

Notice to Members

SEPTEMBER 2002

SUGGESTED ROUTING

Executive Representatives
Legal & Compliance
Operations
Senior Management

KEY TOPICS

Rule 3010
IM-8310-2
Taping Rule

INFORMATIONAL

Taping Rule

SEC Approves Proposed Changes to the Taping Rule and NASD Interpretive Material 8310-2; **Effective Date: October 14, 2002**

Executive Summary

On August 28, 2002, the Securities and Exchange Commission (SEC) approved amendments to NASD Rule 3010(b)(2), also known as the Taping Rule, and NASD IM-8310-2. The amendments to the Taping Rule (1) permit firms that become subject to the Taping Rule a one time opportunity to adjust their staffing levels to fall below the prescribed threshold levels and thus avoid application of the Rule; (2) revise the criteria by which firms become subject to the Taping Rule by not including certain short-term employees of disciplined firms into the calculations of the Taping Rule threshold levels; (3) expand the compliance deadline from 30 to 60 days for firms subject to the Taping Rule to install taping systems; (4) clarify NASD's authority to grant exemptions from the Rule pursuant to the Rule 9600 Series only in exceptional cases; and (5) extend the taping requirements from two years to three years to eliminate conflicting time periods in the Taping Rule. In addition, the amendments to NASD IM-8310-2 permit, upon request, public disclosure of whether a particular firm is subject to the Taping Rule.

The amendments become effective on October 14, 2002. The text of the amendments to Rule 3010(b)(2) and IM-8310-2 is provided in Attachment A.

Questions/Further Information

Questions regarding this *Notice to Members* may be directed to Grace Yeh, Assistant General Counsel, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-6939, or to Kyra Armstrong, Senior Attorney, Department of Member Regulation, NASD Regulatory Policy and Oversight, at (202) 728-6962.

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Discussion

The Taping Rule, which was adopted in 1998, is designed to ensure that members with a large number of registered persons from firms that have been expelled from membership or have had their registration revoked for sales practice violations (Disciplined Firms) have proper supervisory procedures over telemarketing activities to prevent fraudulent and improper sales practices or other customer harm. Under the Rule, firms that hire a significant number of employees from Disciplined Firms must establish, maintain, and enforce special written procedures for supervising the telemarketing activities of all their registered persons. In addition, such firms are required to install taping systems to record all telephone conversations between all of their registered persons and both existing and potential customers, review the tape recordings, and file quarterly reports with NASD.

Generally, the amendments refine the application of the Taping Rule and provide additional flexibility to assist member firms in meeting their compliance obligations under the Rule.

1. *Establishment of a 30-Day Staff Adjustment Period*

The amendments provide all firms that, on or after October 14, 2002, trigger application of the Taping Rule (for the first time) a one-time opportunity to obtain relief from the Taping Rule requirements by adjusting their staffing levels.¹ In particular, the amendments permit firms, within 30 days after receiving the notice that they are subject to the Taping Rule or obtaining actual knowledge that they are subject to the Rule (and have promptly notified the Department of Member Regulation that

they are subject to the Rule), to reduce their staffing levels to fall below the threshold levels set forth in the Taping Rule and thus avoid application of the Taping Rule.² Firms will not be permitted to hire additional registered representatives to fall below the stated thresholds but rather will be required to reduce their number of registered representatives from Disciplined Firms. Once a firm has made the reductions, the firm will not be permitted to rehire the terminated individuals for a period of at least 180 days. Firms may elect, but are not required, to make reductions to their staffing levels. If a firm chooses not to make the adjustment, then it will be required to comply with the Taping Rule requirements.

A firm is permitted to adjust its staffing levels only when it becomes subject to the Taping Rule for the first time. If the firm re-triggers the Taping Rule at any point in the future, then the firm automatically will become subject to its provisions. While the amendments allow a new entity resulting from a restructuring (by a merger, acquisition, or otherwise) to make a staff adjustment to avoid application of the Taping Rule even if one of the participating members in the restructuring had previously adjusted its staff level pursuant to the amendments, this will not be the case for an entity that was restructured in an effort to avoid compliance with the Rule.

2. *Revision of the Criteria by Which Firms Become Subject to the Taping Rule*

The amendments revise the criteria for determining whether a firm is subject to the Taping Rule by excluding from the firm's calculations registered persons who were associated with a Disciplined Firm for only a short period of time.

