by the syndicate member are purchased in syndicate covering transactions.

(e) Supervisory Procedures. Each member subject to this rule must adopt and implement written procedures reasonably designed to ensure that the member and its employees comply with the provisions of this rule.

EXHIBIT B

New language is underlined.

Rule 2710. Corporate Financing Rule – Underwriting Terms and Arrangements

* * *

(b) Filing Requirements

(1) – (3) No change

(4) Requirement for Filing

(A) Unless filed by the issuer, the managing underwriter, or another member, a member that anticipates participating in a public offering of securities subject to this Rule shall file with the Association the documents and information with respect to the offering specified in subparagraphs (5) and (6) below no later than one business day after the filing of any such documents:

* * *

; provided, however, that the information required under Rule 2710(b)(6)(A)(viii) must be filed no later than 15 calendar days after the conclusion of the 180 calendar-day period immediately following the effective date of the offering.

(5) No change

(6) Information Required to be Filed

(A) Any person filing documents with the Association pursuant to subparagraph (4) above shall provide the following information with respect to the offering:

(i) - (vi) No change.

(vii) a statement regarding whether any executive officer or director of the issuer acquired from the book-running managing underwriter of the public offering any shares in an initial public offering of securities (“IPO”) during the 180 calendar-day period immediately preceding the required filing date of the offering. For each executive officer or director of the issuer who acquired those IPO shares, the statement must disclose:

-
- a. the name of the executive officer or director;
- b. the date of the IPO, the name of the issuer in the IPO, the number of securities purchased or received by the executive officer or director and the price paid for those securities;
and
- c. whether the executive officer or director participated in any capacity in the selection of the book-running managing underwriter for the issuer's public offering.
- (viii) a statement containing the information required in Rule 2710(b)(6)(vii)(a)-(c) if any executive officer or director of the issuer purchases or acquires from the book-running managing underwriter any shares in an IPO within 180 calendar days after the effective date of the offering.

Disciplinary Actions

REPORTED FOR AUGUST

NASD® has taken disciplinary actions against the following firms and individuals for violations of 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 July 2002.

Firms Fined, Individuals Sanctioned

The Partners Financial Group, Inc. (CRD #31979, Miami, Florida) and Oilda Caradad Hernandez (CRD #1076766, Registered Principal, Miami, Florida) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$15,000, jointly and severally, with Hernandez. In addition, Hernandez was suspended from association with any NASD member as a general securities principal for five business days. Without admitting or denying the allegations, the firm and Hernandez consented to the described sanctions and to the entry of findings that they permitted a representative to act in a registered capacity while his registration was inactive. The findings also stated that the firm and Hernandez failed to maintain written supervisory procedures reasonably designed to achieve compliance with applicable securities laws, regulations, and NASD Rules regarding monitoring compliance with the requirements of the Regulatory Element of continuing education requirements by its registered representatives.

Hernandez' suspension began July 15, 2002, and concluded at the close of business July 19, 2002. (NASD Case #C07020049)

Taglich Brothers, Inc. (CRD #29102, New York, New York) and Michael Nicholas Taglich (CRD #1343730, Registered Principal, Sag Harbor, New York) submitted an Offer of Settlement in which they were censured and fined \$35,000, jointly and severally. In addition, the firm was fined an additional \$5,000 and Taglich was required to requalify by exam as a general securities principal (Series 24) within 90 days of issuance of the Order Accepting the Offer of Settlement. If Taglich fails to requalify, he will be prohibited from serving in a principal capacity with any firm until he successfully requalifies. Without admitting or denying the allegations, the firm and Taglich consented to the described sanctions and to the entry of findings that they failed to disclose to public customers that they had an arrangement whereby the firm's clearing firm would make markets in securities requested by the firm and then pay the firm a portion of the clearing firm's spread earned on some, but not all, trades executed by the clearing firm in these securities. The findings stated that the amount of the spread—which was not disclosed to customers on confirmations—would be split between the firm and the registered representative generating the trade who also received a regular commission. In addition, the firm failed to correct the confirmation slips to reflect the additional compensation, and the confirmations failed to state clearly whether

the firm or the clearing firm was acting in a principal or agency capacity. NASD also found that the firm failed to detect and correct this ambiguity on confirmation slips for these trades. Moreover, NASD found that the firm failed to create and maintain order tickets that reflected the times the orders were received and executed. (NASD Case #CAF010028)

Firms Fined

Alexander, Wescott, & Co., Inc. (CRD #35935, Utica, New York) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$5,000, jointly and severally. The firm was also fined an additional \$5,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to report to the Automated Transaction ServiceSM (ACTSM) transactions in non-Nasdaq and Nasdaq SmallCapSM securities effected by the firm, and failed to record the time of execution or cancellations on sales memoranda for transactions effected by the firm. The findings also stated that the firm, acting through an individual, conducted a securities business while failing to maintain the minimum required net capital. (NASD Case #C10020056)

C.E. Unterberg, Towbin (CRD #24790, New York, New York) 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, as a market maker in securities, it was a party to a locked or crossed market condition prior to the market opening; received a Trade-or-Move message in each instance through SelectNet;[®] and, within 30 seconds of receiving such messages, failed to fill the incoming Trade-or-Move message for the full size of the message or move its bid down (offer up) by a quotation increment that would have unlocked/uncrossed the market. (NASD Case #CMS020110)

Goldman, Sachs & Company (CRD #361, 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, as a market maker in securities, without making reasonable efforts to avoid a locked or crossed market by executing transactions with all market makers whose quotations would be locked or crossed, entered bid or asked quotations in the Nasdaq Stock Market that caused a locked or crossed market condition to occur in each instance. (NASD Case #CMS020112)

HD Brous & Co., Inc. (CRD #22062, Great Neck, New York) submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined \$10,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it submitted to the Order Audit Trail SystemSM (OATSSM) reports with respect to equity

securities traded on the Nasdaq Stock Market that were not in the electronic form prescribed by NASD. The findings also stated that the firm failed to follow written supervisory procedures concerning OATS and thus failed to maintain a system that was reasonably designed to achieve compliance with NASD Marketplace Rule 6955(a). (NASD Case #CMS020108)

