NASD NOTICE TO MEMBERS 97-89

SEC Approves Bank Broker/Dealer Rule; Effective February 15, 1998

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Executive Summary

On November 4, 1997, in Release No. 34-39294, the Securities and Exchange Commission (SEC or Commission) approved new National Association of Securities Dealers, Inc. (NASD®) Rule 2350, which specifies requirements applicable to broker/dealers operating on the premises of financial institutions (Bank Broker/Dealer Rule or Rule).[1] The new Rule will be effective on February 15, 1998. This *Notice* contains questions and answers to assist members in complying with the new Rule. The text of the new Rule and the *Federal Register* version of the SEC Release are attached.

Questions concerning this *Notice* should be directed to R. Clark Hooper, Senior Vice President, Office of Disclosure and Investor Protection, NASD Regulation, Inc., at (202) 728-8325, or Mary N. Revell, Associate General Counsel, Office of General Counsel, NASD Regulation℠, at (202) 728-8203. Questions concerning the SEC's approval order should be directed to the SEC's Office of Interpretations and Guidance, at (202) 942-0069.

Background

The NASD initially published the Bank Broker/Dealer Rule for member comment in *NASD Notice to Members 94-94*. The proposed Rule was revised substantially in response to the 284 comment letters that were received. The proposed Bank Broker/Dealer Rule was filed for approval with the SEC on December 28, 1995 (original proposal or original proposed Bank Broker/Dealer Rule).[2]

The SEC published notice of the proposed Bank Broker/Dealer Rule and three amendments to the Rule in the *Federal Register* in March, 1996 (March *Federal Register* Release).[3] The SEC received 98 comment letters on the original proposal. About one-third of the comment letters expressed support for the proposal. While a few commenters supported the proposal as published, most were generally supportive of the proposal's goals but suggested modifications to the proposed Rule. More than half of the commenters opposed some or all of the provisions of the original proposal.

Amendment No. 4, which was filed with the SEC on March 24, 1997, responded to these comments and substantially revised the original proposal. Among other things, Amendment No. 4: (1) deleted the provision restricting the use and release of confidential financial information; (2) deleted the provision governing compensation of unregistered persons; and (3) revised the provisions regarding setting and communications with the public.[4] *See Notice to Members 97-26* for a complete description of the revisions.

Amendment No. 5 to the Bank Broker/Dealer Rule was submitted to the SEC on July 17, 1997.[5] The purpose of this amendment was to respond to the 11 public comments received by the SEC in response to publication in the *Federal Register* of Amendment No. 4. Several technical changes were made to the Rule language to make the Rule clearer, less ambiguous, and more in accord with the standards set forth in the 1994 Interagency Statement on Retail Sales of Nondeposit Investment Products issued by the banking regulators.

The text of the new Rule is set forth below. For a complete description of the new Rule, members should review in detail the attached *Federal Register* version of the SEC Release.

Questions And Answers

Included below are questions and answers to provide guidance to members on compliance with the new Bank Broker/Dealer Rule.

Applicability

Question #1: The Rule applies only to "broker/dealer services conducted by members on the premises of financial institutions where retail deposits are taken." What financial institutions are encompassed by the Rule? What is meant by "the premises of a financial institution where retail deposits are taken" within the meaning of paragraph (a) of the Rule?

Answer: Paragraph (b)(1) of the Rule defines a "financial institution" as a federal or state-chartered bank, a savings and loan association, a savings bank, a credit union, and the required service corporations of such institutions. The phrase "premises ... where retail deposits are taken" generally means an area of a financial institution where the public (or members, in the case of a credit union) can access the deposit services of the institution. It does not, however, include areas of a financial institution that are physically separate from the retail deposit-taking area, *e.g.*, a broker/dealer operating in separate office space on another floor or in another part of the same building (even if the building is owned or primarily occupied by the financial institution) and having no physical presence on the premises of the financial institution where retail deposits are taken or office space that is not generally accessible to the public without an appointment, such as a location where trust or private banking services are provided. An area may be considered physically separate even though entry through a common building lobby or an exterior entrance is permitted.

Question #2: What type of presence is required to be deemed to be conducting broker/dealer services on the premises of the financial institution?

Answer: The Rule applies only where broker/dealer services are conducted either in person, over the telephone, or through any other electronic medium, on the premises of a financial institution where retail deposits are taken, by a broker/dealer that has a physical presence on those premises. Thus, for example, the Rule would apply in the following situations:

• a broker/dealer opens an account for a customer when both are present on the premises of a financial institution;

• a financial institution customer places a telephone call from outside the premises to a broker/dealer located on the premises;

• a customer calls a broker/dealer from a telephone at a broker/dealer's desk located on the premises or from a telephone dedicated to or identified as for use only to contact the broker/dealer; or the broker/dealer is aware that the customer is contacting the broker/dealer via telephone or other electronic medium on the premises of a financial institution where retail deposits are taken.

