

NASD NOTICE TO MEMBERS 97-26

NASD Regulation Files Amendment To Bank Broker/Dealer Rule With The SEC

Suggested Routing

- Senior Management
- Advertising
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- Municipal
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Executive Summary

On March 24, 1997, NASD Regulation, Inc. (NASD RegulationSM) filed with the Securities and Exchange Commission (SEC) for its approval Amendment No. 4 to proposed NASD[®] Rule 2350, which specifies requirements applicable to broker/dealers operating on the premises of financial institutions (bank broker/dealer Rule). Amendment No. 4 responds to public comments received by the SEC on the original proposed bank broker/dealer Rule filed with the SEC in December 1995. Among other things, NASD Regulation is proposing to: (1) delete the provision restricting the use of confidential financial information; (2) delete the provision governing compensation of unregistered persons; and (3) revise the provisions regarding setting and communications with the public. NASD Regulation is separately soliciting public comment on proposed rules relating to the use and release of confidential financial information and compensation of unregistered persons that would apply to all members. The SEC has published Amendment No. 4 to the proposed bank broker/dealer Rule in the *Federal Register* for comment.¹ **The revised Rule will not become effective until approved by the SEC.**

Background

NASD Regulation is publishing this Notice to alert members that Amendment No. 4 to the proposed bank broker/dealer Rule was submitted to the SEC on March 24, 1997. The amendment has been published by the SEC for public comment in the *Federal Register*.² Members should review the *Federal Register* release and submit comments directly to the SEC.

The bank broker/dealer Rule was originally published 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 by the NASD. 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).³

The SEC published the original proposal for comment in the *Federal Register* in March 1996 (March *Federal Register* Release).⁴ The SEC received 98 comment letters on the original proposal. About one-third of the comment letters expressed support for the original proposal. While a few commenters supported the original proposal as published, most were generally supportive of the original 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 responds to public comments received by the SEC.

Amendments To The Bank Broker/Dealer Proposal

The original proposed bank broker/dealer Rule was substantially revised to respond to the comments received by the SEC. The following is a brief discussion of some of the revisions to the original proposal. Members should not rely on this *Notice* as a basis for developing comments but, rather, should review Amendment No. 4 to the proposed Rule as published in the *Federal Register*.

Setting. This provision in the original proposed bank broker/dealer Rule specified certain requirements, including physical separation, designed to reduce customer confusion between deposit taking and securities activities. The overwhelming majority of the commenters that addressed the original proposal criticized language in the March *Federal*

Register Release that indicated that there may be certain business settings where the member may not be able to comply with the Rule and may, therefore, be prevented from conducting business in such a location. These commenters indicated that this position conflicts with the 1994 *Interagency Statement on Retail Sales of Nondeposit Investment Products (Interagency Statement)*⁵ and have requested a clarification that this provision would not prohibit a member from conducting a brokerage business in a one-person branch as long as adequate safeguards are adopted, including adequate disclosure and signage.

In response, the proposed Rule has been revised to clarify that the bank broker/dealer Rule will impose the same standards on broker/dealers as are imposed on financial institutions by the *Interagency Statement* and require only that sales of non-deposit products should be conducted in a physically distinct location **wherever practical**. Where a physically distinct location is not practical, the broker/dealer would not be prohibited from conducting business in this manner. However, 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.

Compensation of Registered/Unregistered Persons. A provision in the original proposal stipulated that members may not provide cash or non-cash compensation to financial institution employees in connection with referring customers of the financial institution to the member. A related provision required that networking and brokerage affiliate agreements between a member and a financial institution stipulate that transaction-related cash or non-cash

compensation to unregistered financial institution employees for referrals is prohibited. Strenuous opposition to these referral fee provisions was expressed by many of the commenters on the original proposal. Commenters also were concerned with language in the March *Federal Register* Release that stated that an NASD member may not do indirectly what it is prohibited from doing directly, by compensating employees of a financial institution for referrals through payments directed in the first instance to a financial institution. Commenters were particularly concerned that this provision should be clarified to ensure that the NASD is not attempting to regulate a financial institution's compensation practices with respect to its own employees, practices that are subject to regulation by the banking agencies. Finally, commenters maintain that including provisions in the bank broker/dealer Rule prohibiting referral fee payments and not prohibiting such payments by all member firms would create a competitive disadvantage to bank broker/dealers.

In response, these provisions have been deleted, and NASD Regulation has solicited comment on a proposed rule governing compensation of unregistered persons that would apply to all members.⁶

Customer Disclosure and Written Acknowledgment. This provision specifies the disclosures a member must make when a customer opens an account, and also requires members to make reasonable efforts to obtain a written acknowledgment of the required disclosures during the account-opening process. Many of the commenters on the original proposal have asked the NASD to consider allowing the use of abbreviated disclosures allowed by the banking agencies under a 1995 interpretation of the *Interagency Statement (1995 Interpretation)* under appropriate cir-

cumstances.⁷ Other commenters have argued that NASD-required disclosure and the disclosure required by the banking agencies (as reflected in the *Interagency Statement*) should be the same.

