

NASD Notice to Members 99-57

SEC Approves Rule
Amendments Governing
Clearing Firms And Their
Introducing Firm Clients'
Relationship; **Effective
Date: July 19, 1999**

Suggested Routing

- ☒ Senior Management
- ☐ Advertising
- ☐ Continuing Education
- ☐ Corporate Finance
- ☐ Executive Representatives
- ☐ Government Securities
- ☐ Institutional
- ☐ Insurance
- ☒ Internal Audit
- ☒ Legal & Compliance
- ☐ Municipal
- ☐ Mutual Fund
- ☒ Operations
- ☐ Options
- ☐ Registered Representatives
- ☐ Registration
- ☐ Research
- ☐ Syndicate
- ☒ Systems
- ☐ Trading
- ☐ Training
- ☐ Variable Contracts

Executive Summary

On June 2, 1999, the Securities and Exchange Commission (SEC) approved amendments to National Association of Securities Dealers, Inc. (NASD® or Association) Rule 3230, which governs clearing agreements between members, with respect to: (1) the handling of customer complaints about introducing firms that are received by their clearing firms; (2) exception and other reports clearing firms make available to their introducing firm clients to assist them in their supervisory obligations; and (3) clearing firms granting their introducing firm clients check writing privileges on the clearing firm's account.

The amendments, which are substantially the same as amendments to New York Stock Exchange (NYSE) Rule 382 which were also approved on June 2, 1999, will take effect on July 19, 1999; however, members will be given up to 90 days to comply with certain provisions. The deadlines are discussed in more detail below.

Questions regarding this *Notice* may be directed to Samuel Luque, Associate Director, Compliance Department, (202) 728-8472; or Elliott R. Curzon, Assistant General Counsel, Office of General Counsel, (202) 728-8451.

Background

Recent concerns about questionable sales practices and potentially fraudulent activity by certain introducing firms, and the handling of customer complaints about those firms by their clearing firms, caused NASD Regulation, Inc. (NASD Regulation®) and the NYSE to examine the relationship between clearing firms and their client introducing firms. The resulting amendments are included in this

Notice. The NASD's and NYSE's amendments address the content and approval of clearing agreements to specify requirements for handling customer complaints; providing, requesting, and retaining exception reports; and issuing checks.

The amendments establish limited requirements to enable the introducing member to carry out its responsibilities under its clearing or carrying agreement with the clearing member, but they are not intended to change the fundamental nature of the relationship between introducing and clearing firms, or otherwise affect any existing rights, responsibilities, or liabilities under law or contract.

Description Of Rule Change

Customer Complaints. It is generally the practice of clearing firms to forward to introducing firms customer complaints they receive relating to matters that are the responsibility of the introducing firm. Under NASD Rule 3070, a member is required to report to the Association any written customer complaint against it involving allegations of theft or misappropriation of funds or securities or of forgery. The failure of introducing firms to comply in a timely manner with the requirements of Rule 3070 when their clearing firms forward customer complaints to them may prevent the Association from receiving reports in a timely manner. Since there is no mechanism other than Rule 3070 designed to provide this information to NASD Regulation, such late reporting undermines the purpose of Rule 3070, which is to provide NASD Regulation with early warning indicators to generate a regulatory response to problems. In addition, receipt by clearing firms of large numbers of complaints regarding introducing firms may be indicative of sales practice problems requiring prompt regulatory attention.

To address this concern, new paragraph (b) states that when a clearing firm receives a customer complaint about an introducing firm relating to the functions and responsibilities of the introducing firm, the clearing firm must forward the complaint to the introducing firm and send a copy of the complaint to the introducing firm's Designated Examining Authority (DEA). The requirement may provide an early warning to the DEA of potential problems at introducing firms. The amendment also provides that the clearing agreement must expressly direct and authorize the clearing firm to forward complaints in this way. In addition, the amendment requires that the clearing firm must notify the customer in writing that the complaint was received, and was forwarded to the introducing firm and to the introducing firm's DEA.

Members will be expected to begin handling customer complaints in accordance with these amendments on the effective date of the amendments (July 19, 1999). NASD Regulation's copy of customer complaints should be directed to:

Rule 3230(b) Coordinator
Member Regulation Department
NASD Regulation, Inc.
1735 K Street, N.W.
Washington, D.C. 20006

Exception Reports. All NASD member firms are required under NASD and federal regulations to establish, maintain, and enforce supervisory systems and procedures that are designed to address all areas of a member's business. A key aspect of these supervisory procedures is exception and other compliance reports that a member creates to help meet these supervisory responsibilities. In a fully disclosed clearing arrangement, the clearing member generally provides exception reports that are available to assist the introducing member in carrying out its supervisory

obligations. In addition, officers and managers of introducing members should be on notice of the reports and information that were available to them in meeting their supervisory and monitoring obligations. Paragraph (c) of the amendments addresses these issues.