The Rule would not apply, however, when a customer located on the premises of a financial institution calls a broker/dealer located off the premises from a telephone located in the financial institution that is not dedicated to the broker/dealer (*i.e.*, a regular pay phone), and the broker/dealer is not aware that the customer is calling from the premises of a financial institution.

Question #3: If a member has many branch offices, some of which are located on the premises, and some of which are not, does the Rule apply to all of the firm's branches?

Answer: No; the Rule applies only to broker/dealer services conducted on the premises of a financial institution where retail deposits are taken. Therefore, the Rule would apply only to those branch offices that meet this description and only to accounts opened at those branches.

Setting

Question #4: Paragraph (c)(1) of the Rule requires that sales of non-deposit products should be conducted in a physically distinct location wherever practical. What does that mean with respect to (a) kiosks and (b) Automated Teller Machine (ATM) screens?

Answer: The Rule recognizes that sales of non-deposit products should be conducted in a physically distinct location wherever practical. In all situations, including those where a physically distinct location is not practical, the location must be identified in a manner that clearly distinguishes the broker/dealer services from the activities of the financial institution, and the member's name must be clearly displayed in the area in which the member conducts its broker/dealer services. Indeed, when a member is unable to achieve ideal physical distinction between member activities and the financial institution's retail deposit-taking area, the member must pay particular attention to signage in order to eliminate customer confusion and misidentification.

The Rule imposes the same standards on broker/dealers as are imposed on financial institutions by the Interagency Statement on Retail Sales of Nondeposit Investment Products issued by the banking regulators on February 15, 1994 (Interagency Statement). In particular, in regard to setting, the Interagency Statement imposes the following requirements:

> Selling or recommending nondeposit investment products on the premises of a depository institu-

tion may give the impression that the products are FDIC-insured or are obligations of the depository institution. To minimize customer confusion with deposit products, sales or recommendations of nondeposit investment products on the premises of a depository institution should be conducted in a physical location distinct from the area where retail deposits are taken. Signs or other means should be used to distinguish the investment sales area from the retail deposit-taking area of the institution. However, in the limited situation where physical considerations prevent sales of nondeposit products from being conducted in a distinct area, the institution has a heightened responsibility to ensure appropriate measures are in place to minimize customer confusion.

The NASD intends to work closely with the banking regulators to ensure that NASD interpretations and requirements applicable to broker/dealers conducting business on the premises of a financial institution are consistent with interpretations and requirements applied to financial institutions by banking regulators, and will issue interpretations or propose rule amendments to notify members of any changes.

(a) *Kiosks*. Kiosks or windows operated by a single person in a public place, such as a supermarket, require very special attention to avoid confusion to the public. The difficulties of operating such settings may be resolved if the member exercises exceptional caution and adopts specific operational and signage controls designed to avoid customer confusion and to distinguish the member's operations from those of the financial institution. Additional training and supervision of personnel at kiosks may be necessary and appropriate to make sure that customer confusion does not occur.

(b) *ATM machines*. Paragraph (c)(1) of the Rule requires that the location where the member operates must be identified in a manner that clearly distinguishes the member's services from the activities of the financial institution. While the Rule does not specifically address services provided by computer terminal or ATM, this requirement may be satisfied by displaying the member's name on the first ATM screen after the "investment or securities brokerage" option is chosen by the customer, and, when the customer first enters the "pages" that involve the member's services, by displaying on the screen the disclosures required by paragraph (c)(3)(A) or (c)(4)(C) of the Rule.

Question #5: May the member use directional signs in the deposit-taking area to help customers find the location where broker/dealer services are provided?

Answer: There is no prohibition against directional signs regarding broker/dealer services in the deposit-taking area, so long as the signage meets the other requirements of the Rule and other NASD rules requiring accurate information that is not misleading under the circumstances in which it is used. The member should discuss with the bank where directional signage should be placed. If necessary, the bank could consult with the appropriate federal banking regulator regarding location and content.

Question #6: May a member enter into an arrangement with a financial institution whereby a teller can accept customer deposits into a brokerage account of the member?

Answer: No. Such an arrangement would violate the requirement that the member's broker/dealer services be conducted in a physical location distinct from the area in which the financial institution's retail deposits are taken. The member may want to address this issue in its agreement with the financial institution, which could contain a provision requiring the financial institution to instruct its tellers to direct customers who want to make such a deposit to the member's location on the premises. A member may enter into an arrangement with a financial institution, however, in which cash deposited into a bank account is automatically swept into a money market fund or a brokerage account.