J. Alexander Securities, Inc. (CRD #7809, Los Angeles, California) 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 within 30 business days of acceptance of the AWC by NASD. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it published quotations for Over-the-Counter (OTC) equity securities, or directly or indirectly submitted such quotations for publication, in a quotation medium, and did not have in its records the documentation required by SEC Rule 15c2-11(a); did not have a reasonable basis under the circumstances for believing the information was accurate in all material respects or that the sources of the information were reliable; and failed to represent a customer's indication of unsolicited interest. The findings also stated that the firm failed to file a Form 211 with NASD at least three business days before the firm's quotations were published or displayed in a quotation medium. In addition, NASD found that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with applicable rules and regulations concerning SEC Rule 15c2-11 and NASD Marketplace Rule 6740, including a statement of the steps to be taken to ensure compliance and a statement as to how enforcement of such written supervisory procedures should be documented at the firm. (NASD Case #CMS020103)

J.B. Oxford & Company (CRD #14343, Beverly Hills, California) submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured, fined \$27,000, and required to pay \$1,018.75, plus interest, in restitution to public customers. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it executed short sale orders in certain securities and failed to make an affirmative determination prior to executing the transactions. The findings also stated that the firm failed to display immediately customer limit orders in Nasdaq securities in its public quotation when each such order was at a price that would have improved the firm's bid or offer in each such security, or when the order was priced equal to the firm's bid or offer and the national best bid or offer for each such security, and the size of the order represented more than a de minimis change in relation to the size associated with the firm's bid or offer in each such security. NASD also found that the firm failed to use reasonable diligence to ascertain the best inter-dealer market, and failed to buy or sell in such market so that the resultant price to its customer was as favorable as possible under prevailing market conditions. In addition, NASD found that the firm improperly transmitted duplicate execution reports to OATS. (NASD Case #CMS020101)

Ladenburg Capital Management f/k/a GBI Capital Partners, Inc. (CRD #14623, Bethpage, New York) 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 used confidentiality clauses in written settlement agreements with public customers that contained language that may have impeded NASD investigations and NASD's prosecution of disciplinary actions. The findings also stated that the firm's sales personnel engaged in improper telemarketing practices in an effort to induce public customers to establish accounts with the firm including harassment, intimidation, and indecorous language. **(NASD Case #C10020055)**

Lehman Brothers, Inc. (CRD #7506, New York, New York) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined \$23,000, and required to pay \$568.75, plus interest, in restitution to public customers. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed, in transactions for or with a customer, to use reasonable diligence to ascertain the best inter-dealer market; failed to buy or sell in such market so that the resultant price to its customers was as favorable as possible under prevailing market conditions; and failed to execute an order fully and promptly. The findings also stated that the firm executed short sale orders in certain securities and failed to maintain a written record of the affirmative determination made for such orders; executed short sale transactions and failed to report each of these transactions to ACT with a short sale modifier; failed to disclose on customer confirmations that the disclosed price was an average price; and failed to reference on the required average price legend that details of the transactions would be provided upon request. NASD also found that the firm failed to display immediately customer limit orders in Nasdaq securities in its public quotation when each such order was at a price that would have improved the firm's bid or offer in each such security, or when the order was priced equal to the firm's bid or offer and the national best bid or offer in such security, and the size of the order represented more than a de minimis change in relation to the size associated with its bid or offer in each such security. **(NASD Case #CMS020113)**

Needham & Company, Inc. (CRD #16360, New York, New York) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined \$67,500, and required to revise the firm's written supervisory procedures with respect to firm quotations. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to execute orders presented to the firm at its published bid or offer in an amount up to its published quotation size, thereby failing to honor its published quotations. The findings also stated that the firm's supervisory system failed

to provide for supervision reasonably designed to achieve compliance with applicable securities laws and regulations concerning firm quotations.

NASD found that the firm, as a market maker in securities, caused a locked/crossed market condition prior to the market opening by entering a bid (ask) quotation, that locked or crossed another market maker's quotations, without immediately sending through SelectNet to the market maker(s) whose quote(s) it locked or crossed a Trade-or-Move Message that was at the receiving market maker's quoted price and whose aggregate size was at least 5,000 shares. In addition, the firm was a party to a locked or crossed market condition prior to the market opening, received a Trade-or-Move message in each instance through SelectNet, and, within 30 seconds of receiving such messages, failed to fill the incoming message for the full size of the message or move its bid down (offer up) by a quotation increment that would have unlocked/uncrossed the market. Furthermore, NASD found that the firm failed to display immediately customer limit orders in Nasdaq securities in its published quotation when each such order was at a price that would have improved the firm's bid or offer in each securities, or when the order was priced equal to the firm's bid or offer and the national best bid or offer for each such security, and the size of the order represented more than a de minimis change in relation to the size associated with the firm's bid or offer in each such security. **(NASD Case #CMS020104)**

Pacific Growth Equities, Inc. (CRD #24835, San Francisco, California) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$12,500. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that orders were presented to the firm at the firm's published bid or published offer in an amount up to its published quotation size, failed to execute the orders upon presentment, and thereby failed to honor its published quotation. **(NASD Case #CMS020111)**

Pershing Trading Company, L.P. (CRD #36671, Jersey City, New Jersey) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$50,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that, as a market maker in securities, it caused a locked/crossed market condition prior to the market opening by entering a quotation that locked or crossed another market maker's quotations without immediately thereafter sending through SelectNet to the market maker(s) whose quotes it locked or crossed a Trade-or-Move Message that was at the receiving market maker's quoted price and whose aggregate size was at least 5,000 shares. NASD found that the firm was a party to a locked or crossed market condition prior to the market opening, received a Trade-or-Move Message in each instance

through SelectNet, and, within 30 seconds of receiving such messages, failed to fill the incoming Trade-or-Move message for the full size of the message or move its quotation by an increment that would have unlocked or uncrossed the market. (NASD Case #CMS020102)

Scott & Stringfellow, Inc. (CRD #6255, Richmond, Virginia) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined \$15,000, and required to pay \$4,861.13, plus interest, in restitution to public customers. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed, in transactions for or with a customer, to use reasonable diligence to ascertain the best inter-dealer market, and failed to buy or sell in such market so that the resultant price to its customer was as favorable as possible under prevailing market conditions. (NASD Case #CMS020106)

Service Asset Management Company (CRD #47157, Austin, Texas) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$20,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that, as a market maker in securities, it was a party to a locked or crossed market condition prior to the market opening and received a Trade-or-Move Message in each instance through SelectNet, and, within 30 seconds of receiving such message, failed to fill the incoming Trade-or-Move Message for the full size of the message or move its bid down (offer up) by a quotation increment that would have unlocked/uncrossed the market. (NASD Case #CMS020115)