New paragraph (c)(1) requires the clearing firm to provide each introducing firm, both at the commencement of the introducing/clearing arrangement and annually thereafter (can be a single date for all agreements instead of the anniversary date of each agreement), a list or description of all exception or other reports that it offers to the introducing firm to assist it in supervising its activities, monitoring its accounts, and carrying out its functions and responsibilities under the clearing agreement. Paragraph (c)(1) also requires the introducing member to notify promptly the clearing member, in writing, of those specific reports offered by the clearing member that the introducing member requires to supervise and monitor its customer accounts. Failure to provide notification would not only be a violation of Rule 3230, but also of Rule 3010, which requires that members establish and maintain proper supervisory systems.

The staff recognizes that some clearing firms do not create such reports, but instead provide data and data formatting software to their introducing clients that allow the introducing firms to prepare their own reports. Clearing firms can comply with this provision where they communicate with their introducing firms about the data and data formatting the clearing firms can provide so that the introducing firms can determine which reports they will need to create in order to meet their supervisory and monitoring needs.

Paragraph (c)(2) requires the clearing firm to retain, as part of its books and records, copies of any

reports requested or provided to the introducing firm. The provision permits a clearing firm to meet the requirement if it retains the data that was used to prepare the report, but only if the clearing member, at the request of the DEA, can recreate the report or provide the data and data formatting that was used to prepare the report. Similarly, if the clearing firm provided data and report formatting to the introducing firm, the clearing firm could provide this to the DEA to fulfill this requirement.

Paragraph (c)(3) requires that each year, no later than July 31, the clearing member must notify the introducing member's chief executive and compliance officers of the reports offered to the introducing member pursuant to paragraph (c)(1), and the reports requested by or supplied to the introducing firm as of such date. The clearing member must also provide a copy of the notice to the introducing firm's DEA. This provision is designed to make the responsible principals of the introducing firm aware of the reports and data available from the clearing firm to assist the introducing firm in meeting supervisory and other functions and responsibilities under the clearing agreement, and to alert the DEA.

Clearing firm members and their introducing firm clients will be expected to provide notice of the exception reports available, the reports they are requesting, and the notices specified under the provisions of paragraphs (c)(1) and (c)(3) 90 days after the effective date of these amendments, or October 18, 1999.

Finally, new paragraph (c)(4) grants the staff of NASD Regulation the authority to grant exemptions from the requirements of the rule for good cause shown in instances in which the clearing and introducing firms are affiliated, and compliance with the rule could disrupt established integrated compliance systems.

Check Writing. Under new paragraph (d), the clearing agreement may permit the introducing firm to issue checks to the introducing firm's customers that are drawn on the clearing member's account upon written representation from the introducing firm that it has established, and will maintain and enforce, supervisory procedures with respect to the issuance of negotiable instruments. This provision is not intended to affect any liability that a clearing firm may otherwise have in connection with checks for which the clearing firm acts as drawer or maker. Instead, the rule simply requires introducing firms to establish clear safeguards and procedures that are satisfactory to the clearing member when the introducing member issues checks to customers drawn on the clearing member's account.

Clearing firm members will be required to comply with the requirements of paragraph (d) with respect to all new agreements on the effective date of the amendments (July 19, 1999). With respect to all existing agreements, as of October 18, 1999, members will be required to revoke check writing privileges unless the requirements of paragraph (d) have been complied with.

Finally, NASD Regulation notes that an interpretation regarding the introducing broker's ability to issue checks or drafts on behalf of the clearing firm was issued by the SEC's Division of Market Regulation to the NASD in 1993 and is summarized under the "Customer Protection Rule" section in the NASD's publication entitled *NASD Guide To Rule Interpretations*. The interpretation states that a firm that meets the requirements of Exchange Act Rule 15c3-3(k)(2)(ii) may issue checks or drafts on behalf of the clearing firm so long as:

- (i) the bank account is in the name of the clearing firm;

- (ii) the written contract between the two firms specifies that the introducing firm is acting as agent for the clearing firm; and
- (iii) the clearing firm does not debit customer brokerage accounts for checks issued by the introducing firm and drawn on the account until the checks clear (as an alternative to not debiting a customer's account, members are permitted to reduce debits in their Reserve Formula by an amount equal to outstanding customer checks).

Text Of Amendments

(Note: New text is underlined; deletions are in brackets.)