Customer Disclosure And Written Acknowledgment

Question #7: A member is required by paragraph (c)(3)(B) of the Rule to make reasonable efforts to obtain from each customer, during the account opening process, a written acknowledgment of the required disclosures. What is the meaning of "during the account opening process"?

Answer: The account opening process commences at the time of the first contact between the member and the customer. Written documentation may be sent to the customer by the member after the account is opened. Even in the case of accounts opened in person, a customer may wish to bring the disclosure document home for a careful reading. During this process, the member should make reasonable efforts to obtain the acknowledgment.

Question #8: What constitutes reasonable efforts to obtain the required acknowledgment?

Answer: Because some customers may be reluctant to provide the written acknowledgment at the time the account is opened (or, indeed, at any time), the Rule does not mandate that

the acknowledgment be obtained; the Rule does, however, require that the member make reasonable efforts to obtain it. Reasonable efforts should include contacting the customer by telephone, mail, or electronic means to encourage the customer to return the written acknowledgment of disclosures. If such efforts are unsuccessful, the member is not required to close the account. (Compare approach in connection with obtaining suitability information under NASD Rules 2310(b) and 3110, where the member is required to make reasonable efforts to obtain a customer's information and is not required to close the account if the information is not obtained.)

In the order approving the Rule, the SEC specifically addressed this issue. In particular, the Commission stated the following:

> The disclosures required by the rule, and the written acknowledgment of disclosures obtained pursuant to the rule, are intended to assist investors in making investment decisions based on a better understanding of the distinctions between insured deposits and uninsured securities products. Although the rule requires only that members "make reasonable efforts" to obtain written customer acknowledgment of the required disclosures in the account opening process, the Commission expects members to obtain such written acknowledgment in all but rare circumstances (e.g. when a customer refuses to sign the acknowledgment). It is anticipated that, as is the case today, many firms will provide these disclosures in the new account opening form which, when signed by the customer, constitutes written acknowledgment. The Commission believes that in the rare circumstances where acknowledgment is not obtained, heightened supervisory procedures would be necessary. Reasonable supervisory procedures would include procedures for the registered representative receiving approval from the member's compliance department prior to opening the account, and documenting that the customer has refused to sign the written acknowledgment of such disclosure.

We have confirmed with SEC staff our understanding of the meaning of this language. To the extent the approval order imposes an obligation beyond the requirement in the Rule to make reasonable efforts to obtain written acknowledgment of the required disclosures, the obligation must be enforced as a general failure to establish and maintain supervisory procedures that are designed to achieve compliance with applicable securities laws and NASD rules, including the Bank Broker/Dealer Rule, under NASD Rule 3010, rather than as a violation of the Bank Broker/Dealer Rule. Examinations wherein member compliance with the Bank Broker/Dealer Rule are reviewed will be conducted, and consideration of potential disciplinary action will be undertaken, consistent with this understanding.

Question #9: What constitutes a written acknowledgment of the required disclosures?

Answer: It can be substantially identical to the statement described in the Interagency Statement: a statement, signed by the customer, obtained during the account opening process, acknowledging that the customer has received and understands the disclosure. It does not have to be set forth in a separate document, with a separate signature, but can, for example, be included in the member's account opening documentation as long as the disclosure is conspicuous and near the signature line.

Communications With The Public

Question #10: Paragraph (c)(4)(A) requires all member confirmations and account statements to indicate clearly that the broker/dealer services are provided by the member. Would a member be required to provide this disclosure to customers for accounts opened off the premises of a financial institution where retail deposits are taken?

Answer: No. Paragraph (c)(4)(A) does not apply to customer confirmations or customer statements reflecting transactions in customer accounts opened off the financial institution's premises where retail deposits are taken. If broker/dealer services are conducted by members on the premises of a financial institution where retail deposits are taken, as clarified in answers to Questions #1 and #2, then indication that the investment banking or securities business is provided by the member broker/dealer must be prominently indicated on the face of the customer confirmation and on the face of the customer statement. There is no prescribed language, format or type size, but an investor should be able to clearly view the information on the documents.

Notifications Of Terminations

Question #11: Paragraph (c)(5) requires a member to provide prompt notification to the financial institution of the termination for cause of any of its associated persons who are employed by the financial institution. How may this notification be provided?

Answer: A copy of Form U-5 may be used for the notice of termination.

Text Of New Rule

(Note: all language is new.)

2350. Broker/Dealer Conduct on the Premises of Financial Institutions

(a) Applicability

This section shall apply exclusively to those broker/dealer services conducted by members on the premises of a financial institution where retail deposits are taken. This section does not alter or abrogate members' obligations to comply with other applicable NASD rules, regulations, and requirements, nor those of other regulatory authorities that may govern members operating on the premises of financial institutions.