Trident Securities, Inc. (CRD #566, Cleveland, Ohio) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined \$10,000, and required to revise the firm's written supervisory procedures with respect to firm quote rules. 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, it failed to execute the orders presented to the firm at its published bid or offer in an amount up to its published quotation size upon presentment, and thereby failed to honor its published quotation. The findings also stated that the firm's supervisory system failed to provide for supervision reasonably designed to achieve compliance with applicable securities rules and regulations concerning firm quote compliance. (NASD Case #CMS020100)

WM Financial Services, Inc. (CRD #599, Irvine, California) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$12,500. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to disclose customer complaints and settlements on the Forms U-4 and/or Forms U-5 of registered representatives as required. The findings also stated that the firm failed to establish, maintain, and

enforce written procedures to ensure that the firm made required disclosures on Forms U-4 and U-5 concerning customer complaints and settlements. (NASD Case #C02020036)

Individuals Barred or Suspended

Seymour Isaac Abramowitz a/k/a Seymour Abrams (CRD #4412506, Associated Person, Tarzana, 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, Abramowitz consented to the described sanction and to the entry of findings that he willfully misrepresented material facts on a Form U-4. (NASD Case #C02020033)

Kevin Eric Aizenshtat (CRD #2860587, Registered Representative, Naples, Florida) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$3,500 and suspended from association with any NASD member in any capacity for five business days. The fine must be paid before Aizenshtat reassociates with any NASD member in any capacity following the suspension or before requesting relief from any statutory disqualification. In light of Aizenshtat's payment of \$28,105.75 in restitution to the customer, no additional monetary sanction has been imposed. Without admitting or denying the allegations, Aizenshtat consented to the described sanctions and to the entry of findings that he exercised discretionary authority in the account of a public customer, pursuant to oral authority granted by the customer, without having that authority reduced to writing and without having the account accepted in writing by his member firm. The findings also stated that Aizenshtat negligently misrepresented that a bond purchased by a client was returning principal with its interest payments when, in fact, it was not, causing the client to sell the bond.

Aizenshtat's suspension began August 5, 2002, and concluded at the close of business August 9, 2002. (NASD Case #C07020056)

Brent Allen Atwood (CRD #2540982, Registered Principal, Durham, North Carolina) 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, Atwood consented to the described sanction and to the entry of findings that he participated in private securities transactions without providing written notice to, or obtaining written approval from, his member firm. The findings stated that Atwood received \$20,000 from public customers to purchase Class A shares in a security that Atwood claimed to own although he did not, and failed to obtain such shares to fulfill his agreement with the customers. NASD found that Atwood made improper use of these funds or converted the funds to his own use before repaying \$19,500 to the customers. (NASD Case #C07020047)

Robert Wells Bailey (CRD #1622898, Registered Representative, Wayne, Michigan) 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 40 days. The fine must be paid before Bailey reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Bailey consented to the described sanctions and to the entry of findings that he failed to respond to NASD requests for information.

Bailey's suspension began July 15, 2002, and will conclude at the close of business August 23, 2002. (NASD Case #C8A020041)

Robert Joseph Borson (CRD #2828890, Registered Representative, Fullerton, California) 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, Borson consented to the described sanction and to the entry of findings that he received a check for \$2,000 from a public customer for investment purposes payable to Borson's member firm. The findings stated that Borson failed to apply the customer funds as instructed and, without the customer's authorization or consent, altered the payee line of the customer check to read "Robert Borson" and inserted the customer's initials above to make it appear as though the customer had authorized the alteration. In addition, the findings stated that Borson, without the customer's authorization or consent, added the notation, "Given to Rob Borson" next to the customer's notation on the memo portion of the check, to make it appear as though Borson was the authorized payee on the customer check. The findings further stated that after altering the customer check, Borson endorsed and deposited it into his personal checking account and held the funds for a period of time, without the customer's authorization or consent. (NASD Case #C02020022)

Donald Christopher Bowers (CRD #4291781, Associated Person, Long Beach, California) was barred from association with any NASD member in any capacity. The sanction was based on findings that Bowers failed to disclose material information on his Form U-4 and failed to respond to NASD requests for information. (NASD Case #C02020001)

Scott Michael Brown (CRD #2642492, Registered Representative, San Francisco, California) 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 12 months. The fine must be paid before Brown reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Brown further agrees to provide additional testimony to NASD and to appear personally and testify truthfully and completely in connection with its investigation or any disciplinary hearing conducted in connection with the

investigation. If Brown fails to appear or to testify truthfully and completely, he consents to a sanction including a bar from the securities industry. Without admitting or denying the allegations, Brown consented to the described sanctions and to the entry of findings that he failed to respond to NASD requests to provide on-the-record testimony.

Brown's suspension began April 1, 2002, and will conclude at the close of business March 31, 2003. (NASD Case #CAF020010)

Arthur Kenny Bryant (CRD #1827620, Registered Representative, Edmonds, Washington) was barred from association with any NASD member in any capacity. The sanction was based on findings that Bryant obtained a \$4,000 check drawn on a public customer's account at his member firm, altered the check to make himself the payee, deposited the check in the net amount of \$3,900 into his personal credit union savings account, and later withdrew the funds for his own purposes, thereby converting the funds to his own use. (NASD Case #C3B020002)

Allen Gene Davis (CRD #2783495, Registered Representative, Deer Lodge, 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, Davis consented to the described sanction and to the entry of findings that he received \$3,760.97 in checks from a public customer for investment purposes. The findings stated that Davis cashed the checks and neglected to purchase securities for the account of the public customer before remitting the funds to his member firm after a period of time. (NASD Case #C05020031)

Thomas Rayvon Daye (CRD #2596342, Registered Representative, Raleigh, North Carolina) 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, Daye consented to the described sanction and to the entry of findings that he submitted wire transfer instructions to his member firm, causing \$180,000 in funds to be transferred from client accounts to a bank account under his control without the authorization of the clients. The findings also stated that Daye failed to respond to NASD requests for information. (NASD Case #C07020055)

Paul DePasquale (CRD #2832113, Registered Representative, Miami Beach, Florida) 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 90 days. Without admitting or denying the allegations, DePasquale consented to the described sanctions and to the entry of findings that he acted in a registered capacity while his registration was inactive. In addition, NASD found that DePasquale provided false testimony during an NASD on-the-record interview.

