



February 13, 2007

Dear NASD Member:

Last year I sent a letter to members that highlighted new and existing regulations that were of particular significance to NASD's examination program. The letter was designed to offer you guidance by identifying areas of potential examination focus, allowing you to enhance related supervisory and compliance procedures and systems at your firm. Because the response to last year's letter was so positive, I wanted to once again address some of the most important topics in NASD's examinations that you may want to consider when assessing your operations. Also, attached to this letter is a list of additional resources that provide more in-depth discussion on the issues highlighted below.

In addition to the regulatory topics outlined in this letter, I am pleased to inform you of some other recent developments.

- **Advance Notice of Examinations.** For the vast majority of firms, NASD is doubling the amount of notice in advance of a routine examination. Specifically, we are moving the notice period from 14 days to 30 days. This change will provide member firms with adequate time to respond to the WebIR and to gather the records and other information requested prior to the on-site portion of the examination. Similarly, it will provide our examiners with more time to review materials, leading to a more efficient examination.
- **Examination Webcast:** To help members prepare for an examination, NASD produced a webcast that briefly explains our examination process. For your convenience, I have enclosed a CD of that webcast, and you may also view it at www.nasd.com/webcasts/whattoexpect.
- **WebIR:** NASD is working with the industry to gather input on the WebIR to streamline its contents and better ensure effective pre-examination preparation by NASD staff. Our goal is to make submission of the WebIR as easy as possible for you while allowing our examiners to collect a sufficient amount of relevant information in preparation for an on-site examination.
- **NASD Liaison Program:** In 2006, NASD assigned a dedicated NASD Liaison to each member firm. NASD Liaisons are part of local District Office staff and serve as the principal point of contact for your regulatory comments and questions. Since the program's inception, NASD Liaisons have handled over 13,000 inquiries, with over 97 percent responded to within 48 hours. You can contact your designated Liaison through your local NASD District Office.
- **Best Execution:** NASD amended its Best Execution Rule (Rule 2320(a)), effective November 8, 2006, to expand to the scope of the member's duty of best execution to customers of another broker-dealer. The purpose of this rule change was to better ensure that customer orders receive equivalent best execution protections, irrespective of whether a customer order is executed by the originating broker-dealer or routed to a recipient member for handling and execution.

In my May 17, 2006 letter, which you can read at www.nasd.com/exampriorities, I highlighted a number of issues that were of particular significance for 2006. Most of these areas continue to be of importance in 2007, especially supervision, anti-money laundering, the NASD Contact System, sales of new products, use of electronic systems, use of email, branch offices, business continuity planning and municipal securities transaction reporting. For further discussion on each item, please reference my prior letter.

Below is a discussion of new developments that member firms should consider when reviewing their supervisory and compliance programs.

Data Integrity

In 2007, NASD examiners will be focusing more on the accuracy of information that member firms submit to NASD—not just the timeliness of the submitted information. As I have mentioned at recent conferences, NASD's next generation examination program will entail more off-site reviews and more advanced risk-based examination. In order to support this program, it is essential that the data available to NASD is accurate. Members can expect to see data integrity reviews with respect to CRD filings (Forms U4, U5, BD and BR), the 3070 reporting system and data reported pursuant to NASD Rule 3150.

NASD Report Center

The NASD Report Center provides firms with secure access to data and reports designed to support their compliance activities. This information is intended to aid firms in the early detection of reporting problems, and to help them identify areas for improvement. In 2006, the Report Center published a new 3070 Disclosure Timeliness Report Card to help member firms identify late 3070 disclosure filings. In January 2007, NASD further enhanced the report center to include four new risk monitoring reports, including statistics on the number of representatives with customer complaint disclosures and prior employment at a disciplined firm.

Electronic Filing Requirements

Effective December 6, 2006, the SEC approved NASD Rule 3170, which requires member firms to file or submit electronically any regulatory notice or other document that a member is required to file with (or otherwise submit to) NASD. In *Notice to Members 06-61*, NASD announced the first set of filings that would be covered under the new rule. Effective January 1, 2007, member firms were required to make filings via NASD's regulatory form filing system pursuant to the following rules:

- 15c3-1(e)
- 15c3-3(i)
- 17a-4(f)(2)(i)
- 17a-4(f)(3)(vii)
- 17a-5(f)(4)
- 17a-11(b)
- 17a-11(c)(1)
- 17a-11(c)(2)
- 17a-11(c)(3)
- 17a-11(d)
- 17a-11(e)

Protection of Customer Information

The primary rule in this area is Regulation S-P, which addresses, among other things, the protection of customer information and records. It is essential that members protect customer information adequately in order to ensure that such information cannot be accessed by a third-party and used to commit fraud or otherwise cause harm to investors. In order to ensure compliance with Regulation S-P, member firms should consider whether testing or training in this area is appropriate.

Hedge Funds

Hedge funds are complex investment vehicles that are often risky and lacking in transparency. Many investors, especially retail investors, may not understand the risks associated with investing in hedge funds and funds of hedge funds. Given these considerations and the fact that certain hedge funds are now being offered to a broader investor segment, NASD has reminded members that it is essential to reach a suitability determination before recommending such funds.