(b) Definitions

(1) For purposes of this section, the term "financial institution" shall mean federal and state-chartered banks, savings and loan associations, savings banks, credit unions, and the service corporations of such institutions required by law.

(2) "Networking arrangement" and "brokerage affiliate arrangement" shall mean a contractual or other arrangement between a member and a financial institution pursuant to which the member conducts broker/dealer services for customers of the financial institution and the general public on the premises of such financial institution where retail deposits are taken.

(3) "Affiliate" shall mean a company that controls, is controlled by, or is under common control with a member as defined in Rule 2720.

(4) "Broker/dealer services" shall mean the investment banking or securities business as defined in paragraph (o) of Article I of the By-Laws.

(c) Standards for Member Conduct

No member shall conduct broker/dealer services on the premises of a financial institution where retail deposits are taken unless the member complies initially and continuously with the following requirements:

(1) Setting

Wherever practical, the member's broker/dealer services shall be conducted in a physical location distinct from the area in which the financial institution's retail deposits are taken. In all situations, members shall identify the member's broker/dealer services in a manner that is clearly distinguished from the financial institution's retail deposit-taking activities. The member's name shall be clearly displayed in the area in which the member conducts its broker/dealer services.

(2) Networking and Brokerage Affiliate Agreements

Networking and brokerage affiliate arrangements between a member and a financial institution must be governed by a written agreement that sets forth the responsibilities of the parties and the compensation arrangements. The member must ensure that the agreement stipulates that supervisory personnel of the member and representatives of the Securities and Exchange Commission and the Association will be permitted access to the financial institution's premises where the member conducts broker/dealer services in order to inspect the books and records and other relevant information maintained by the member with respect to its broker/dealer services.

(3) Customer Disclosure and Written Acknowledgment

At or prior to the time that a customer account is opened by a member on the premises of a financial institution where retail deposits are taken, the member shall:

(A) disclose, orally and in writing, that the securities products purchased or sold in a transaction with the member:

(i) are not insured by the Federal Deposit Insurance Corporation ("FDIC");

(ii) are not deposits or other obligations of the financial institution and are not guaranteed by the financial institution; and

(iii) are subject to investment risks, including possible loss of the principal invested; and

(B) make reasonable efforts to obtain from each customer during the account opening process a written acknowledgment of the disclosures required by paragraph (c)(3)(A).

(4) Communications with the Public

(A) All member confirmations and account statements must indicate clearly that the broker/dealer services are provided by the member.

(B) Advertisements and sales literature that announce the location of a financial institution where broker/dealer services are provided by the member or that are distributed by the member on the premises of a financial institution must disclose that securities products: are not insured by the FDIC; are not deposits or other obligations of the financial institution and are not guaranteed by the financial institution; and are subject to investment risks, including

possible loss of the principal invested. The shorter, logo format described in paragraph (c)(4)(C) may be used to provide these disclosures.

(C) The following shorter, logo format disclosures may be used by members in advertisements and sales literature, including material published, or designed for use, in radio or television broadcasts, Automated Teller Machine ("ATM") screens, billboards, signs, posters, and brochures, to comply with the requirements of paragraph (c)(4)(B), provided that such disclosures are displayed in a conspicuous manner:

• Not FDIC Insured

• No Bank Guarantee

• May Lose Value

(D) As long as the omission of the disclosures required by paragraph (c)(4)(B) would not cause the advertisement or sales literature to be misleading in light of the context in which the material is presented, such disclosures are not required with respect to messages contained in:

• radio broadcasts of 30 seconds or less;

• electronic signs, including billboard-type signs that are electronic, time, and temperature signs and ticker tape signs, but excluding messages contained in such media as television, on-line computer services, or ATMs; and

• signs, such as banners and posters, when used only as location indicators.

(5) Notifications of Terminations

The member must promptly notify the financial institution if any associated person of the member who is employed by the financial institution is terminated for cause by the member.

Endnotes

[1] *See* Release No. 34-39294 (November 4, 1997), 62 F.R. 60542 (November 10, 1997) (SEC Release).

[2] *See* File No. SR-NASD-95-63; *NASD Notice to Members 96-3* (January 1996).

[3] *See* Release No. 34-36980 (March 15, 1996), 61 F.R. 11913 (March 22, 1996).

[4] *See* Release No. 34-38506 (April 14, 1997), 62 F.R. 19378 (April 21, 1997), requesting comments by May 12, 1997.

[5] *See* letter from Mary N. Revell, Assistant General Counsel, NASD Regulation, to Belinda Blaine, Associate Director, SEC, dated July 17, 1997.