3230. Clearing Agreements

(a) All clearing or carrying agreements entered into by a member, except where any party to the agreement is also subject to a comparable rule of a national securities exchange, shall specify the respective functions and responsibilities of each party to the agreement and shall, at a minimum, specify the responsibility of each party with respect to each of the following matters:

- (1) opening, approving and monitoring customer accounts;
- (2) extension of credit;
- (3) maintenance of books and records;
- (4) receipt and delivery of funds and securities;
- (5) safeguarding of funds and securities;
- (6) confirmations and statements;
- (7) acceptance of orders and execution of transactions;

- (8) whether, for purposes of the Commission's financial responsibility rules adopted under the Act, and the Securities Investor Protection Act, as amended, and regulations adopted thereunder, customers are customers of the clearing member; and
- (9) the requirement to provide customer notification under paragraph [(d)] (g) of this Rule.

(b) (1) In order for the introducing member to carry out its functions and responsibilities under the agreement, each clearing member must forward promptly any written customer complaint received by the clearing member regarding the introducing member or its associated persons relating to functions and responsibilities allocated to the introducing member under the agreement directly to: (A) the introducing member; and (B) the introducing member's examining authority designated under Section 17 of the Act ("DEA") (or, if none, to its appropriate regulatory agency or authority). The clearing or carrying agreement must specifically direct and authorize the clearing member to do so.

- (2) The clearing member must also notify the customer, in writing, that it has received the complaint, and that the complaint has been forwarded to the introducing member and to the introducing member's DEA (or, if none, to its appropriate regulatory agency or authority).
- (3) Pursuant to the 9600 Series, the Association may exempt a member or person associated with a member from the requirements of this paragraph for good cause shown in instances where the introducing organization is an affiliated entity of the carrying organization.

(c) (1) A clearing member, when it enters into a clearing agreement, must immediately, and annually thereafter, provide the introducing member a list or description of all reports (exception and other types of reports) which it offers to the introducing member to assist the introducing member in supervising its activities, monitoring its customer accounts, and carrying out its functions and responsibilities under the clearing agreement. The introducing member must notify promptly the clearing member, in writing, of those specific reports offered by the clearing member that the introducing member requires to supervise and monitor its customer accounts.

(2) The clearing member must retain as part of its books and records required to be maintained under the Act and the Association's rules, copies of the reports requested by or provided to the introducing member. For purposes of this Rule, the clearing member will be in compliance with the requirements of this paragraph if it retains the data from which the original report was produced, provided, the clearing member can, at the request of the DEA (or, if none, to its appropriate regulatory agency or authority), either (A) recreate the report; or (B) provide the data and the data formatting that was used to prepare the report.

(3) Each year, no later than July 31, the clearing member must notify in writing the introducing member's chief executive and compliance officers of the reports offered to the introducing member pursuant to paragraph (c)(1) and the reports requested by or supplied to the introducing member as of such date. The clearing member must also provide a copy of the notice to the introducing member's DEA (or, if none, to its appropriate regulatory agency or authority).

(4) Pursuant to the 9600 Series, the Association may exempt a member or person associated with a member from the requirements of this paragraph for good cause shown in instances where the introducing organization is an affiliated entity of the carrying organization.

(d) The clearing or carrying agreement may permit the introducing member to issue negotiable instruments directly to the introducing member's customers using instruments for which the clearing member is the maker or drawer. The clearing member may not grant the introducing member the authority to issue negotiable instruments until the introducing member has notified the clearing member in writing that it has established, and will maintain and enforce, supervisory procedures with respect to the issuance of such instruments that are satisfactory to the carrying organization.

[(b)] (e) Whenever a clearing member designated to the Association for oversight pursuant to Section 17 of the Act, or a rule of the Commission adopted thereunder, amends any of its clearing or carrying agreements with respect to any item enumerated in subparagraphs (a)(1) through (a)(9) or enters into a new clearing or carrying agreement with an introducing member, the clearing member shall submit the agreement to the Association for review and approval.

[(c)] (f) Whenever an introducing member designated to the Association for oversight pursuant to Section 17 of the Act, or a rule of the Commission adopted thereunder, amends its clearing or carrying agreement with a clearing member designated to another self-regulatory organization for oversight with respect to any item enumerated in subparagraphs (a)(1) through (a)(9) enters into a new clearing agreement with another clearing member, the introducing member shall submit the agreement to its local Association district office for review.

[(d)] (g) Each customer whose account is introduced on a fully disclosed basis shall be notified in writing upon the opening of his account of the existence of the clearing or carrying agreement.

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