TRACE Reporting

All NASD member firms have an obligation to report transactions in corporate bonds to NASD's Trade Reporting and Compliance Engine (TRACE) system within 15 minutes of order execution pursuant to NASD Rule 6230. Beginning January 3, 2007, member firms have had access to inter-dealer trade report alerts that may represent unreported trades, erroneously reported trades or duplicate reported trades. These reports are designed to assist members in their trade reporting compliance.

Regulation NMS Compliance Dates Extended

In June 2005, the SEC adopted Regulation NMS (Reg NMS), a set of rules designed to modernize and strengthen U.S. equity markets. There are four parts to Reg NMS: (1) Rule 610 (the Access Rule); (2) Rule 611 (the Order Protection Rule); (3) Rule 612 (the Sub-Penny Rule); and (4) amendments to rules governing the distribution of tape revenue among markets (Market Data Rules). The two rules that impact members most directly are the Order Protection Rule and the Access Rule. The Order Protection Rule, also commonly referred to as the "trade-through rule," provides intermarket protection against trade-throughs for all "automated" quotations displayed on markets. The Order Protection Rule imposes requirements on trading centers to establish, maintain and enforce policies and procedures to prevent trade-throughs of automated quotations, subject to certain exceptions. The Order Access Rule prohibits markets from imposing "unfairly discriminatory terms" on access to their quotations.

The compliance dates for Regulation NMS's Order Protection Rule and Access Rule are as follows:

- **Trade Phase Date:** March 5, 2007. The revised Trading Phase has been extended from March 5, 2007 to July 9, 2007.
- **Pilot Stocks Phase Date:** July 9, 2007. The revised Pilot Stock Phase has been extended from July 9, 2007 to August 20, 2007.
- **All Stocks Phase Date:** August 20, 2007. The revised All Stocks Phase has been extended from August 20, 2007 until October 8, 2007.
- **Completion Date:** October 8, 2007.

Additionally, NASD has issued *Notice to Members 06-67*, which discusses NASD rule amendments adopted to align NASD rules with those in Regulation NMS.

Order Audit Trail System

OATS Phase III became effective on July 10, 2006. The OATS Phase III amendments: (1) require members to report to OATS manual orders in NASDAQ-listed securities; (2) require members to capture and report both the time the order is received by the member from the customer and the time the order is received by the member's trading desk or trading department, if different; (3) exclude certain members from the definition of "Reporting Member"; and (4) permit NASD to grant exemptive relief from the OATS reporting requirements in certain circumstances. In April 2006, NASD issued *Notices to Members 06-15* and *06-17* to discuss, respectively, NASD's exemptive authority and the implementation date.

On October 10, 2006, the SEC approved amendments to the OATS rules to expand the OATS reporting requirements to over-the-counter (OTC) equity securities. Under the amendments, members will be required to record and report order information relating to "OTC equity securities" beginning on June 11, 2007. In December 2006, NASD issued *Notice to Members 06-70* to discuss the amendments and the effective date.

Fixed Income Research

SEC Regulation AC and NASD Rule 3010 apply to both fixed income and equity research. SEC Regulation AC requires certifications to be made by analysts who issue research reports and NASD Rule 3010 requires that member firms establish adequate supervisory procedures and systems in areas where they conduct a business. In addition, while NASD Rule 2711 does not apply to fixed income research, SIFMA (in its former capacity as the Bond Market Association) has issued a best practices document that members who issue fixed income research are advised to review. NASD and the NYSE issued joint guidance on a review of fixed income research compliance, published in *Notice to Members 06-36*.

Gifts and Gratuities

NASD Rule 3060 prohibits any member or person associated with a member from giving, or permitting to be given, anything of value in excess of \$100 per individual per year, where such payment is in relation to the business of the recipient's employer. The rule is designed to guard against potential conflicts of interest. In 2006, NASD issued *Notice to Members 06-69* to discuss common deficiencies in member firms' supervisory systems with respect to Rule 3060.

Business Continuity Planning

All member firms are required to create and maintain a business continuity plan and update it as needed. In December 2006, NASD issued *Notice to Members 06-74* to report the results of a member firm survey following Hurricanes Katrina and Rita. The goal of the survey was to assess the value of business continuity planning and to learn from firms' experiences with a natural disaster. In addition to developing business continuity plans, firms are encouraged to periodically test such plans.

Anti-Money Laundering

As stated in last year's letter, all NASD member firms are required to comply with NASD Rule 3011. The nature of a firm's compliance program can and should be tailored to the firm's business mix. In 2006, NASD issued *Notice to Members 06-41* to remind member firms of FinCEN's authority to issue regulations under Section 311 of the USA PATRIOT Act. In the two most recent rules issued pursuant to this authority, member firms were required to take affirmative steps to notify correspondent accounts of the requirements of the new rule.