DePasquale's suspension began July 15, 2002, and will conclude October 12, 2002. (NASD Case #C07020050)

Michael Scott Dreher (CRD #2701679, Registered Representative, Denver, Colorado) 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, Dreher consented to the described sanction and to the entry of findings that he forged the name of a manager of his member firm on a letter sent to a prospective customer. (NASD Case #C3A020027)

Ernest Yoshitsugo Fukumoto (CRD #215511, Registered Representative, Pasadena, 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, Fukumoto consented to the described sanction and to the entry of findings that he engaged in private securities transactions, for compensation, without prior written notice to, and approval from, his member firm. (NASD Case #C02020029)

Roland Raymond Gaboury (CRD #1284789, Registered Representative, West Brookfield, Massachusetts) 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, Gaboury consented to the described sanction and to the entry of findings that a public customer provided him with \$20,000 to invest in a high-yield account that Gaboury said would provide a fixed rate of return, failed to invest the customer's funds as directed, and, instead, misused the funds by purchasing for the customer a security offered by a friend. The findings also stated that Gaboury engaged in a private securities transaction without prior written notice to, or approval from, his member firm. NASD found that Gaboury created and sent fictitious account statements to the public customer that falsely indicated that the \$20,000 investment, plus accrued interest, was located in a firm account. In addition, NASD found that Gaboury had learned that the outside investment was a fraud and that someone had absconded with the customer's funds, but instead of informing the customer, Gaboury continued to create and send fictitious reports falsely indicating that the investment was at the firm and continuing to accrue interest. Moreover, NASD found that Gaboury created and provided to the customer a letter on firm stationery showing a fictitious policy number and account value for the customer's \$20,000 investment and forged a firm employee's signature on this document. (NASD Case #C11020025)

Matthew James Gervasio (CRD #2844164, Registered Representative, West Islip, New York) was barred from association with any NASD member in any capacity. The sanction was based on findings that Gervasio received checks and silver bars from public customers for deposit in their accounts and in a

safe deposit box, respectively, at his member firm. The findings stated that Gervasio converted the checks and bars to his personal use and benefit without the authorization of the customers. NASD also found that Gervasio failed to respond to NASD requests for information. (NASD Case #C10010157)

Foster J. Gibbons (CRD #2766670, Registered Principal, New York, 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, Gibbons consented to the described sanction and to the entry of findings that a member firm, acting through Gibbons, failed to implement, maintain, and enforce a reasonable supervisory system that would have enabled the firm to comply effectively with NASD Rules and federal securities laws and regulations by preventing and detecting violations by the firm regarding unauthorized transactions in the accounts of public customers; churning of accounts of public customers; and charging unreasonable, unfair, and excessive commissions in transactions effected on behalf of public customers. (NASD Case #C10020057)

Edward Hossein Haghani (CRD #3055635, Associated Person, King of Prussia, Pennsylvania) was barred from association with any NASD member in any capacity. The sanction was based on findings that Haghani caused an unauthorized withdrawal of \$650 from the bank account of a public customer for his own personal financial benefit and failed to respond to NASD requests for information. (NASD Case #C9A020003)

Kim Ione Halliburton (CRD #1058579, Registered Principal, Dunedin, Florida) and Carl Dominic Martellaro (CRD #320959, Registered Principal, Chico, California) submitted a Letter of Acceptance, Waiver, and Consent in which Halliburton was fined \$7,500, jointly and severally, suspended from association with any NASD member in a supervisory capacity for 90 days, and suspended from association with any NASD member as a financial and operations principal (FINOP) for 30 days. Martellaro was fined \$10,000 and barred from association with any NASD member in any principal or proprietary capacity. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that a member firm, acting through Halliburton, failed to maintain properly adequate net capital while conducting a securities business. The findings also stated that a member firm, acting through Halliburton, failed to establish, maintain, and enforce a supervisory system and written supervisory procedures reasonably designed to achieve compliance with rules and regulations applicable to sales practices by registered representatives, and failed to supervise a branch office. NASD also found that Martellaro acted in a principal capacity while failing to be registered with NASD in any capacity, and the member firm, acting through Halliburton, permitted Martellaro to act in a principal capacity without registration as such with NASD.

Halliburton's suspension in a supervisory capacity began August 5, 2002, and will conclude November 2, 2002. Halliburton's suspension in a FINOP capacity began August 5, 2002, and will conclude at the close of business September 3, 2002. (NASD Case #C07020053)

Henry Joseph Jedziniak (CRD #1731003, Registered Representative, Bernardsville, New Jersey) 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, Jedziniak consented to the described sanction and to the entry of findings that he failed to respond to an NASD request to appear for an on-the-record interview. (NASD Case #C9B020044)

Tameka Darsaleik Johnson (CRD #2828002, Registered Representative, Philadelphia, Pennsylvania) 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 one year. The fine must be paid before Johnson reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Johnson consented to the described sanctions and to the entry of findings that she willfully failed to amend her Form U-4 to disclose a material fact.

Johnson's suspension began July 15, 2002, and will conclude at the close of business July 14, 2003. (NASD Case #C9A020026)

Daniel Steven Kippert (CRD #2327018, Registered Representative, Ogden, Utah) was barred from association with any NASD member in any capacity. The sanction was based on findings that Kippert instructed a member firm sales assistant to transfer \$1,700 from a public customer's account maintained at his member firm to his personal bank account without the prior knowledge, authorization, or consent of the public customer. (NASD Case #C3A020011)

Victor Kozirovsky (CRD #2841043, Registered Representative, Woodmere, New York) submitted an Offer of Settlement in which he was suspended from association with any NASD member in any capacity for four months. In light of the financial status of Kozirovsky, no monetary sanctions have been imposed. Without admitting or denying the allegations, Kozirovsky consented to the described sanction and to the entry of findings that he caused purchases of stock during the initial public offering of a security for persons who had not agreed to purchase stock or to open accounts with his member firm.