Specifically, in calculating whether firms exceed the Taping Rule thresholds set forth in the Rule, registered persons who were registered with one or more Disciplined Firms for 90 days or less within the last three years and who have no disciplinary history by a finding of a violation of the provisions set forth in IM-1011-1, while still included in the total number of registered persons at a firm, may be excluded from the number of registered persons at the firm from Disciplined Firms. The amendments recognize that persons registered with Disciplined Firms for a short period of time (*i.e.*, an aggregate total of 90 days or less) are less likely to have acquired the “bad habits” from the Disciplined Firms that the Taping Rule seeks to redress.

In addition, the amendments clarify that the calculation of registered representatives from Disciplined Firms includes independent contractors previously registered with a Disciplined Firm.

3. *Expansion of the Compliance Deadline from 30 to 60 Days*

The amendments extend the period for firms to implement the special supervisory procedures, including the installation of taping systems from 30 days to 60 days of receiving notice from NASD (or obtaining actual knowledge) that they are subject to the Taping Rule. Based on NASD’s experience, 60 days should provide adequate time for firms to install the taping systems and would alleviate the need for firms to request extensions of time. NASD notes that generally, an acceptable taping system would not include one where a firm’s associated persons whose communications with customers are

required to be taped have control over the operation of, or the tape recordings produced from, the taping system.

4. *Clarification of the Exemptive Relief Authority*

The amendments clarify that NASD may grant exemptions from the Taping Rule in “exceptional circumstances” only. In reviewing exemptive requests, NASD generally has established high standards and required a firm to establish that it has alternative procedures to assure supervision at a level functionally equivalent to a taping system.

5. *Increase Duration of the Special Supervisory Requirements*

The amendments extend the time period for which firms must maintain taping systems from two years to three years. The period for which firms are required to maintain the taping system begins from the date that the member establishes its special supervisory procedures and implements the taping system. The amendments further clarify that a firm is required to both establish and implement the taping system within 60 days of receiving notice from NASD or obtaining actual knowledge that it is subject to the Taping Rule.

Publication of the Identity of Firms Subject to the Taping Rule

The amendments allow investors and the general public to ascertain, upon request, whether an identified firm is subject to the Taping Rule. Inquiries about whether a particular firm is subject to the Taping Rule may be made through the Public Disclosure Program’s toll-free telephone listing.

Endnotes

- 1 Firms that, as of October 14, 2002, have a pending exemption request from the Taping Rule requirements, based on the firm's first-time triggering of the Rule, (or related appeal before the (National Adjudicatory Council) (NAC)), or for which the time period in which to seek an applicable exemption (or related appeal to the NAC) has not yet expired, may elect to comply with the Taping Rule as modified by the amendments in lieu of complying with the current requirements under the Rule.
- 2 Firms that reduce their staffing levels pursuant to the amendments may consider reporting the termination as a voluntary termination on the Form U-5.

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ATTACHMENT A

New language is underlined; deletions are in brackets.

3010. Supervision

(a) No Change.

(b) Written Procedures

(1) No Change.

(2) Tape recording of conversations

(A) [(i)] Each member that either is notified by NASD Regulation or otherwise has actual knowledge that it meets one of the criteria in paragraph (b)(2)(H)~~[(viii)]~~ relating to the employment history of its registered persons at a Disciplined Firm as defined in paragraph (b)(2)(J)~~[(x)]~~ shall establish, maintain, and enforce special written procedures for supervising the telemarketing activities of all of its registered persons.

(B)[(ii)] The member must establish and implement the supervisory procedures required by this paragraph within [30] 60 days of receiving notice from NASD Regulation or obtaining actual knowledge that it is subject to the provisions of this paragraph.

A member that meets one of the criteria in paragraph (b)(2)(H) for the first time may reduce its staffing levels to fall below the threshold levels within 30 days after receiving notice from NASD Regulation pursuant to the provisions of paragraph (b)(2)(A) or obtaining actual knowledge that it is subject to the provisions of the paragraph, provided the firm promptly notifies the Department of Member Regulation, NASD Regulation, in writing of its becoming subject to the Rule. Once the member has reduced its staffing levels to fall below the threshold levels, it shall not rehire a person terminated to accomplish the staff reduction for a period of 180 days. On or prior to reducing staffing levels pursuant to this paragraph, a member must provide the Department of Member Regulation, NASD Regulation with written notice, identifying the terminated person(s).

