

NASD NOTICE TO MEMBERS 98-3

Electronic Delivery Of Information Between Members And Their Customers

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Executive Summary

This *Notice* sets forth the policy of NASD Regulation, Inc. (NASD RegulationSM) applicable to electronic delivery of information between members and their customers as required or permitted by National Association of Securities Dealers, Inc. (NASD[®]) Rules.¹

Questions concerning this *Notice* may be directed to Mary Revell, Associate General Counsel, NASD Regulation, at (202) 728-8203.

Background And Discussion

On May 9, 1996, the Securities and Exchange Commission (SEC or Commission) issued an interpretive release publishing its views on the use of electronic media by broker/dealers for delivery of information.² The SEC stated that broker/dealers and others may satisfy their delivery obligations under federal securities laws by using electronic media as an alternative to paper-based media within the framework established in the SEC's October 1995 interpretive release on the use of electronic media for delivery purposes.³ The SEC also indicated that an electronic communication from a customer to a broker/dealer generally would satisfy the requirements for written consent or acknowledgment under the federal securities laws.

NASD Regulation will permit members to electronically transmit documents that they are required or permitted to furnish to customers under NASD Rules, provided they adhere to the standards contained in the SEC Releases summarized below. Members also may receive electronic communications from customers. Members are urged to review the May 1996 and October 1995 Releases in their entirety to ensure they comply with all aspects of the SEC's electronic delivery requirements.

SEC Releases

According to the standards established by the SEC, broker/dealers may use electronic media to satisfy their delivery obligations, provided the electronic communication satisfies the following principles:

Notice: The electronic communication should provide timely and adequate notice to customers that the information is available electronically. If necessary, broker/dealers should consider supplementing the electronic communication with another communication that would provide notice similar to that provided by delivery in paper through the postal mail that information has been sent electronically that the recipient may wish to review.

Access: Customers who are provided information through electronic delivery should have access to that information substantially equivalent to the access that would be provided if the information were delivered in paper form (*i.e.*, the electronically transmitted document must convey all material and required information). For instance, if a paper document is required to present information in a certain order, then the information delivered electronically should be in substantially the same order. The use of a particular electronic medium should not be so burdensome that intended recipients cannot effectively access the information provided. A recipient should have the opportunity to retain the information through the selected medium or have ongoing access equivalent to personal retention.⁴ Also, as a matter of policy, the SEC believes that a person who has a right to receive a document under the federal securities laws, and chooses to receive it electronically, should be provided with a paper version of the document if consent to receive documents electronically is revoked or upon specific request.⁵

Evidence to Show Delivery:

Broker/dealers must have reason to believe that electronically delivered information will result in the satisfaction of the delivery requirements under the federal securities laws. Broker/dealers should consider the need to establish procedures to ensure that applicable delivery obligations are met, and should take reasonable precautions to ensure that information transmitted using either electronic or paper media is delivered as intended. Broker/dealers may be able to evidence satisfaction of delivery obligations, for example, by:

- (1) obtaining the intended recipient's informed consent⁶ to delivery through a specified electronic medium, and ensuring that the recipient has appropriate notice and access;
- (2) obtaining evidence that the intended recipient actually received the information, such as by an electronic mail return-receipt or by confirmation that the information was accessed, downloaded, or printed; or
- (3) disseminating information through certain facsimile methods.

The SEC also made the following statements regarding the communication of personal financial information (e.g., confirmations and account statements).

Confidentiality and Security: Broker/dealers sending personal financial information through electronic means or in paper form should take reasonable precautions to ensure the integrity, confidentiality, and security of that information. Broker/dealers transmitting personal financial information electronically must tailor those precautions to the medium used in order to ensure that the information is reasonably secure from tampering or alteration.

Consent: Prior to delivering personal financial information electronically, the broker/dealer must notify the intended recipient that the information will be delivered electronically and obtain the recipient's informed consent. The customer's consent may be made either by a manual signature or by electronic means.

The SEC also stated that an electronic communication from a customer to a broker/dealer will satisfy requirements under certain Commission Rules to receive or obtain written customer consent or acknowledgment.⁷ Further, the SEC reminded broker/dealers that they must reasonably supervise firm personnel to prevent violations, and suggested that firms should evaluate the need for systems and procedures to deter or detect misconduct by firm personnel in connection with the delivery of information, whether by electronic or paper means.

The SEC release stated that the above standards are intended to permit broker/dealers to comply with their delivery obligations under the federal securities laws when using electronic media. While compliance with the guidelines is not mandatory for the electronic delivery of non-required information that, in some cases, is being provided voluntarily to customers, NASD Regulation believes adherence to the guidelines should be considered, especially with respect to documents furnished pursuant to agreements or other specific arrangements with customers.