Kozirovsky's suspension began July 15, 2002, and will conclude at the close of business November 14, 2002. (NASD Case #CAF020004)

Gene Louis Lancour (CRD #3164906, Registered Representative, Hampton, Virginia) 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, Lancour consented to the described sanction and to the entry of findings that he received a \$2,400.05 check from a public customer to be used for investment purposes, cashed the check, and failed to make the investment as directed. The findings also stated that Lancour held the customer's funds until he returned them with interest, but misused them in that he failed to make the investment as directed and held the funds for over two months before returning them to the customer. (NASD Case #C07020029)

Rebecca English Lantz (CRD #4250342, Registered Representative, Youngsville, Louisiana) 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, Lantz consented to the described sanction and to the entry of findings that she processed credit entries totaling \$1,500 to her personal checking account, thereby converting the funds to her own use and benefit. The findings also stated that Lantz failed to respond to NASD requests for information. (NASD Case #C05020029)

Gregory Scott Long (CRD #2495123, Registered Representative, San Diego, California) 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 five business days. Without admitting or denying the allegations, Long consented to the described sanction and to the entry of findings that he made recommendations to a public customer without having reasonable grounds for believing that such recommendations were suitable for the customer in light of the size and nature of the transactions, and the facts disclosed concerning the customer's other securities holdings, financial situation, investment objectives, circumstances, and needs.

Long's suspension began August 5, 2002, and will conclude at the close of business August 9, 2002. (NASD Case #C02020034)

James Hugh Long (CRD #1790073, Registered Principal, Plant City, Florida) submitted a Letter of Acceptance, Waiver, and Consent in which he was suspended from association with any NASD member in any capacity for 18 months. In light of the financial status of Long, no monetary sanctions have been imposed. Without admitting or denying the allegations, Long consented to the described sanction and to the entry of findings that he engaged in private securities transactions without prior written notice to, and approval from, his member firm.

Long's suspension began July 15, 2002, and will conclude at the close of business January 14, 2003. (NASD Case #C07020052)

Robert David Luecke (CRD #1999585, Registered Principal, Bellevue, Washington) 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 30 days. Without admitting or denying the allegations, Luecke consented to the described sanctions and to the entry of findings that broker/dealers he owned and operated posted misleading information on Web sites and made claims and comparisons that were unwarranted, exaggerated, and without support. The findings also stated that Luecke, through a Web site, promoted day trading without sufficiently disclosing the risks of that type of trading strategy, and discussed after-hours trading without sufficiently disclosing the risks of after-hours trading.

Luecke's suspension began July 15, 2002, and concluded on July 28, 2002; it will begin again August 19, 2002, and conclude at the close of business September 3, 2002. (NASD Case #CAF020019)

Tracie Lynn Mason (CRD #4041253, Registered Representative, Minot, North Dakota) 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, Mason consented to the described sanction and to the entry of findings that she altered incoming and outgoing insurance-related checks and converted the funds to her own personal use and benefit. (NASD Case #C04020017)

Jeffrey Henry Massey (CRD #2395900, Registered Representative, Cumberland, Rhode Island) submitted a Letter of Acceptance, Waiver, and Consent in which he was suspended from association with any NASD member in any capacity for nine months and required to disgorge \$20,000 in partial restitution to public customers. Restitution must be paid before Massey reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. In light of the financial status of Massey, no monetary sanction has been imposed. Without admitting or denying the allegations, Massey consented to the described sanctions and to the entry of findings that he engaged in private securities transactions without prior written notice to, or approval from, his member firm.

Massey's suspension began July 15, 2002, and will conclude at the close of business April 14, 2003. (NASD Case #C11020026)

Jack Alan Moloney (CRD #2190471, Registered Principal, Hoboken, New Jersey) submitted an Offer of Settlement in which he was suspended from association with any NASD member in any capacity for one year and required to pay \$20,000 in disgorgement of commissions in partial restitution to public customers. In the light of the financial status of Moloney, no fine has been imposed and the restitution amount was reduced. Restitution must be paid before Moloney reassociates

with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Moloney consented to the described sanctions and to the entry of findings that he engaged in private securities transactions without prior written notice to, or approval from, his member firm.

Moloney's suspension began August 5, 2002, and will conclude at the close of business August 4, 2003. (NASD Case #C9B020010)

William Benjamin Muller Jr. (CRD #1892075, Registered Representative, Novi, Michigan) was barred from association with any NASD member in any capacity. The sanction was based on findings that Muller failed to disclose a material fact on his Form U-4. NASD also found that Muller failed to respond to requests for information. (NASD Case #C8A010091)

David Bruce Novak (CRD #2700222, Registered Principal, Winnetka, 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 \$96,898, plus interest, in restitution to a public customer. The restitution must be paid before Novak reassociates with any NASD member or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Novak consented to the described sanctions and to the entry of findings that he made improper use of approximately \$96,898 from the securities accounts of a public customer. The findings also stated that Novak failed to respond to an NASD request for information. (NASD Case #C8A020035)

Fred John Pascaris (CRD #2213626, Registered Representative, Dearborn Heights, Michigan) was barred from association with any NASD member in any capacity. The sanction was based on findings that Pascaris engaged in private securities transactions, for compensation, and failed to provide written notice to, and obtain prior written authorization from, his member firm to engage in the private securities transactions. The findings also stated that Pascaris willfully failed to timely update his Form U-4. (NASD Case #C8A010096)

Howard Charles Penn (CRD #811882, Registered Principal, Briarcliff Manor, New York) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$7,500, suspended from association with any NASD member in any capacity for 10 business days, and required to disgorge \$6,270 in commissions received in partial restitution to a public customer. The restitution must be paid before Penn reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Penn consented to the described sanctions and to the entry of findings that he recommended and purchased limited partnership interests in businesses totaling approximately \$100,000 for a public customer without reasonable grounds for believing that these recommendations and resultant transactions were suitable for the customer on the

basis of the customer's financial situation, investment objectives, and needs.

Penn's suspension began August 5, 2002, and will conclude at the close of business August 16, 2002. (NASD Case #C11020027)

James Patrick Philbin (CRD #721998, Registered Representative, Dunellen, New Jersey) 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 six months, and required to disgorge \$25,000 in commissions in partial restitution to public customers. The fine and restitution must be paid before Philbin reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Philbin consented to the described sanctions and to the entry of findings that he engaged in private securities transactions without prior written notice to, or approval from, his member firm.