(C) [(iii)] The procedures required by this paragraph shall include tape-recording all telephone conversations between the member's registered persons and both existing and potential customers.

(D) [(iv)] The member shall establish reasonable procedures for reviewing the tape recordings made pursuant to the requirements of this paragraph to ensure compliance with applicable securities laws and regulations and applicable rules of [this] the Association. The procedures must be appropriate for the member's business, size, structure, and customers.

(E) [(v)] All tape recordings made pursuant to the requirements of this paragraph shall be retained for a period of not less than three years from the date the tape was created, the first two years in an easily accessible place. Each member shall catalog the retained tapes by registered person and date.

(F) [(vi)] Such procedures shall be maintained for a period of [two] three years from the date that the member establishes and implements the procedures required by the provisions of this paragraph.

(G) [(vii)] By the 30th day of the month following the end of each calendar quarter, each member firm subject to the requirements of this paragraph shall submit to the Association a report on the member's supervision of the telemarketing activities of its registered persons.

(H) [(viii)] The following members shall be required to adopt special supervisory procedures over the telemarketing activities of their registered persons:

- A firm with at least five but fewer than ten registered persons, where 40% or more of its registered persons have been [employed by] associated with one or more Disciplined Firms in a registered capacity within the last three years;
- A firm with at least ten but fewer than twenty registered persons, where four or more of its registered persons have been [employed by] associated with one or more Disciplined Firms in a registered capacity within the last three years;
- A firm with at least twenty registered persons, where 20% or more of its registered persons have been [employed by] associated with one or more Disciplined Firms in a registered capacity within the last three years.

For purposes of the calculations required in subparagraph (H), firms should not include registered persons who:

- (1) have been registered for an aggregate total of 90 days or less with one or more Disciplined Firms within the past three years; and

(2) do not have a disciplinary history.

(I)(ix) For purposes of this Rule, the term “registered person” means any person registered with the Association as a representative, principal, or assistant representative pursuant to the Rule 1020, 1030, 1040, and 1110 Series or pursuant to Municipal Securities Rulemaking Board (“MSRB”) Rule G-3.

(J)(x) For purposes of this Rule, the term “disciplined firm” means a member that, in connection with sales practices involving the offer, purchase, or sale of any security, has been expelled from membership or participation in any securities industry self-regulatory organization or is subject to an order of the Securities and Exchange Commission revoking its registration as a broker/dealer.

(K)(xi) For purposes of this Rule, the term “disciplinary history” means a finding of a violation by a registered person in the past five years by the Securities and Exchange Commission, a self-regulatory organization, or a foreign financial regulatory authority of one or more of the provisions (or comparable foreign provision) listed in IM-1011-1 or rules or regulations thereunder.

(L) Pursuant to the Rule 9600 Series, the Association may in exceptional circumstances, taking into consideration all relevant factors, exempt any member unconditionally or on specified terms and conditions from the requirements of this paragraph [upon a satisfactory showing that the member’s supervisory procedures ensure compliance with applicable securities laws and regulations and applicable rules of the Association].

* * *

IM-8310-2. Release of Disciplinary [Information] and Other Information Through the Public Disclosure Program

(a) In response to a written inquiry, electronic inquiry, or telephonic inquiry via a toll-free telephone listing, the Association shall release certain information contained in the Central Registration Depository regarding a current or former member, an associated person, or a person who was associated with a member within the preceding two years, through the Public Disclosure Program. Such information shall include:

(1) the person’s employment history and other business experience required to be reported on Form U-4;

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- (2) currently approved registrations for the member or associated person;
 - (3) the main office, legal status, and type of business engaged in by the member; and
 - (4) an event or proceeding–
 - (A) required to be reported under Item 23 on Form U-4;
 - (B) required to be reported under Item 11 on Form BD; or
 - (C) reported on Form U-6.

The Association also shall make available through the Public Disclosure Program certain arbitration decisions against a member involving a securities or commodities dispute with a public customer. In addition, the Association shall make available in response to telephonic inquiries via the Public Disclosure Program's toll-free telephone listing whether a particular member is subject to the provisions of Rule 3010(b)(2). The Association shall not release through the Public Disclosure Program social security numbers, residential history information, or physical description information, or information that the Association is otherwise prohibited from releasing under Federal law.

(b) through (l) No Change.