Conclusion

A list of current NASD Conduct Rules, Marketplace Rules, and Procedural Rules that require or permit communications between members and their customers for which electronic delivery may be used in accordance with the standards set forth in the SEC May 1996 and October

1995 Releases is set forth below. The summary of delivery obligations provided is intended for reference only, and is not intended to be a statement of all requirements under the Rules listed. NASD Regulation believes this list is complete. The interpretation set forth in this *Notice* also will apply to a new Rule or an amendment to an existing Rule that requires or permits communications between members and their customers unless NASD Regulation specifies otherwise at the time of adoption of the Rule or amendment.

NASD Rules That Require Or Permit Delivery Of Information Between Firms and Customers Conduct Rules

Rule 2210(d)(2)(B)(i), (ii), and (iv) (Communications with the Public; Standards Applicable to Communications with the Public; Specific Standards; Recommendations) requires a member to disclose certain "conflicts of interest" situations, if applicable, when making a recommendation; requires a member to provide, or offer to furnish upon request to the customer, available investment information to support a recommendation; and allows a member to offer to furnish a list of all recommendations made within the past year or over longer periods of time.

Rule 2220(d)(2)(D)(i) (Options Communications with the Public; Standards Applicable to Communications with the Public; Specific Standards) requires a member to state in sales literature pertaining to options that supporting documentation for any claims, comparisons, recommendations, statistics, or other technical data will be supplied upon request.

Rule 2230 (Confirmations) requires a member at or before the completion of each transaction to give or send to a customer written notification dis-

closing the member's role and other facts in connection with the transaction. In addition, if the member was acting as a broker for the customer, the member must disclose from whom the security was purchased or to whom it was sold or the fact that such information will be furnished upon request of the customer.

IM-2230 ("Third Market" Confirmations) requires a member that acts as a broker for customers in listed securities in the "third market" to provide certain disclosures in a legend on the confirmation to the customer.

Rule 2240 (Disclosure of Control Relationship with Issuer) requires a member who has a control relationship with the issuer of the security being purchased or sold to provide written disclosure of the relationship to the customer at or before the completion of the transaction.

Rule 2250 (Disclosure of Participation or Interest in Primary or Secondary Distribution) requires a member to provide written disclosure to the customer at or before completion of a transaction in a primary or secondary distribution of the security, if the member is participating or has an interest in the distribution.

Rule 2260 (Forwarding of Proxy and Other Materials) requires a member to forward proxy materials, annual reports, information statements, and other material to each beneficial owner of shares of a stock held by the member.

Rule 2270(a) (Disclosure of Financial Condition to Customers) requires that, upon request, a member must make available to inspection by any bona fide regular customer financial condition information disclosed in its most recent balance sheet.

Rule 2310(a) and (b) (Recommendations to Customers (Suitability)) requires a member to make a suitability determination based on information disclosed by the customer as to the customer's other security holdings, financial situation, and need, and requires a member to make reasonable efforts to obtain specified information concerning non-institutional customers.

IM-2310-2(e) (Fair Dealing with Customers with Regard to Derivative Products or New Financial Products) requires a member to make every effort to make customers aware of the pertinent information regarding certain products. To meet this obligation, members may deliver written documents to the customer under certain circumstances.

Rule 2330(c) (Customers' Securities or Funds; Authorization to Lend) requires a member to obtain from a customer a written authorization permitting the lending of securities carried by the member.

Rule 2330(f)(2)(D) and (G) (Customer's Securities or Funds; Sharing in Accounts; Extent Permissible) requires that a compensation arrangement to share profits in an account must be set forth in a written agreement executed by the customer and the member, and that the member must disclose to the customer all material information relating to the arrangement, including the method of compensation and potential conflicts of interest that may result from the compensation formula.

Rule 2340(a) (Customer Account Statements) requires delivery of a statement of account containing a description of any securities positions, money balances, or account activity to each customer whose account had a security position, money balance, or account activity during the period since the last state-

ment was sent to the customer (see May 1996 Release, which covers confirmations of transactions pursuant to Securities Exchange Act Rule 10b-10).

Rule 2510(b) (Discretionary Accounts; Authorization and Acceptance of Account) requires the customer's prior written authorization before a member may exercise discretionary power in a customer's account.

Rule 2510(d) (Discretionary Accounts; Exceptions) allows an exception from the requirements of the rule under certain circumstances for members utilizing negative response letters for bulk exchanges of net asset value of money market mutual funds.

