

INFORMATIONAL

**Confidential
Customer
Information**

NASD Regulation
Withdraws Proposed
Rule Regarding
Confidential Customer
Financial Information;
SEC Issues Regulation
S-P, "Privacy of
Consumer Financial
Information"

SUGGESTED ROUTING

The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.

- Legal & Compliance
- Senior Management

KEY TOPICS

- Consumer Information
- SEC Regulation S-P

Executive Summary

In light of recently enacted federal law, NASD Regulation, Inc. (NASD RegulationSM) has withdrawn its rule proposal announced in *Notice to Members 97-12* (March 1997) regarding the use and release of confidential customer financial information. The new law mandates rulemaking governing the privacy of consumer financial information by federal agencies, including the Securities and Exchange Commission (SEC), thereby eliminating the need for NASD Regulation to pursue its own rules.

On June 22, 2000, the SEC issued Regulation S-P, "Privacy of Consumer Financial Information." Regulation S-P goes into effect on a voluntary basis starting November 13, 2000; it becomes mandatory on July 1, 2001. A copy of Regulation S-P is included with this *Notice*.

Questions/Further Information

Legal questions or comments concerning this *Notice* may be directed to Gregory Dean, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8159. Other questions or comments concerning this *Notice* may be directed to Paul Voketaitis, Member Regulation, NASD Regulation, at (202) 728-8843.

Background

In *Notice to Members 97-12*, NASD Regulation proposed requirements regarding the use of confidential financial information obtained from a customer by a member firm, either directly or through a business affiliate, and the release of such information to any third party, whether affiliated or nonaffiliated. In general, the proposal prohibited the release by a member (or its

affiliate) of confidential customer financial information unless prior written consent was obtained from the customer or proper notification was given to the customer about the intended release of the information.

NASD Regulation received approximately 50 comments in response to the proposal in *Notice to Members 97-12*. Many of the comments raised significant concerns about the proposed rule. Because of the substantial opposition to the proposed rule and due to potential congressional action in this area, NASD Regulation did not take any action on the proposal.

Gramm-Leach-Bliley Act

On November 12, 1999, the President signed into law the Gramm-Leach-Bliley Act (GLB).¹ Title V of the GLB sets forth privacy requirements for use of nonpublic personal financial information by banks, securities industry members, insurance companies, and other financial institutions. The GLB required the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision (collectively known as the "federal banking regulators"), the SEC, the National Credit Union Administration (NCUA), and the Federal Trade Commission (FTC) to coordinate the issuance of regulations governing the collection, use, and safeguarding of nonpublic personal financial information. In addition, the law recommended that the federal regulators work with state insurance commissioners on the regulations. The federal banking regulators, NCUA, and FTC issued proposed regulations in February 2000 and issued final regulations in

May 2000. The SEC's final regulation, Regulation S-P, "Privacy of Consumer Financial Information," was issued in June 2000.

Due to the privacy provisions of GLB and the SEC's issuance of Regulation S-P, NASD Regulation believes that its proposed rule regarding confidential customer financial information is no longer necessary. On July 26, 2000, the NASD Regulation Board approved a measure to withdraw *Notice to Members 97-12*.

SEC Regulation S-P

On March 2, 2000, the SEC issued a proposed regulation, Regulation S-P,² and on June 29, the SEC's final regulation was published in the *Federal Register*.³ Regulation S-P will go into effect on November 13, 2000, on a voluntary basis, and will become mandatory on July 1, 2001.

Regulation S-P is built around an "opt-out" policy. This means that as long as certain notices are given to consumers and customers, then financial institutions⁴ (broker/dealers) are permitted to share their clients' financial information with the broker/dealers' affiliated and non-affiliated third parties unless the consumers and customers opt out of the information sharing arrangement. The SEC defines a "consumer" as an individual who obtains or has obtained a financial product or service from a financial institution. Typically, a consumer has no further contact with the financial institution other than the one-time delivery of products or services. In addition, the SEC defines a "customer" as a consumer who has developed a continuing relationship with a financial institution to provide products or services.⁵

According to the SEC, in the first year a broker/dealer becomes subject to the rule, a broker/dealer must comply with the following requirements:

- (1) prepare notices describing the firm's privacy policies;
- (2) provide an initial privacy notice and opt-out notice to each consumer;
- (3) provide an initial privacy notice to each new customer (who did not receive a notice when he or she was a consumer);
- (4) provide an annual privacy notice to each existing customer; and
- (5) adopt policies and procedures that address the protection of customer information and records.

The SEC also recommends that broker/dealers review their contracts with third parties for administrative services and joint marketing agreements to ensure that the contracts reflect the firms' privacy policies. After the first year, broker/dealers would be required to revise notices only to reflect changes in their privacy policies. Similarly, these firms would have to revise their policies and procedures on safeguarding customer information as appropriate to ensure the protection of the information.

Privacy Notices

For the privacy notices, the rule requires broker/dealers to disclose details on the broker/dealers' information sharing arrangements. Specifically, the rule requires broker/dealers to disclose:

- the categories of nonpublic personal information that a broker/dealer may collect;

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- the categories of affiliates and nonaffiliated third parties to whom a broker/dealer discloses nonpublic personal information other than service providers and third parties that aid in fulfilling the service requested by a consumer;
- the broker/dealer's policies with respect to sharing information about former customers;
- the categories of information that are disclosed under agreements with third party service providers and joint marketers and the categories of third parties providing the services;
- a consumer's right to opt out of the disclosure of nonpublic personal information to nonaffiliated third parties;
- any disclosures regarding affiliate information sharing opt outs a financial institution is providing under the Fair Credit Reporting Act; and
- the institution's policies and practices with respect to protecting the confidentiality, security, and integrity of nonpublic personal information.

