



May 17, 2006

Dear NASD Member:

As you know, there have been numerous events that have greatly impacted the industry in recent years. These events have resulted in new and amended regulations implemented by Congress, the SEC, or NASD for which we must examine. Since NASD conducts routine examinations of firms on one, two, and four year cycles, the next examination for some firms will be broader in scope because it will encompass for the first time certain of these regulatory changes.

As such, we decided to take this opportunity to highlight for you some of the new regulations, as well as existing regulations that are of particular significance at this time. This list is not exhaustive, but it will help you understand the current scope of routine examinations. Importantly, you can use the information in this letter as guidance in reviewing your compliance procedures and supervisory systems.¹ Attached to this letter is a list of additional resources that will provide you with a more in-depth discussion of the issues highlighted below.

Supervision

In late 2004 and early 2005, new NASD Rules 3012 and 3013 took effect. The new rules are designed to ensure the integrity of a member firm's existing supervisory systems by requiring that the CEO certify annually that the firm has processes to put in place supervisory procedures that are reasonably designed to achieve compliance with the federal securities laws and NASD rules and that the firm annually test those procedures to verify that they are reasonably designed to achieve compliance.

Rule 3012 also includes a requirement that producing managers be supervised by a person who is either senior to or "otherwise independent of" the producing manager and that the firm implement heightened supervisory procedures for any producing manager who is responsible for 20% or more of the revenue of the business units supervised by the producing manager's supervisor.

Discretionary Accounts

Effective January 31, 2005, NASD Rule 2510 was amended to limit the use of time and price discretion in a customer account until the end of the business day on which the customer granted the discretion, unless the customer consents in writing to extend the time and price discretion. The limitation does not apply to time and price discretion exercised for orders in an institutional account pursuant to valid Good-Till-Cancelled instructions issued on a "not held" basis.

Anti-Money Laundering (AML)

NASD Rule 3011 has been in effect since April 24, 2002, yet members continue to have trouble complying with the requirements of the rule. The requirement to have an AML program is a federal

¹ This letter attempts to present information regarding certain rules and regulations in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the text of the rule or regulation prevails.

requirement, and there are no exceptions. All member firms, regardless of business type or customer interactions, are subject to the requirements of NASD Rule 3011 and the requirements of the Bank Secrecy Act.

Effective March 6, 2006, NASD Rule 3011 was amended to require each member firm to conduct an annual independent test of its AML compliance program. There is a limited exception that allows some firms to test every two years, but this exception is generally limited to firms that do not deal with customers and do not execute customer transactions. The exception is not based upon the amount or type of business conducted by the firm. Regardless of which category a firm falls into, a firm must test its AML program more frequently if circumstances warrant.

NASD also adopted IM-3011-1 to clarify the requirements for the independent test. The IM includes a limited exception that allows certain firms, under specified circumstances, to conduct the test with certain internal personnel.

NASD Contact System

Members are required to designate certain contacts to NASD through the NASD Contact System and to verify and certify the accuracy of this information on a quarterly basis. The required contacts are: Executive Representative, Business Continuity Plan Primary Contact, Business Continuity Plan Secondary Contact, Continuing Education Contact, and Anti-Money Laundering Primary Contact. The quarterly certification must be completed by the 17th business day following the end of each calendar quarter.

Sales of New Products

In recent years, NASD has issued a number of Notices to Members addressing new products, such as structured products and equity indexed annuities, as well as general guidance in Notice to Members 05-26 addressing the compliance issues members should consider when offering new products to customers. For example, where a member firm markets a new product to customers, the member must, among other things, ensure that the recommendation of the product is suitable for the investor. In addition, the sale of proprietary or affiliated products may create a greater potential for conflicts of interest.

Use of Electronic Systems

Many firms now use electronic systems to assist in monitoring for compliance or to address routine regulatory or business requirements. A firm that relies on electronic systems for compliance should test the operation of those systems against the underlying rule requirements on a periodic basis to ensure that the systems are adequately capturing and processing information.