Rule 2710(c)(8)(A) (Corporate Financing Rule—Underwriting Terms and Arrangements; Underwriting Compensation and Arrangements; Conflicts of Interest) requires disclosure of conflicts of interest and the name of the qualified independent underwriter assuming the role of pricing the offering and conducting due diligence.

Rule 2720(d) and (h) (Distributions of Securities of Members and Affiliates—Conflicts of Interest; Disclosure and Periodic Reports) requires a member to make certain disclosures in the registration statement, offering circular, or similar document and requires a member that makes a distribution to the public of its securities pursuant to this Rule to send to each of its shareholders or investors: (1) quarterly, a summary statement of its operations and (2) annually, independently audited and certified financial statements.

Rule 2720(k) (Distributions of Securities of Members and Affiliates—Conflicts of Interest; Suitability) requires a member underwriting an

issue of securities where a conflict of interest exists to make a suitability determination based on information furnished concerning the customer's investment objectives, financial situation, and needs.

Rule 2720(l) (Distributions of Securities of Members and Affiliates—Conflicts of Interest; Discretionary Accounts) requires specific written approval of the customer prior to execution in a discretionary account of a transaction in securities issued by a member or an affiliate of a member, or by a company with which a member has a conflict of interest.

Rule 2730(b) (Securities Taken in Trade) defines the term "taken in trade" as a purchase by a member as principal, or as agent for the account of another, of a security from a customer pursuant to an agreement or understanding that the customer purchase securities from the member that are part of a fixed price offering.

Rule 2810(b)(2) (Direct Participation Programs; Requirements; Suitability) requires a member to obtain information from a participant concerning his investment objectives, other investments, financial situation, and needs before making a recommendation.

Rule 2810(b)(3)(D) (Direct Participation Programs; Requirements; Disclosure) requires that, prior to executing a purchase transaction in a direct participation program, a member must inform the prospective participant of all pertinent facts relating to the liquidity and marketability of the program during the term of the investment.

Rule 2830(n) (Investment Company Securities; Disclosure of Deferred Sales Charges) requires, in addition to the disclosures required by Rule 2230, disclosure on written confir-

mations if the transaction involves the purchase of shares of any investment company that imposes a deferred sales charge on redemption. In addition, a specified legend on the confirmation is required.

Rule 2845 (Discretionary Accounts) requires a customer's prior written authorization for trading of warrants in a discretionary account, pursuant to the requirements of Options Rule 2860(b)(18).

Rule 2848 (Communications with the Public and Customers Concerning Index Warrants, Currency Index Warrants, and Currency Warrants). The requirements of Rule 2220(d)(2)(D)(i) apply to communications to the public and customers concerning warrants. Rule 2848, therefore, requires the member to state in its sales literature that supporting documentation for any claims on behalf of the warrants will be supplied upon request.

Rule 2860(b)(11) (Options; Requirements; Delivery of Current Disclosure Document) requires delivery of the appropriate Options Clearing Corporation disclosure document to each customer at or prior to the time the customer's account is approved for options trading. Thereafter, delivery must be made to each customer of amendments or revisions to the disclosure document.

Rule 2860(b)(12) (Options; Requirements; Confirmations) requires members to promptly furnish customers with a written confirmation of each transaction in options contracts.

Rule 2860(b)(15) (Options; Requirements; Statements of Account) requires a member to send monthly statements to options account holders.

Rule 2860(b)(16)(A) (Options; Requirements; Opening of Accounts;

Approval Required) prohibits a member from accepting an options order from a customer or from approving a customer's account for options trading unless the broker/dealer has furnished to the customer the appropriate options disclosure document(s).

Rule 2860(b)(16)(B) (Options; Requirements; Opening of Accounts; Diligence in Opening Accounts) requires a member to exercise due diligence to ascertain the essential facts relative to a customer before approving a customer's account for options trading.

Rule 2860(b)(16)(C) (Options; Requirements; Opening of Accounts; Verification of Customer Background and Financial Information) requires that background and financial information on every new options account natural person customer be sent to the customer for verification within 15 days after the account is approved for options trading.

Rule 2860(b)(16)(D) (Options; Requirements; Opening of Accounts; Account Agreement) requires a member to obtain from the customer a written agreement that the customer is aware of and agrees to be bound by the NASD Rules applicable to the trading of option contracts within 15 days after a customer's account has been approved for trading of options contracts.

Rule 2860(b)(16)(E)(v) (Options; Requirements; Opening of Accounts; Uncovered Short Option Contracts) requires that a short written description of the risks inherent in writing uncovered short option transactions must be furnished to applicable customers.

