

NASD Notice to Members 98-47

SEC Approves Changes To Books And Records Requirements

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Executive Summary

On May 29, 1998, the Securities and Exchange Commission (SEC) approved amendments to National Association of Securities Dealers, Inc. (NASD[®]) Rule 3110 (the Books and Records Rule) that (i) change the definition of "institutional account" to include the accounts of investment advisers that are now required to register with the states pursuant to the National Securities Markets Improvement Act of 1996 (NSMIA), and (ii) exclude certain customer accounts from the requirement to obtain certain tax and employment information from the customer.

Questions concerning this *Notice* may be directed to Joseph E. Price, Counsel, Advertising/Investment Companies Regulation, NASD Regulation, Inc., at (202) 728-8877 or Robert J. Smith, Assistant General Counsel, Office of General Counsel, NASD RegulationSM, at (202) 728-8176.

Discussion

The Books and Records Rule requires that members obtain certain information for all accounts. The Rule requires that, for accounts other than institutional accounts and accounts limited to money market funds, members must make reasonable attempts to obtain: (i) a customer's tax identification or social security number; (ii) a customer's occupation and the name and address of the employer; and (iii) information about whether the customer is an associated person of another member (Retail Customer Information).

Similarly, NASD Conduct Rule 2310 (Suitability Rule) requires members to make reasonable efforts to obtain certain information, such as the customer's financial status and investment objectives, from retail customers prior to the execution of a transaction.

Interpretive Material 2310-3 (IM-2310-3) describes members' suitability obligation in making recommendations to institutional customers. The primary considerations under IM-2310-3 include the customer's capability to evaluate risk independently and the extent to which individual judgment is exercised when making investment decisions.

Accounts Of Registered Investment Advisers

NSMIA and new rules recently adopted by the SEC under the Investment Advisers Act of 1940 (Advisers Act) reallocated regulatory oversight of investment advisers between the SEC and the states. Under the new rules, advisers to registered investment companies and those with assets under management of at least \$25 million generally will register exclusively with the SEC. Most others will register exclusively with the states.

The Books and Records Rule provides that, for purposes of both the Books and Records Rule and the Suitability Rule, the term "institutional account" includes the account of an investment adviser registered with the SEC. Consequently, advisory accounts that were considered to be "institutional accounts" when the Retail Customer Information provision in the Books and Records Rule was adopted became excluded from the definition because they migrated to state regulation under NSMIA.

The amendments take into account the bifurcation of investment adviser regulation between the SEC and the states by changing the definition of "institutional account" in subparagraph (c)(4) of the Books and Records Rule to include both investment advisers required to register with the SEC and those required to register with the states. The amendments treat the state-regulated advi-

sory accounts as “institutional accounts” for purposes of the Books and Records Rule and the Suitability Rule.

Accounts Limited To Mutual Fund Shares

A primary purpose of obtaining Retail Customer Information is to help a member evaluate the suitability of a recommendation. NASD Regulation has determined that the requirement to obtain Retail Customer Information is burdensome and largely unnecessary as it applies to members who distribute directly marketed mutual funds and other unsolicited accounts that are limited to mutual fund shares and for which no recommendations are made. With regard to the requirement in the Books and Records Rule to obtain a customer’s tax identification or social security number, the tax laws already impose obligations on funds to obtain this information.¹ The requirement in the Books and Records Rule to determine whether a customer is an associated person of another member also is unnecessary because NASD Conduct Rule 3050, which provides the obligations of executing members when the member knows that a person associated with an employing member has an interest in an account, expressly excludes accounts that are limited to transactions in mutual fund shares.

The amendments thus revise subparagraph (c)(2) of the Books and Records Rule to exclude mutual funds that are not recommended by the member or its associated persons from the obligation to obtain Retail Customer Information. Members are still required to make reasonable efforts to obtain Retail Customer Information for retail accounts that are not subject to these limitations. This change will not affect the need to obtain any information from customers or others

in order to meet any other regulatory obligations that may exist.

Text Of New Rule

(Note: New language is underlined; deletions are bracketed.)

3100. Books and Records, and Financial Condition

3110. Books and Records

(a) Requirements

Each member shall keep and preserve books, accounts, records, memoranda, and correspondence in conformity with all applicable laws, rules, regulations and statements of policy promulgated thereunder and with the Rules of this Association.

(c) Customer Account Information

Each member shall maintain accounts opened after January 1, 1991 as follows:

(1) for each account, each member shall maintain the following information:

(A) customer’s name and residence;

(B) whether customer is of legal age;

(C) signature of the registered representative introducing the account and signature of the member or partner, officer, or manager who accepts the account; and

(D) if the customer is a corporation, partnership, or other legal entity, the names of any persons authorized to transact business on behalf of the entity;

(2) for each account, other than an institutional account, and accounts in which investments are limited to transactions in [money market funds] open-end investment company

shares that are not recommended by the member or its associated persons, each member shall also make reasonable efforts to obtain, prior to the settlement of the initial transaction in the account, the following information to the extent it is applicable to the account:

(A) customer’s tax identification or Social Security number;

(B) occupation of customer and name and address of employer; and

(C) whether customer is an associated person of another member; and

(3) for discretionary accounts, in addition to compliance with subparagraphs (1) and (2) above, and Rule 2510(b) of these Rules, the member shall:

(A) obtain the signature of each person authorized to exercise discretion in the account;

(B) record the date such discretion is granted; and

(C) in connection with exempted securities other than municipals, record the age or approximate age of the customer.

(4) For purposes of this Rule and Rule 2310 the term “institutional account” shall mean the account of:

(A) a bank, savings and loan association, insurance company, or registered investment company;

(B) an investment adviser registered either with the Securities and Exchange Commission under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or any agency or office performing like functions); or

(C) any other entity (whether a natural person, corporation, partnership,

trust or otherwise) with total assets of at least \$50 million.

Endnote

¹ If a customer refuses to provide tax identification, Internal Revenue Service rules require a fund to withhold 31 percent of all redemptions or distributions.

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