

# Notice to Members

JUNE 2002

## SUGGESTED ROUTING

Executive Representative  
Legal & Compliance  
Operations

## KEY TOPICS

Rule 2260  
IM 2260  
Debt Securities  
Operations  
Forwarding of Communications

## INFORMATIONAL

### Debt Securities

SEC Approves Amendments to NASD Rule 2260  
Requiring Broker/Dealers to Forward Information  
Regarding Debt Securities to Beneficial Owners

#### Executive Summary

On April 11, 2002, the Securities and Exchange Commission (SEC) approved amendments to NASD Rule 2260<sup>1</sup> that require a broker/dealer to make reasonable efforts to forward promptly communications regarding a debt security to the beneficial owner of such security.

The text of the amendments as provided in Attachment A become effective on July 9, 2002.

#### Questions/Further Information

Questions concerning this *Notice* may be directed to Sharon K. Zackula, Assistant General Counsel, at (202) 728-8985.

#### Background and Discussion

The SEC, other financial services regulators, broker/dealers, and other major participants in the securities markets have been engaged in efforts to eliminate "paper" or physically "certificated" securities and to encourage all investors to transition from physical securities certificates to electronic record of ownership. A central and guiding principle in these efforts has been that the beneficial owners of securities held in "street name" would be entitled to the same rights and privileges as an owner holding paper certificates. The Depository Trust and Clearing Corporation's (DTCC) book-entry system establishes a chain of record, documenting securities ownership in positions above the beneficial owner. Through this chain of record, certain communications from issuers, trustees, and others regarding securities, are passed through from nominee to nominee until the communication reaches the broker/dealer that holds the securities in street name for its customers.

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Rule 2260 currently provides that a member has an inherent duty to forward certain information regarding a security to the beneficial owner of such security (or the beneficial owner's designated investment adviser) if the security is held by the member for the beneficial owner, is in the member's possession and control, and is registered in a name other than the name of the beneficial owner. However, the Rule does not specifically require broker/dealers to forward information to customers who are beneficial owners of debt securities. Under the amendments to Rule 2260 approved by the SEC, members that carry customer accounts and that can identify the beneficial holders of the accounts are required to make "reasonable efforts" to forward promptly information to such beneficial holders. In those cases where an introducing broker/dealer does not disclose the identities of its customers to its clearing broker/dealer, but instead establishes an omnibus account at the clearing broker/dealer, the introducing broker/dealer is viewed as carrying such customer accounts and is responsible for complying with the requirements of Rule 2260.

### Types of Information that Must Be Forwarded

For a debt security (other than a municipal security),<sup>2</sup> members must make reasonable efforts to forward any communication, document, or collection of documents pertinent to the issue that (1) was prepared by, or on behalf of, the issuer or the trustee of the issue; and (2) contains material information about the issue. Material information includes, but is not limited to, notices concerning monetary or technical defaults, financial

reports, information statements, and material event notices. In addition, a member is required to forward such information to beneficial owners only if the member is furnished with sufficient copies of the material by the issuer or trustee and is requested by the issuer or trustee to forward the material to the beneficial owners.

### Satisfactory Assurance of Reimbursement of Expenses

A member is required to forward information to a beneficial holder only after the member "receives satisfactory assurance" that it will be reimbursed by the issuer or trustee for all out-of-pocket expenses, including reasonable clerical expenses. This is consistent with the provisions currently in effect under Rule 2260 regarding the forwarding of proxy statements, annual reports and other information to the beneficial owners of stock.

### Use of "Reasonable Efforts" to Forward Information

A member must use "reasonable efforts" to forward information to the beneficial owners of debt securities, based on the type and quality of information that is currently made available by an issuer or a trustee, and the current lack of standardization in transmitting information of interest to investors. When a broker/dealer receives a notice or other information from the issuer or trustee, NASD believes, as provided in the revisions to Rule 2260, that the member has an obligation to forward promptly the information.

However, a member may be unable to do so if the information forwarded contains statements about one or more debt securities and fails to provide crucial identifying information, such as the CUSIP number, on the notification. In such instances, the broker/dealer must make reasonable efforts to identify the relevant CUSIP numbers, and to forward the information, but the broker/dealer is not in violation of the rule if after reasonable efforts, the member is unable to forward the information to all holders of that security. NASD generally will not characterize or interpret broker/dealer conduct as "reasonable efforts" if CUSIP numbers are provided in the notice or other information and the broker/dealer does not promptly forward the information to beneficial owners holding such securities on the broker/dealer's books and records. Similarly, if the broker/dealer makes no effort to determine from the issuer or the trustee if it may obtain reimbursement of its reasonable costs for forwarding the information, the NASD will not characterize such conduct as "reasonable efforts."

### Additional Amendments

NASD has also made other minor changes to Rule 2260 and IM-2260. For example, NASD amended IM-2260, regarding reimbursement of costs, to clarify that, in forwarding proxies and other materials, members may not charge for envelopes that are provided by the issuer or the trustee, as well as by persons soliciting proxies.

### Effective Date of Amendments

These amendments will become effective on July 9, 2002.

### ENDNOTES

- 1 See Securities Exchange Act Release No. 45736 (April 11, 2002), 67 FR 19291 (April 18, 2002).
- 2 The Municipal Securities Rulemaking Board (MSRB) recently amended MSRB Rule G-15 to impose similar forwarding requirements with respect to information regarding municipal securities. See MSRB Rule G-15(g).