Philbin's suspension began August 5, 2002, and will conclude at the close of business February 4, 2003. (NASD Case #C9B020045)

Paul Edison Renfroe, Jr. (CRD #2557149, Registered Representative, Collierville, 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, Renfroe consented to the described sanction and to the entry of findings that he received \$84,000 from a public customer for investment purposes, deposited the funds into his personal checking account, purchased contracts totaling \$80,000 in his own name, returned \$4,000 to the customer and, at a later date, transferred ownership of the contracts to the customer. The findings also stated that Renfroe participated in private securities transactions without providing prior written notice to his member firm. (NASD Case #C05020030)

James Eric Smartt (CRD #4195655, Associated Person, Inglewood, 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, Smartt consented to the described sanction and to the entry of findings that he received and converted a \$2,100 check payable to his member firm's proprietary account. The findings also stated that Smartt received and converted a \$3,000 check payable to a customer's investment account. (NASD Case #C02020035)

Patrick Hoell Smith (CRD #1821303, Registered Principal, Gastonia, North Carolina) was fined \$30,000, suspended from association with any NASD member in a general securities principal and FINOP capacities for two years, suspended from association with any NASD member in any capacity for three months, and ordered to requalify by exam as a general securities

principal and FINOP before he resumes those responsibilities. For one year following Smith's association with any NASD member, his firm shall review and pre-approve all transactions for his personal accounts (including all accounts in which he has a beneficial interest), and require that he have sufficient funds in his accounts to settle all transactions before they are executed. The sanctions were based on findings that Smith effected purchases of securities in his personal securities account for a total purchase price of \$11,593,471.98, running the account as if it were a proprietary trading account without paying for the purchases as required by Regulation T. The findings also stated that Smith netted out his short-term positions against other trades in his account because his member firm was self-clearing and his strategy was to sell each position before payment was due. NASD also found that Smith, as FINOP for his firm, arranged for extensions of credit because he was unable to pay for the purchases effected in his account, in violation of Regulation X.

Smith's suspension as a general securities principal and FINOP began July 1, 2002, and will conclude at the close of business June 30, 2004. Smith's suspension in any capacity began July 1, 2002, and will conclude at the close of business September 30, 2002. (NASD Case #C07010095)

Martin Ronald Sprenger (CRD #2200424, Registered Representative, Omaha, Nebraska) was barred from association with any NASD member in any capacity. The sanction was based on findings that Sprenger willfully failed to disclose material facts on his Form U-4. The findings also stated that Sprenger failed to respond to NASD requests for information. (NASD Case #C04010030)

Clarence Joe Susaeta (CRD #837418, Registered Principal, Park City, Utah) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity, with a right to reapply to become associated with an NASD member after three years from the date the AWC becomes final. Without admitting or denying the allegations, Susaeta consented to the described sanction and to the entry of findings that he received \$46,221 from a public customer, deposited the funds into a bank account he controlled, and paid the premiums on insurance policies owned by the customer in the total amount of \$54,134. The findings also stated that Susaeta's failure to segregate such funds from his own funds constituted an improper use of public customer funds. (NASD Case #C3A020028)

Dave Hung Trinh (CRD #2916910, Registered Representative, Renton, Washington) 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, Trinh consented to the described sanction and to the entry of findings that he affixed the signature of a public customer to an account application to open a securities account at a member firm other than his own without the customer's

knowledge or consent, and provided his telephone number and e-mail address, falsely representing that they were the customer's telephone number and e-mail address. The findings also stated that Trinh affixed the customer's signature to a margin agreement for the customer's account without the customer's knowledge or consent. In addition, Trinh affixed the customer's signature to a memorandum to the other member firm requesting the address on the account be changed, without the customer's knowledge or consent, and provided his own home address as the new address in the memorandum.

NASD also found that Trinh received a \$24,916.50 check from a public customer to purchase shares of stock; deposited the funds in a money market account linked to the customer's account but failed to purchase the stock; affixed the customer's signature to a \$24,000 check drawn on the money market account payable to Trinh without the customer's knowledge or consent; and deposited the check in his own checking account, thereby converting \$24,000 to his own use and benefit. Furthermore, NASD found that Trinh received a \$423 check from his member firm, payable to the employer of a public customer, to refund an excess contribution to the customer's qualified variable annuity contract; endorsed the check; and deposited it in his own checking account, thereby converting \$423 to his own use and benefit. Moreover, the findings stated that Trinh made false statements in response to an NASD request for information and delivered a false document concealing his conversion of \$423 to NASD to impede the investigation. (NASD Case #C3B020009)

Christopher Thomas Votta (CRD #2760656, Registered Representative, Ronkonkoma, New York) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,222.50, including disgorgement of \$222.50 in commissions, and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the allegations, Votta consented to the described sanctions and to the entry of findings that he effected an unauthorized sale transaction in the account of a public customer without the customer's prior knowledge, authorization, or consent.

Votta's suspension began July 15, 2002, and concluded at the close of business July 26, 2002. (NASD Case #C10020053)

Charles Eugene Williams (CRD #727212, Registered Principal, Macy, Indiana) 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 three months, and required to disgorge \$4,080 in commissions to public customers. Without admitting or denying the allegations, Williams consented to the described sanctions and to the entry of findings that he engaged in private securities transactions without providing prior written notice to, and receiving written approval from, his member firm.

Williams' suspension began July 1, 2002, and will conclude at the close of business September 30, 2002. (NASD Case #C8A020043)

Mimy Wong (CRD #2284425, Registered Principal, La Canada, California) submitted a Letter of Acceptance, Waiver, and Consent in which she was fined \$9,125 and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the allegations, Wong consented to the described sanctions and to the entry of findings that she participated in private securities transactions without providing prior written notice to her member firm.

Wong's suspension began August 5, 2002, and will conclude at the close of business August 16, 2002. (NASD Case #C02020031)

Decision Issued

The following default decision has been issued by the DBCC or the Office of Hearing Officers, and has been appealed to or called for review by the NAC as of July 5, 2002. The findings and sanctions imposed in the default decision may be increased, decreased, modified, or reversed by the NAC. Initial decisions whose time for appeal has not yet expired will be reported in the next *Notices to Members*.

Juan Gascot-Jimenez (CRD #1385156, Registered Representative, Rio Piedras, Puerto Rico) was barred from association with any NASD member in any capacity. The sanction was based on findings that Gascot-Jimenez possessed and reviewed unauthorized materials during his Series 7 qualification exam.

Gascot-Jimenez has appealed this decision to the NAC, and the sanction is not in effect pending consideration of the appeal. (NASD Case #C07020018)

Complaints Filed

The following complaints were issued by NASD. Issuance of a disciplinary complaint represents the initiation of a formal proceeding by 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.