Use of E-mail

Pursuant to SEC Rule 17a-4, firms are required to establish an adequate system for the retention of all e-mail relating to their business as such. Additionally, all e-mail sent from a registered representative to a customer relating to the firm's investment banking or securities business, irrespective of where the e-mail originates, is subject to the applicable NASD rules regarding communications with the public, as well as NASD rules regarding the supervision, review and retention of such correspondence.

Branch Offices

On September 9, 2005, the SEC approved the Uniform Branch Office Definition, which becomes effective on July 3, 2006. On September 30, 2005, the SEC approved the new Form BR to replace

Schedule E of the Form BD. Form BR became effective on October 31, 2005. The Form BR allows firms to register branch offices with participating state regulators, NASD, and the NYSE via a single filing through the CRD[®] system. All branches listed on Schedule E in existence as of October 14, 2005 were transitioned to the new form and were assigned new branch identification numbers. Firms have until July 3, 2006 to update the Form BR for these branches with any missing information; amend the Form U4 of all registered representatives to assign them to the new branch office numbers; and file a Form BR for each new location that will be a “branch office” under the Uniform Definition.

Effective July 3, 2006, the definition of branch office will change to conform more closely to the SEC’s definition and to ensure greater consistency of the definition across regulators. The Uniform Definition defines a “branch office” as “any location where one or more associated persons of a member regularly conducts 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.” There are exemptions from the definition of branch office that are covered in detail in the rule. In addition, a firm’s main office is required to be registered as a branch office if it meets the new definition.

Business Continuity Planning

In 2004, new NASD Rule 3510 became effective. The rule requires each member to create and maintain a business continuity plan and to conduct an annual review of their plans and update them accordingly. The catastrophic events of hurricanes Katrina and Rita underscore the need for effective business continuity plans. To assist members in complying with the BCP requirements, NASD published a Small Introducing Firm Business Continuity Planning Template.

Municipal Transaction Reporting

MSRB Rule G-14 requires that municipal securities brokers and dealers report all transactions in municipal securities in an accurate and timely manner. The MSRB has noted that, in situations where a clearing broker reports trades for one of its correspondents, the responsibility for proper trade submission is shared between the correspondent and its clearing broker. Both parties need to take steps that are reasonably designed to ensure compliance with the reporting requirements. NASD and the MSRB provide various reports and tools to assist NASD members in monitoring their trade reporting compliance, namely the MSRB’s Dealer Feedback System (DFS) and reports provided through NASD’s Report Center.

Effective January 31, 2005, MSRB Rules G-14 and G-12 require all municipal securities brokers and dealers to report transactions in municipal securities within 15 minutes of the time of trade. Previously, municipal securities brokers and dealers had until midnight of the date of the trade to report transactions. Certain transactions are exempt from the reporting requirements and are addressed in the rule.

Initial Public Offerings

In 2004, NASD replaced IM-2110-1 (the Free-Riding and Withholding Interpretation) with NASD Rule 2790. The Rule removed the distinction for “hot offerings” and set forth general guidelines that prohibit the sale of any initial public offering to a restricted person and most accounts in which a restricted person has a beneficial interest.

Regulation SHO

In June 2004, the SEC adopted Regulation SHO, which provides a new uniform regulatory framework governing short selling of securities. The compliance date for Regulation SHO was January 3, 2005.

Regulation SHO established uniform locate and delivery requirements to address problems associated with failures to deliver, including potentially abusive “naked” short selling (i.e., selling short without having borrowed the securities to make delivery) and created uniform marking requirements for sales of all equity securities. Regulation SHO also established a short sale price test pilot that began in May 2005 to evaluate the overall effectiveness and necessity of short sale price restrictions.