Essentially, consumers and customers must be given notice when information is going to be shared and then be given the opportunity to opt out of that sharing arrangement.

In certain circumstances, Regulation S-P permits broker/dealers to use "short-form" initial notices for consumers with whom the broker/dealer does not

have a customer relationship. The short-form notice must be accompanied by an opt-out notice and information on where the consumer may obtain additional information on the firm's privacy policies.

Under Regulation S-P, any information given by consumers or customers to broker/dealers to obtain a product or service will generally be considered to be nonpublic financial information. In addition, any list, description, or other grouping of consumers and customers that is derived from this information also may be considered nonpublic information. A broker/dealer may consider the information received to be publicly available (and therefore not subject to the restrictions of Regulation S-P) if the broker/dealer reasonably believes that the information is lawfully available from three sources:

- (1) federal, state, or local government records;
- (2) widely distributed media; or
- (3) disclosures to the general public that are required to be made by federal, state, or local law.

Information Sharing Arrangements

Another important aspect of Regulation S-P concerns the information sharing arrangements broker/dealers may have with their affiliates and with nonaffiliated third parties.

Affiliates

Generally, broker/dealers may share consumers' and customers' information with the broker/dealers' affiliates as long as that fact is disclosed in the privacy notices. Consumers and customers may not

opt out of that information sharing arrangement.

Nonaffiliated Third Parties

If, however, a broker/dealer has an information sharing agreement with nonaffiliated third parties, then that fact must be disclosed, and consumers and customers may generally opt out of having their information shared under that agreement.

The GLB does provide a series of exceptions that permit broker/dealers to share information with nonaffiliated third parties and in which consumers and customers may not opt out of those sharing arrangements. These exceptions include, but are not limited to, arrangements with joint marketers and service providers. While consumers and customers may not opt out of these information sharing arrangements, these arrangements must be disclosed in the privacy statements.

Introducing And Clearing Brokers

With regard to the information sharing arrangements between introducing brokers and clearing brokers, the regulation considers introducing brokers and clearing brokers as each having an individual relationship with consumers and customers. In other words, Regulation S-P recognizes that either the introducing broker or the clearing broker could share nonpublic consumer or customer financial information with third parties outside of the introducing/clearing relationship. The regulation will, however, permit the introducing brokers and clearing brokers to send one joint privacy notice to consumers and customers as long as the introducing and clearing brokers' privacy policies and notices are accurate for each institution.

Delivery Of Initial Privacy Notices

The delivery of the initial privacy notices to consumers and customers is another important aspect to Regulation S-P. For a consumer, the privacy notice must be delivered by broker/dealers before any nonpublic information is to be disclosed to third parties. For a customer, the privacy notice must be delivered by broker/dealers prior to the establishment of the customer relationship. Recognizing that many customer relationships with broker/dealers may be established through telephone calls, Regulation S-P will permit the initial privacy notices to be given as part of a Customer Agreement Form even if the form is sent out after the request for service by a consumer or customer. This may only be permitted when the sending of the notice prior to the establishment of a customer relationship "would substantially delay the consumer's transaction" and the customer agrees to receive the notice at a later time.

As Regulation S-P highlights the use of electronic communications and Web sites, the privacy policies, initial and annual notices, and opt-out notices may, under certain conditions, be delivered through e-mail and the Internet.

Small Firm Compliance

With regard to small firms, the SEC believes that compliance will be relatively simple. As stated in the SEC's release, since most small firms do not share nonpublic consumer financial information other than with service providers, the SEC believes that a simple set of model notices will assist small firms in their compliance. The SEC includes examples and model disclosure forms as part of the *Federal Register* release; **however, unlike the federal banking regulators', NCUA's, and FTC's**

rules, the SEC will not permit the use of the examples and model forms as a safe harbor by firms.

Regulation S-P And Other Federal Agencies' Regulations

While Regulation S-P is substantially similar to the final regulations issued by the federal banking regulators, NCUA, and FTC, there are differences (e.g., the SEC's lack of a safe harbor for the use of the SEC's model forms). Firms that are affiliated with banks and/or other financial entities should pay particular attention to the differences between these regulations and adopt procedures concerning the release of consumer and customer financial information that ensure compliance with all applicable requirements.

GLB And State Law

GLB was not intended to alter or supersede any state law, and expressly permits states to adopt any statute, regulation, order, or interpretation that affords persons greater protection than is provided under GLB's privacy provisions.

Endnotes

¹Public Law 106-102.

²Privacy of Consumer Financial Information (Regulation S-P), Exchange Act Release No. 42484 (March 2, 2000), 65 Fed. Reg. 12354 (March 8, 2000).

³Exchange Act Release No. 42974 (June 22, 2000), 65 Fed. Reg. 40333 (June 29, 2000).

⁴For the term "financial institution," the SEC uses the definition contained in the GLB law which is any institution that engages in financial activities as described in section 4(K) of the Bank Holding Company Act of 1956. For Regulation S-P, the term includes broker/dealers, investment advisers, investment companies, and other entities engaging in activities that are financial in nature or incidental to such financial activities.

⁵Generally, references in Regulation S-P to "consumers" also apply to "customers."

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