IM-2860-2 (Diligence in Opening Options Accounts)

Paragraph (a) requires members to seek to obtain certain information at a minimum with respect to options customers who are natural persons in order to fulfill their obligations under Rule 28860(b)(16)(B).

Paragraph (c) recommends that members consider utilizing a standard account approval form to ensure the receipt of all required information.

Paragraph (e) states that the requirements of Rule 2860(b)(16)(C), regarding initial and subsequent verification of customer background and financial information, can be satisfied by sending to the customer the information required in paragraphs (a)(1) through (a)(6) of IM-2860-2 and providing the customer with an opportunity to correct or complete the information.

Rule 2860(b)(18)(A) (Options; Requirements; Discretionary Accounts; Authorization and Approval) requires the written authorization of a customer before a member may exercise any discretionary power with respect to trading an options contract in a customer account.

Rule 2860(b)(19) (Options; Requirements; Suitability) prohibits a member from recommending an options transaction unless the member has reasonable grounds to believe, based on the information furnished by the customer, that the recommended transaction is not unsuitable for the customer.

Rule 2860(b)(23)(C)(i) (Options; Requirements; Tendering Procedures for Exercise of Options; Allocation of Exercise Assignment Notices) requires notification to customers of the method used to allocate exercise

notices to customers' accounts.

Rule 3110(c) (Books and Records; Customer Account Information) requires members to obtain specified customer information.

Rule 3110(f)(3) (Books and Records; Requirements when Using Pre-dispute Arbitration Agreements with Customers) requires that a copy of the agreement containing a pre-dispute arbitration clause must be given to the customer, who must acknowledge receipt on the agreement or on a separate document.

Rule 3110(g)(2) and (3) (Books and Records; Telemarketing Requirements) requires members to obtain written customer authorization before obtaining a check drawn on a customer's account.

Rule 3230(d) (Clearing Agreements) requires notification upon the opening of an account to each customer whose account is introduced on a fully disclosed basis of the existence of the clearing or carrying agreement.

Marketplace Rules: The Nasdaq Stock Market Rules

Rule 4643 (Customer Confirmations) prohibits members from effecting transactions in Nasdaq SmallCap MarketSM securities unless, at or before completion of the transaction, the member gives or sends the customer written notification disclosing specified information.

Procedural Rules: Complaints, Investigations & Sanctions

Rule 8110 (Availability to Customers of Certificate, By-Laws and Rules) requires a member to provide customer access to copies of the NASD Certificate of Incorporation, By-Laws, and Rules.

Procedural Rules: Uniform Practice Code

Rule 11860(a)(3) and (4) (Acceptance and Settlement of COD Orders) requires a member to deliver to the customer a confirmation, or all relevant data customarily contained in a confirmation, not later than the close of business on the next business day after any such execution and to obtain an agreement from the customer to furnish instructions regarding the receipt or delivery of the securities involved in the transaction.

Rule 11870(c) (Customer Account Transfer Contracts; Transfer Instructions): customers must be informed of the conditions for account transfers and must authorize the transfer.

Endnotes

¹ This *Notice* was filed with the Securities and Exchange Commission in SR-NASD-97-57 and was approved in Securities Exchange Act Release No. 39356 (November 25, 1997); 62 FR 64421 (December 5, 1997).

² See Securities Act Release No. 7288 (May 9, 1996); 61 FR 24644 (May 15, 1996) (May 1996 Release). The release also contained a list of current Rules to which broker/dealers apply the guidance provided in the interpretation.

³ See Securities Act Release No. 7233 (October 6, 1995); 60 FR 53458 (October 13, 1995) (October 1995 Release).

⁴ The SEC stated that the ability to download the document or print from the electronic medium would be sufficient to satisfy this need.

⁵ See May 1996 Release, n.17.

⁶ The SEC described an informed consent as one that specifies the electronic medium or source through which the information will be delivered and the period during which the consent will be effective, and describes the information that will be delivered using such

means. Except where manual consent is required under the Penny Stock Rules (*see* discussion *infra*), broker/dealers may obtain consents either manually or electronically. *See* May 1996 Release, n.23.

⁷ The SEC, however, cautioned broker/dealers that they should be aware of their responsibilities to prevent unauthorized transactions. In this regard, the Commission stated its belief that broker/dealers should have reasonable assurance that the response received from a customer is authentic. The

SEC also will continue to require broker/dealers to obtain the manual signature of customers on certain disclosure documents required under the Penny Stock Rules. *See* May 1996 Release, nn.23, 29, & 50.

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