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## ATTACHMENT A

### Text of Rule

New language is underlined; deletions are in brackets.

#### 2260. Forwarding of Proxy and Other Materials

(a) A member has an inherent duty [in carrying out high standards of commercial honor and just and equitable principles of trade] to forward promptly certain information regarding a security to the beneficial owner (or the beneficial owner's designated investment adviser) if the member carries the account in which the security is held for the beneficial owner and the security is registered in a name other than the name of the beneficial owner.

##### (1) Equity Securities

For an equity security, the member must forward:

(A)[(1)]all proxy material [which] that is properly furnished to the member [it] by the issuer of the securities or a stockholder of such issuer; [to each beneficial owner of shares of that issue (or the beneficial owner's designated investment adviser) which are held by the member for the beneficial owner thereof] and

(B)[(2)]all annual reports, information statements and other materials sent to stockholders[, which] that are properly furnished to the member [it] by the issuer of the securities. [to each beneficial owner of shares of that issue (or the beneficial owner's designated investment adviser) which are held by the member for the beneficial owner thereof.]

##### (2) Debt Securities

For a debt security other than a municipal security, the member must make reasonable efforts to forward any communication, document, or collection of documents pertaining to the issue that: (A) was prepared by or on behalf of, the issuer, or was prepared by or on behalf of, the trustee of the specific issue of the security; and (B) contains material information about such issue including, but not limited to, notices concerning monetary or technical defaults, financial reports, information statements, and material event notices.

(b) No member shall give a proxy to vote stock [which] that is registered in its name, except as required or permitted under the provisions of paragraphs (c) or (d) hereof, unless such member is the beneficial owner of such stock.

(c) (1) No change.

(A) sufficient copies of all soliciting material [which] that such person is sending to registered holders, and

(B) satisfactory assurance that he or she will reimburse such member for all out-of-pocket expenses, including reasonable clerical expenses incurred by such member in connection with such solicitation,

such member shall transmit promptly to each beneficial owner of stock of such issuer (or the beneficial owner's designated investment adviser) [which] that is in its possession or control and registered in a name other than the name of the beneficial owner, all such material furnished. Such material shall include a signed proxy indicating the number of shares held for such beneficial owner and bearing a symbol identifying the proxy with proxy records maintained by the member, and a letter informing the beneficial owner (or the beneficial owner's designated investment adviser) of the time limit and necessity for completing the proxy form and forwarding it to the person soliciting proxies prior to the expiration of the time limit in order for the shares to be represented at the meeting. A member shall furnish a copy of the symbols to the person soliciting the proxies and shall also retain a copy thereof pursuant to the provisions of SEC Rule 17a-4 [under the Act].

(c) (2) through (3) No change.

(d) (1) No change.

(2) A member [which] that has in its possession or within its control stock registered in the name of another member and [which] that desires to transmit signed proxies pursuant to the provisions of paragraph (c), shall obtain the requisite number of signed proxies from such holder of record.

(3) No change.

(A) No change.

(B) any designated investment adviser [person registered as an investment adviser under the Investment Advisers Act of 1940 who exercises investment discretion pursuant to an advisory contract for the beneficial owner to vote the proxies for stock which is in the possession or control of the member,] may vote such proxies.

(e) (1) As required in paragraph (a), a[A] member[when so requested by an issuer and upon being furnished with:] must forward promptly the material set forth in (a)(1), in connection with an equity security, or must make reasonable efforts to forward promptly the material set forth in (a)(2), in connection with a debt security, provided that the member:

(A) is furnished with sufficient copies of the material (e.g., annual reports, information statements or other material sent to [stockholders, and] security holders) by the issuer, stockholder, or trustee;

(B) is requested by the issuer, stockholder, or trustee to forward the material to security holders; and,

(C) receives [(B)]satisfactory assurance that it will be reimbursed by such issuer, stockholder, or trustee for all out-of-pocket expenses, including reasonable clerical expenses[.]. [shall transmit promptly to each beneficial owner of stock of such issuer (or the beneficial owner's designated investment adviser) which is in its possession and control and registered in a name other than the name of the beneficial owner of all such material furnished.]

(2) No change.

(f) For purposes of this Rule, the term "designated investment adviser" is a person registered under the Investment Advisers Act of 1940 who exercises investment discretion pursuant to an advisory contract for the beneficial owner and is designated in writing by the beneficial owner to receive proxy and related materials and vote the proxy, and to receive annual reports and other material sent to [stockholders] security holders.

(1) No change.

(2) Members [who] that receive such a written designation from a beneficial owner must ensure that the designated investment adviser is registered with the Commission pursuant to the Investment Advisers Act [or] of 1940 and that the investment adviser is exercising investment discretion over the customer's account

pursuant to an advisory contract to vote proxies and/or to receive proxy soliciting material, annual reports and other material. Members must keep records substantiating this information.

(3) No change.

(g) No change.

- For purposes of this Rule, the term "ERISA" is an acronym for the Employee Retirement Income Security Act of 1974.

#### **IM-2260. Suggested Rates of Reimbursement**

(a) No change.

(1) Charges for Initial Proxy and/or Annual Report Mailings

(A) No change.

(B) 20 cents for each copy, plus postage, for annual reports[, which] that are mailed separately from the proxy material pursuant to the instruction of the person soliciting proxies.

(2) No Change.

(3) No Change.

(4) No Change.

(5) No Change.

(b) Members may charge for envelopes, provided that they are not furnished by the issuer, the trustee, or a [the] person soliciting proxies.

(c) No change.