Justin Edward Apgar (CRD #2770606, Registered Representative, Wall Township, New Jersey) was named as a respondent in an NASD complaint alleging that he recommended to a public customer that he invest money in a mutual fund rather than keeping the money in certificates of

deposit. The complaint also alleges that Apgar knowingly or recklessly guaranteed the customer against loss and knowingly or recklessly informed the customer that the fund would pay a guaranteed rate. In addition, the complaint alleges that Apgar forged, or caused to be forged, the signature of his supervisor on a letter sent to the customer, without the supervisor's knowledge or consent. (NASD Case #C9B020046)

John Oliver Edwards (CRD #1627812, Registered Representative, Cincinnati, Ohio) was named as a respondent in an NASD complaint alleging that he participated in private securities transactions for compensation without prior written notice to, or approval from, his firm. The complaint also alleges that Edwards, acting in his capacity as a trustee, caused a member firm to liquidate portions of the trusts' mutual fund investments and deliver the proceeds totaling approximately \$1,149,500 to him. The complaint further alleges that Edwards deposited these funds into a bank account that he controlled, and made improper use of approximately \$1,043,170 of customer funds for his personal benefit. In addition, the complaint alleges that Edwards failed to notify his member firm that he had a financial benefit in an outside securities account maintained in the name of a trust at a member firm, and failed to notify the member firm carrying the account of his association with his member firm. Furthermore, the complaint alleges that Edwards completed and provided to his member firm a firm document in which he falsely represented that he did not have any securities accounts at a broker/dealer other than his member firm when he knew, or should have known, that his financial interest and authority to direct the execution of transactions in the outside account was required to be disclosed to his member firm. The complaint also alleges that Edwards failed to respond, or respond completely, to NASD requests for information. (NASD Case #C3A020029)

Edward Paul Galvan (CRD #2124116, Registered Principal, Addison, Texas) was named as a respondent in an NASD complaint alleging that he executed an unauthorized transaction in the account of a public customer for \$5,393.75. The complaint also alleges that, without the prior knowledge or consent of his member firm, Galvan deposited \$2,000 into the public customer's account in partial payment for the loss incurred as a result of the unauthorized transaction. In addition, the complaint alleges that Galvan failed to respond to NASD requests for information. (NASD Case #C05020032)

Daniel Richard Schmidt (CRD #2652062, Registered Representative, Santa Barbara, California) was named as a respondent in an NASD complaint alleging that he signed public customers' names to Contribution Change Forms (CCF) without their authorization, knowledge, or consent, and submitted them to his member firm requesting an increase in the customer's monthly payroll deductions for which he received \$520 in commission advances. The proposed payroll deduction increases

were not effectuated because Schmidt failed to submit salary reduction agreements (SRAs) along with the forged CCFs. (NASD Case #C02020030)

Craig Frank Wisbiski (CRD #2711742, Registered Supervisor, Williamston, Michigan) was named as a respondent in an NASD complaint alleging that he caused at least \$160,970 to be withdrawn from the securities account of a public customer for which he was the broker, deposited the funds into his own securities account without the customer's knowledge or consent, and used the funds for his own personal benefit or for some purpose other than the benefit of the customer. The complaint also alleges that Wisbiski induced the purchase or sale of securities by means of manipulative, deceptive, or other fraudulent devices or contrivances by inducing public customers to invest funds which he represented would be placed with a "private investment group" and earn 15 percent tax-free annual interest, when, in fact, said investment was nonexistent and Wisbiski used the customer funds for his own purposes. (NASD Case #C8A020036)

Firm Expelled for Failing to Pay Fines and/or Costs in Accordance With NASD Rule 8320

All-Tech Direct, Inc.
Montvale, New Jersey
(June 14, 2002)

Individuals 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.)

Darlington, Douglas K.
Morristown, New Jersey
(June 11, 2002)

Dukes, Robert James
Charlotte, North Carolina
(June 18, 2002)

Farber, David I.
Cranbury, New Jersey
(June 14, 2002)

Flowers, Troy
Lemon Grove, California
(June 18, 2002)

Rooney, Patrick W.
Chula Vista, California
(June 24, 2002)

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.)

Delosh, Rey A.
Clearwater, Florida
(June 14, 2002)

Frankfurter, Patrick N.
Commerce City, Colorado
(June 19, 2002)

Jacks, Roger W.
Kansas City, Missouri
(June 6, 2002)

Melton, Thomas
Visalia, California
(June 19, 2002)

Miranda, Nilsa M.
Chicago, Illinois
(June 19, 2002)

Travale, Stephen D.
Lauderhill, Florida
(June 11, 2002)

Individuals Revoked for Failing to Pay Fines and/or Costs in Accordance With NASD Rule 8320

Aburas, Salam
Berwyn, Illinois
(June 14, 2002)

Blake, Richard A.
DeKalb, Illinois
(June 14, 2002)

Frydrych, Daniel J.
Schaumburg, Illinois
(June 14, 2002)

Green, James C.
Brooklyn, New York
(June 14, 2002)

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.

Couch, Jr., Thomas M.
Houston, Texas
(June 14, 2002 – July 1, 2002)

NASD Charges Hornblower and Weeks with Violating Settlement by Issuing Research During NASD Ban

Report Found to Contain Misleading Information

NASD charged New York investment-banking firm Hornblower & Weeks with violating a recent NASD-imposed prohibition against issuing research reports. NASD also charged in its complaint that the research report issued by Hornblower contained exaggerated and misleading statements and failed to disclose material facts.

On May 7, 2002, Hornblower reached a settlement with NASD regarding charges related to a research report recommending the common stock of MyTurn.com. NASD found that the report contained baseless projections, misleading and exaggerated statements, and omitted to state important facts. As part of the settlement with NASD, Hornblower was suspended from issuing research reports for six months.

According to the current complaint, Hornblower violated the terms of the prior settlement by issuing a research report relating to American Diversified Group, Inc., in late May 2002. NASD charged that the research report was published on two Web sites, including that of American Diversified, a provider of telecommunication services.

NASD also charged that Hornblower failed to disclose material facts in the research report, including that American Diversified has experienced significant losses, the company has received an opinion from its auditors that there is substantial doubt about its ability to continue as a going concern, and the company has had to rely on loans from its executive officers or directors to pay certain operating expenses.

NASD further charged that the research report made exaggerated, unwarranted, and misleading statements about American Diversified, including that the company "is positioned as a premier provider of communication products and enhanced value-added services..." and "is positioned to exploit the upside potential of the vast expansion of the Internet."