Order Audit Trail System (“OATS”) Reporting

In September 2005, the SEC approved amendments to the Rule 6950 Series (OATS Rules) relating to OATS. The compliance date for the amendments is July 10, 2006. The amendments (1) extend the OATS reporting requirements to all manual orders (OATS Phase III); (2) require members to capture and report the time an order is received by the firm from the customer for all orders; (3) expand the order transmittal requirements for intra-firm routes to require firms to include information regarding orders that are routed to the trading desk; (4) exclude certain firms from the definition of “Reporting Member”; and (5) permit NASD to grant exemptive relief from the OATS requirements relating to manual orders to firms meeting specified criteria. NASD also has made several enhancements to NASD’s OATS Web Interface designed to assist firms with limited order volume with their OATS electronic recording and reporting requirements. Members are encouraged to review Notices to Members 05-78, 06-15 and 06-17 for details.

I hope you find this information useful, and I encourage you to contact your District Office or NASD Liaison with any additional questions you may have. You may also contact me in Washington, D.C. at (202) 728-8837 or in New York at (212) 858-5132, or you may reach my Deputy, Daniel M. Sibears, at (202) 728-6911.

Sincerely,



Robert C. Errico
Executive Vice President
NASD, Member Regulation

Attachment

RECENT NOTICE TO MEMBERS

Supervision

NASD Rule 3012. Supervisory Control System

- [06-04 SEC Approves Amendments to NASD Rule 3012 to Require Members Relying on Rule 3012's "Limited Size and Resources" Exception to Notify NASD of their Reliance](#)
- [05-29 Guidance Regarding Rule 3012\(a\)\(1\) Requirement to Test and Verify a Member's Supervisory Policies and Procedures](#)
- [05-08 Guidance Regarding the Application of the Supervisory Control Amendments to Members' Securities Activities, Including Members' Institutional Securities Activities](#)
- [04-71 SEC Approves New Rules and Rule Amendments Concerning Supervision and Supervisory Controls](#)

NASD Rule 3013. Annual Certification of Compliance and Supervisory Processes

- [06-11 SEC Approves Amendment to NASD Interpretive Material 3013 Regarding Timing of Submission of Report that Evidences Processes to a Member's Board of Directors and Audit Committee](#)
- [04-79 SEC Approves New Chief Executive Officer Compliance Certification and Chief Compliance Officer Designation Requirements](#)

Discretionary Accounts

- [04-71 SEC Approves New Rules and Rule Amendments Concerning Supervision and Supervisory Controls](#)

Anti-Money Laundering

- [06-07 SEC Approves Amendments to Anti-Money Laundering Compliance Program Rule and Adoption of Interpretive Material](#)

NASD Contact System

NASD Rule 3011. Anti-Money Laundering Compliance Program and IM-3011-2. Review of Anti-Money Laundering Compliance Person Information

- [06-07 SEC Approves Amendments to Anti-Money Laundering Compliance Program Rule and Adoption of Interpretive Material](#)
- [02-78 NASD Adopts Amendments to Rule 3011 to Require Members to Provide to NASD Contact Information for an Anti-Money Laundering Compliance Person\(s\)](#)

NASD Rule 3520. Emergency Contact Information

- [04-37 SEC Approves Rules Requiring Members to Create Business Continuity Plans and Provide Emergency Contact Information](#)

NASD Membership and Registration Rule 1120. Continuing Education Requirements

- [04-22 SEC Approves Amendments to Rule 1120 \(Continuing Education Requirements\) Regarding Regulatory Element Contact Person](#)

NASD Membership and Registration Rule 1150. Executive Representative and NASD By-Laws Article IV, Section 3. Executive Representative

- [04-32 SEC Approves Amendments to Require Quarterly Review and Update of Executive Representative Contact Information](#)