The *Interagency Statement* requires the longer, written disclosures contained in the proposed Rule when an account is opened. Accordingly, this provision has not been revised, since as currently drafted it is consistent with banking agency guidelines. However, to ensure that the proposed Rule is consistent with the *1995 Interpretation*, a new paragraph has been added to the 'Communications with the Public' provision of the proposed Rule to permit the use of abbreviated disclosures under limited circumstances (*see* discussion below). In addition, NASD Regulation has issued an interpretive *Notice to Members* reminding member firms of their risk disclosure obligations in connection with the sale of insured products and uninsured securities products under existing NASD rules and soliciting comment on whether a new rule, prescribing point-of-sale disclosure in specified circumstances, should be adopted.⁸

Use of Confidential Financial Information. This provision in the original proposal stated that an NASD member shall not use confidential financial information provided by the financial institution regarding its customer unless prior written approval has been granted to the financial institution by the customer to release the information. Most of the commenters who addressed this provision expressed significant objections to the proposed restriction on the use of confidential financial information, stating that this provision should either be deleted or substantially revised. Most of these commenters are of the opinion that, to the extent there are special concerns when a bank provides confidential

financial information to a broker/dealer, the concerns are properly the subject of federal and state banking and privacy laws, and the NASD has no jurisdiction to regulate a financial institution's use of customer information.

The commenters also believe that a member should be able to use such information, provided proper disclosure is made and consent has been obtained in accordance with applicable law, which the commenters state does not require written consent. Commenters believe that, alternatively, a member should be able to rely on a representation by the financial institution that customer consent was obtained. Further, the commenters state that it would be an operational burden to comply with this provision. Also, many commenters believe that customers expect and welcome this sharing of information.

As with other provisions of the proposed Rule, commenters stated that this provision is discriminatory and anti-competitive, noting that restrictions regarding the use of confidential financial information are not applied similarly to broker/dealers who are not operating on the premises of a financial institution. Commenters also believe that any rule adopted by the NASD to regulate the use of confidential information should apply to all members.

In response, this provision has been deleted, and the NASD Regulation Board has issued a *Notice to Members* soliciting comment on a proposed rule governing the use and release of confidential financial information that would apply to all members.⁹

Communications With the Public.

This provision in the original proposal set forth requirements for all communications with customers, including account statements, advertisements, and sales literature. Sever-

al of the commenters who addressed this provision have asked whether the disclosures required by the Rule may be provided in the abbreviated format allowed by the *1995 Interpretation*. Several commenters also stated that the requirements of the provision are duplicative of requirements in existing NASD rules.

In response, those provisions of the proposed Rule that duplicated existing NASD advertising rules have been deleted. Also, several new provisions have been added to clarify the circumstances under which abbreviated risk disclosures may be used and when such disclosures are not required.

Termination for Cause. The original proposed Rule specified that networking and brokerage affiliate agreements must contain a provision requiring a member to notify a financial institution if a dual employee of the member and the financial institution is terminated for cause by the member. This provision has been deleted from the paragraph of the bank broker/dealer Rule pertaining to matters that must be addressed by networking and brokerage affiliate agreements and has been made into a separate affirmative requirement to emphasize the importance of this requirement.

The text of the revised Rule as filed with the SEC on March 24 is set forth below. This *Notice* is not a request for submission of comments to NASD Regulation. Members should review the text of the Rule as well as a description of the revisions to the original proposal in Amendment No. 4 as published in the *Federal Register*. **Any comments should be submitted directly to the SEC.**

Questions concerning this *Notice* should be directed to R. Clark Hooper, Senior Vice President, Office of

Disclosure and Investor Protection, NASD Regulation, at (202) 728-8325; or Mary N. Revell, Assistant General Counsel, NASD Regulation, at (202) 728-8203.

Text Of Proposed NASD Rule 2350

(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 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 (l) 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) or other deposit insurance;

(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 other promotional and sales material 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 or other applicable deposit insurance; are not deposits or other obligations of the financial institution and are not guaranteed by the financial institu-

tion; 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 visual media, such as television broadcasts, Automated Teller Machine (ATM) screens, billboards, signs, posters, and in written advertisements and promotional materials, such as 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 and similar signs, but excluding messages contained on 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. 34-38506 (April 14, 1997), 62 FR 19378 (April 21, 1997), requesting comments by **May 12, 1997**.

² *Id.*

³ See File No. SR-NASD-95-63; *NASD Notice to Members 96-3*.

⁴ See Release No. 34-36980 (March 15, 1996), 61 FR 11913 (March 22, 1996).

⁵ The *Interagency Statement* was issued on February 15, 1994, by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (the banking agencies).

⁶ See *NASD Notice to Members 97-11*.

⁷ See letter from the banking agencies to

Sarah A. Miller, American Bankers Association, dated September 12, 1995.

⁸ See *NASD Notice to Members 97-29*.

⁹ See *NASD Notice to Members 97-12*.

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