NASD Suspends and Sanctions Trader for Marking the Close; Issues Cautionary Note Prior to Russell 2000 Rebalance

NASD suspended Alan M. Remer for four months for market manipulation by "marking the close" on three separate occasions. Remer was also fined \$7,500.

"Marking the close" is a form of market manipulation. The practice involves attempting to influence the closing price of a security by executing purchase or sale orders at or near the close of normal trading hours. Such activity can artificially inflate or depress the closing price for the security and can affect price of "market-on-close" orders. On three occasions, Remer received a market-on-close sell order that required him to purchase a block-sized order of a security at the price of the last trade executed during normal business hours. In each instance, Remer executed the last trade himself and did so at an artificially low price. As a result, Remer was able to purchase the market-on-close block from his customer at the artificially low price established by his last trade.

Effects on Index Rebalancing

The practice of "marking the close" will have a disproportionately adverse impact when it occurs on an expiration Friday or on an index rebalancing day, such as the Russell 2000 Index rebalancing, which takes place on June 28, 2002. On rebalancing days, securities are added to and deleted from an index. Market makers often receive large market-on-close orders on expiration Fridays and rebalancing days as customers adjust their portfolios to reflect the expiration of options, index options, futures, and the rebalanced index. Accurate pricing at and around the market's close on index rebalancing days is critically important to a fair and orderly rebalancing process.

NASD always monitors for manipulative activity and scrutinized market activity on June 28, 2002, for improper attempts to influence closing prices.

NASD Fines U.S. Bancorp Piper Jaffray and Managing Director \$300,000

Cites Threat to Drop Research Analyst Coverage and Cease Market Making Activities in Retaliation for Not Receiving Investment Banking Business

As part of its ongoing regulatory focus on investment banking and research analyst activities, NASD reached a settlement with U.S. Bancorp Piper Jaffray and a Piper Managing Director, Scott Beardsley, who is the senior banker in the firm's

biopharmaceutical investment banking practice. NASD found that Beardsley threatened Antigenics, Inc., a Nasdaq-listed company, by telling them that Piper would discontinue research coverage and stop making a market in the company's stock if it did not select Piper as lead underwriter for a planned secondary offering.

NASD found that the threats were made to force Antigenics to select Piper as lead underwriter. This type of conduct violates NASD's rule requiring all firms and associated persons to adhere to high standards of commercial honor and just and equitable principles of trade. It also has the potential to undermine competition for investment-banking services.

"Brokerage firms and their executives cannot use threats regarding research activities as a way to obtain investment banking business. The threat to drop research coverage if Piper was not selected as the lead underwriter for a secondary offering was totally inappropriate and undermines the integrity of the market," said Mary L. Schapiro, NASD's President of Regulatory Policy and Oversight. "It is essential that investors have confidence that decisions firms make about coverage of companies are based on merit and nothing else."

As part of their settlement with NASD, Piper was censured and fined \$250,000 and Beardsley was censured and fined \$50,000.

NASD found that, on Dec. 27, 2001, the CEO of Antigenics, Inc., informed Beardsley and another Piper investment banker that the company had chosen another firm to serve as lead manager of a planned secondary offering. After speaking with Piper's head of investment banking, Beardsley told the CEO that Piper would either serve as the lead underwriter for the planned secondary offering or would not participate. In the same conversation, Beardsley threatened the CEO that if Piper were not selected as lead underwriter, the firm would drop research coverage of Antigenics and would stop making a market in Antigenics stock. The next day, the CEO of Antigenics wrote a letter to the Chairman of the Board of Piper complaining about the threatened "retaliation." At this time, Piper rated Antigenics a "Strong Buy."

On Jan. 2, 2002, Antigenics announced that it planned to offer 4 million shares of stock to the public in a secondary offering, using another investment banking firm as lead underwriter. Piper did not serve in any capacity in that offering, which went effective on Jan. 11. On Jan. 4, two days after Antigenics's announcement of its proposed secondary offering, Piper discontinued its research coverage of Antigenics.

In settling this matter, Piper and Beardsley neither admitted nor denied NASD's findings.

For Your Information

Update to Web CRD Firm Notification Functionality

NASD, as part of its continuing efforts to assist member firms in fulfilling their compliance and registration-related requirements, is introducing an expanded e-mail notification service to all firms beginning August 22. The e-mail notifications, which are listed below, are intended to assist firms in identifying (1) material changes to a registered person's registration status and (2) critical dates relating to a registered person's CE requirements. NASD recognizes the significance of our member firms' efforts to ensure compliance with registration-related requirements; therefore, as an expanded service to all firms, beginning on August 22, NASD will automatically send the following five e-mail notifications to firm-designated contacts as the conditions occur:

- ◆ Notify when an individual's registration is Inactive Prints with the Firm-BD Only
- ◆ Notify when a registered individual enters Firm Temporary Registration Cancellation Queue
- ◆ Notify when a registered individual is within 30 days of the end of his or her CE Required window – BD Only
- ◆ Notify when a registered individual is within 90 days of the end of his or her CE Required window – BD Only
- ◆ Notify when a registered individual enters Firm CE Inactive Queue – BD Only

In order to ensure that these important e-mails are directed appropriately, NASD requests that all firms select and supply contact information for the five e-mail notifications. Detailed instructions on how to access the selection screens and supply new and/or updated e-mail address information for the receipt of Firm Notifications can be found at: http://www.nasdr.com/pdf-text/webcrd_nav_firmnot.pdf.

continued

For Your Information

Key Dates:

Monday, July 22

- ▶ 16 Firm Notifications available for firms to elect to receive. NASD is asking firms to select, at minimum, the 5 notifications listed in this article.
- ▶ Firms may choose to have one individual at the firm receive all of the e-mails selected, or, as of this date, firms can input a different e-mail address for each Firm Notification it selects.

Wednesday, August 14

- ▶ Deadline for member firms to select and input the appropriate e-mail address(es) for the five e-mail notifications listed.

Thursday, August 22

- ▶ On behalf of firms that do not input contact information by this date, NASD will run a script to automatically select the five e-mail notifications listed in this article and designate the firm's Primary Account Administrator as the recipient for all.
- ▶ If NASD does not have a Primary Account Administrator's e-mail address on file for a firm, the e-mail address of the firm's Executive Representative will be used, and he/she will then automatically receive those five e-mail notifications as the conditions occur.

Questions

If you have any questions regarding Firm Notifications, please contact the Gateway Call Center at 301-869-6699.