Sales of New Products

- [05-59 NASD Provides Guidance Concerning the Sale of Structured Products](#)
- [05-50 Member Responsibilities for Supervising Sales of Unregistered Equity-Indexed Annuities](#)
- [05-26 NASD Recommends Best Practices for Reviewing New Products](#)
- [05-25 NASD Requests Comment on Proposal to Require Pre-Use Filing of Advertisements and Sales Literature for New Types of Securities and of Television, Video and Radio Advertisements](#)
- [05-18 NASD Issues Guidance on Section 1031 Tax-Deferred Exchanges of Real Property for Certain Tenants-in-Common Interests in Real Property Offerings](#)
- [04-89 NASD Alerts Members to Concerns When Recommending or Facilitating Investments of Liquefied Home Equity](#)
- [03-71 NASD Reminds Members of Obligations When Selling Non-Conventional Investments](#)
- [03-07 NASD Reminds Members of Obligations When Selling Hedge Funds](#)

Use of Electronic Systems

- [05-48 Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers](#)

E-mail Retention

- [03-33 Clarification for Members Regarding Supervisory Obligations and Recordkeeping Requirements for Instant Messaging](#)

Branch Offices

- [06-12 Extension of Effective Date of NASD Uniform Branch Office Definition and Certain Form BR and Form U4 Filing Requirements from May 1, 2006 to July 3, 2006 Joint Interpretive Guidance from NASD and the NYSE Relating to Uniform Branch Office Definition Under NASD Rule 3010\(g\)\(2\) and NYSE Rule 342.10](#)
- [05-67 SEC Approves Uniform Branch Office Definition and Related Interpretive Material](#)
- [05-66 SEC Approves Uniform Branch Office Registration Form \(Form BR\) and Conforming and Technical Changes to Forms U4 and U5](#)
- [04-55 NASD Requests Comment on a Proposed Uniform Branch Office Registration Form](#)

Business Continuity Planning

- [04-37 SEC Approves Rules Requiring Members to Create Business Continuity Plans and Provide Emergency Contact Information](#)

Municipal Transaction Reporting

- [04-95 NASD Issues Reminder to Members Regarding the Municipal Securities Rulemaking Board's Implementation of Real-Time Reporting and Dissemination of Transactions in Municipal Securities](#)
- [03-13 NASD Reminds Firms about Transaction Reporting Requirements and Announces Enforcement Actions Against Firms for Violations of MSRB Transaction Reporting Rules G-12 and G-14](#)

Initial Public Offerings

- [03-79 SEC Approves New Rule 2790 \(Restrictions on the Purchase and Sale of IPOs of Equity Securities\); Replaces Free-Riding and Withholding Interpretation](#)

Regulation SHO

- [06-18 SEC Division of Market Regulation Issues Interpretive Guidance Regarding Regulation SHO Close-Out Requirements](#)
- [04-93 Short Sale Requirements -- Issues Relating to the SEC's Adoption of Regulation SHO](#)

OATS

- [06-17 NASD Extends Compliance Date for Recent Amendments to NASD's Order Audit Trail System Rules](#)

- [06-15 SEC Approves Expansion of NASD's Exemptive Authority under the OATS Rules; NASD Provides Additional Guidance Regarding Exemptive Relief and Encourages Exempted and Other Small Firms to Test the Enhanced OATS Web Interface](#)
- [05-78 SEC Approves Amendments to the OATS Rules](#)

ADDITIONAL RESOURCES

Anti-Money Laundering

- [NASD Anti-Money Laundering Guidance Website](#)
- [Financial Crimes Enforcement Network Website](#)

NASD Contact System

- [NASD Contact System \(NCS\) Website](#)

E-mail Retention

- [Books and Records Checklist](#)
- [Guide to the Internet for Registered Representatives](#)

Branch Offices

- [Central Registration Depository \(CRD®\) Website](#)

Business Continuity Planning

- [NASD Business Continuity Planning Website](#)
- [BCP Repository Service, powered by EVault](#)

Municipal Transaction Reporting

- [NASD Report Center Website](#)
- [MSRB Information on the Real-Time Transaction Reporting System](#)
- [MSRB Dealer Feedback System](#)

Regulation SHO

- [SEC Spotlight On: Short Sales](#)

OATS

- [OATS Website](#)