In addition, in 2006, Section 312 of the USA PATRIOT Act became effective. Section 312 requires member firms to establish due diligence policies, procedures and controls reasonably designed to detect and report money laundering through correspondent accounts and private banking accounts that U.S. financial institutions establish or maintain for non-U.S. persons. This regulation has significant implications for firms that handle foreign accounts, since firms are now expected to identify foreign accounts that would be considered financial institutions and to perform an assessment of the money-laundering risk.

I trust that you will find the referenced information useful. 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, DC, at (202) 728-8837 or in New York at (212) 858-5132, or you may contact Daniel M. Sibears, EVP & Deputy of Member Regulation, at (202) 728-6911.

Sincerely,

A handwritten signature in black ink, appearing to be 'R. Errico', with a long horizontal flourish extending to the right.

Robert C. Errico
Executive Vice President
Member Regulation



Recent or Referenced Notices to Members

Best Execution Developments

- NTM 06-58: SEC Approves Amendments to Rule 2320(a) Regarding Best Execution and New Interpretive Material 2320: www.nasd.com/ntm/06-58
- NTM 06-03: NASD Provides Guidance Regarding New Rule 2111 Prohibiting Members from Trading Ahead of Customer Market Orders Under Certain Circumstances: www.nasd.com/ntm/06-03

Electronic Filing Requirements

- NTM 06-61: SEC Approves Rule 3170 Requiring Members to Electronically File with or Otherwise Submit to NASD Specified Regulatory Notices or Other Documents: www.nasd.com/ntm/06-61

Protection of Customer Information

- NTM 05-49: NASD Reminds Members of Their Obligations Relating to the Protection of Customer Information: www.nasd.com/ntm/05-49

Hedge Funds

- NTM 03-07: NASD Reminds Members of Obligations When Selling Hedge Funds: www.nasd.com/ntm/03-07

TRACE Reporting

- NTM 05-77: Transactions in TRACE-Eligible Securities That Occur in Connection with Options, Credit Default Swaps, Other Swaps or Similar Instruments Must be Reported to TRACE: www.nasd.com/ntm/05-77

Regulation NMS Compliance Dates Extended

- NTM 06-67: Alignment of NASD Rules with Regulation NMS: www.nasd.com/ntm/06-67

Order Audit Trail System

- NTM 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: www.nasd.com/ntm/06-15
- NTM 06-17: NASD Extends Compliance Date for Recent Amendments to NASD's Order Audit Trail System Rules: www.nasd.com/ntm/06-17
- NTM 06-70: SEC Approves Amendments Expanding the OATS Requirements to OTC Equity Securities and NASD Publishes Revised OATS Reporting Technical Specifications: www.nasd.com/ntm/06-70

Fixed Income Research

- NTM 06-36: NASD and NYSE Joint Interpretive Guidance on Fixed Income Research: www.nasd.com/ntm/06-36

Gifts and Gratuities

- NTM 06-69: NASD Issues Additional Guidance on Rule 3060 (Influencing or Rewarding Employees of Others): www.nasd.com/ntm/06-69

Business Continuity Planning

- NTM 06-74: Business Continuity Planning – Member Business Continuity Experiences regarding Hurricanes Katrina and Rita: www.nasd.com/ntm/06-74

Anti-Money Laundering

- NTM 06-41: Special Measures against Specified Banks Pursuant to Section 311 of the USA PATRIOT Act: www.nasd.com/ntm/06-41

Additional Resources

Data Integrity

- Speech by Elisse Walter at the 2005 NASD Fall Securities Conference:
www.nasd.com/speeches/fsc05_walter

NASD Report Center

- NASD Report Center Web site:
www.nasd.com/reportcenter

Electronic Filing Requirements

- NASD regulatory notifications Web site:
www.nasd.com/regulatorynotifications

Protection of Customer Information

- NASD webcast on Important Issues in Customer Data Protection: www.nasd.com/webcasts
- Report issued on Improving Financial Privacy Notices for Consumers:
www.sec.gov/news/press/2006-46.htm

Hedge Funds

- NASD Investor Alert: Funds of Hedge Funds-Higher Costs and Risks for Higher Potential Returns:
www.nasd.com/Investor/alerts/alert_hedgefunds.htm
- SEC Investor Publication: Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds: www.sec.gov/answers/hedge.htm

TRACE Reporting

- TRACE reporting information Web site:
www.nasd.com/trace

Regulation NMS Compliance Dates Extended

- SEC Spotlight on Regulation NMS:
www.sec.gov/spotlight/regnms.htm

Extension of Compliance Dates for Regulation NMS:

- www.sec.gov/rules/final/2007/34-55160.pdf

Order Audit Trail System

- OATS Web site:
www.nasd.com/RegulatorySystems/OATS

Fixed Income Research

- Joint Report by NASD and the NYSE on the Operation and Effectiveness of the Research Analyst Conflict of Interest Rules:
www.nasd.com/reports/researchanalyst05
- Guiding Principles to Promote Integrity of Fixed Income Research:
www.bondmarkets.com/assets/files/Guiding_Principles_for_Research.pdf

Anti-Money Laundering

- NASD anti-money laundering Web site:
www.nasd.com/aml