

NASD Notice to Members 98-52

SEC Approves Taping
Rule; Effective August 17,
1998

Suggested Routing

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Executive Summary

On April 17, 1998, in Release No. 34-39883, the Securities and Exchange Commission (SEC) approved an amendment to National Association of Securities Dealers, Inc. (NASD[®]) Rule 3010 to require members to establish special supervisory procedures, including the tape recording of conversations, when they have hired more than a specified percentage of registered persons from certain firms that have been expelled or that have had their broker/dealer registrations revoked for violations of sales practice rules (the Taping Rule or Rule).¹ The new Rule will be effective on August 17, 1998. The text of the new Rule and the *Federal Register* version of the SEC release are attached.

Interpretive questions concerning the new Rule should be directed to Mary Revell, Associate General Counsel, NASD Regulation, Inc., at (202) 728-8203. Questions concerning compliance with the new Rule should be directed to Susan Lang, Senior Research Analyst, Department of Member Regulation, NASD RegulationSM, at (202) 728-6969. Members should submit reports required by the Taping Rule to Compliance, Department of Member Regulation, NASD Regulation, 1735 K Street, N.W., Washington, D.C. 20006.

Background

The Taping Rule was developed to respond to two issues. First, it responds to concerns expressed in the *Joint Regulatory Sales Practice Sweep (Sweep) Report*² regarding the need for heightened supervision of certain registered representatives with troubled regulatory and compliance records. The Rule also addresses the particular problems that occur when a firm hires a large number of individuals who formerly worked at a firm that has been expelled or has had its registration

revoked and where they were inadequately supervised and trained.

The NASD initially published the Taping Rule for comment in *Notice to Members 96-59*. NASD Regulation revised the proposal in response to the 42 comment letters that were received, and filed the proposed Taping Rule with the SEC for approval in September 1997.

The SEC published notice of the proposed Taping Rule and one amendment to the Rule in the *Federal Register* in December 1997. The SEC received one comment letter on the proposed Rule. The SEC approved the proposed Rule, as amended, and Amendment No. 2 to the proposed Rule on April 17, 1998.

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

Taping Rule

The Taping Rule will apply whenever a specified percentage of a member firm's sales force is comprised of registered persons who were employed within the last three years by a firm that has been expelled from membership in a securities industry self-regulatory organization or has had its registration as a broker/dealer revoked by the SEC (a Disciplined Firm). The requisite percentage varies depending on the size of the firm, from 40 percent for a small firm to 20 percent for a larger firm. The firm must establish the required supervisory procedures within 30 days of receiving notice from NASD Regulation, or obtaining actual knowledge, that it is subject to the provisions of the Rule.

Under the Taping Rule, if the requisite percentage of a member's sales

force previously was employed by a Disciplined Firm, the member will be required to adopt special written procedures to supervise the telemarketing activities of all of its registered persons. The procedures require, at a minimum, that the member tape record all telephone conversations between all of its registered persons and both existing and potential customers for a period of two years. The measures required by the Rule are designed to prevent a reoccurrence of sales practice abuse or other customer harm that caused the Disciplined Firm to be expelled or have its registration revoked.

The Rule requires that firms ensure that they tape record any means of telecommunications that is regularly used by registered persons to communicate with customers. In connection with this requirement, firms should ensure that the means of telecommunications used is capable of being taped. If, for example, registered persons use cellular phones on a regular basis to call customers, and it is not possible to tape record cellular telephone conversations, a firm should prohibit the use of cellular telephones for communicating with customers. On the other hand, the occasional use of a cellular telephone where warranted for other business reasons would not be prohibited.

The Rule also requires firms subject to the taping requirement to establish reasonable procedures for reviewing tape recordings to ensure compliance with securities laws and NASD rules, to submit reports to the NASD on their supervision of telemarketing, and to retain and catalog the tapes. NASD Regulation believes that, in adopting review procedures reasonably designed to comply with this requirement, members generally would be expected to:

- specify the minimum percentage of

tape recordings that must be reviewed and how the review will be conducted, or, if a random review is utilized, specify how the random review will be conducted;

- identify one or more senior persons at the firm with appropriate knowledge and training to review the tape recordings;
- identify how the supervisory review will be conducted and documented;
- consider the complaint and overall disciplinary history, if any, of registered persons whose telephone conversations are being recorded in establishing the review procedures and specifying the minimum percentage of tape recordings that must be reviewed (with particular emphasis on complaints regarding telemarketing);
- maintain records documenting how and when tape recordings are reviewed; and
- monitor to ensure that the procedures are being implemented and complied with.

The factors above are not exclusive and members must consider all appropriate factors when developing their review procedures and implementing their supervisory reviews.

In complying with the Taping Rule, members must comply with federal and state civil and criminal statutes governing the tape recording of conversations. Each state has a statute governing wiretapping; there also is a federal statute governing wiretapping and electronic surveillance.³ The federal statute and the majority of the state statutes permit taping of telephone conversations with the consent of one party (one-party statutes);⁴ a minority of state statutes require the consent of all parties to the conversation (two-party

statutes).⁵ Three issues arise from the proposed Rule: what is necessary to comply with one-party statutes; what is necessary to comply with two-party statutes; and how to comply where a conversation occurs between a person in a one-party state and a person in a two-party state.

The question of which state law applies when a conversation occurs between a person in a one-party state and a person in a two-party state is an open issue that depends on the individual laws of each state and the individual facts. Firms would be required to independently determine that state laws are satisfied. The best practice in each case would be for member firms to notify their registered persons and customers that their telephone calls are being tape recorded.

While each firm is responsible for complying with the Taping Rule, NASD Regulation will provide firms with all of the information they need to determine if they are subject to the requirements of the Rule. NASD Regulation will make a monthly determination of which firms are subject to the Rule. NASD Regulation will then notify each firm that is subject to the Rule and that it has 30 days to establish the supervisory procedures required by the Rule. NASD Regulation also will compile and maintain a list of firms that met the definition of "Disciplined Firm" within the last three years that will be placed on the NASD Regulation Web Site (www.nasdr.com). A copy of the initial list is attached to this *Notice*.

NASD Regulation believes that firms should be able to rely on the accuracy of the information provided to them. Firms that are notified by NASD Regulation that they are subject to the Rule must establish the procedures required by the Rule. Firms that do not receive this notifi-

cation are not required to establish the special supervisory procedures. However, if a firm has actual knowledge, inconsistent with the information relied upon by NASD Regulation, that it is subject to the Rule, NASD Regulation anticipates that the firm will be disciplined for failure to comply with the Rule.

Finally, any member required to adopt these procedures may seek an exemption from the requirement. NASD Regulation may grant an exemption upon a satisfactory showing that the member's supervisory procedures ensure compliance with applicable securities laws and regulations and NASD rules. Members should follow the procedures detailed in the Rule 9600 Series when seeking an exemption.

Text Of Amendments To Rule 3010

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

Rule 3010. Supervision

(a) No change

(b) Written Procedures

(1) No change

(2) Tape recording of conversations

(i) Each member that either is notified by NASD Regulation or otherwise has actual knowledge that it meets one of the criteria in paragraph (b)(2)(viii) relating to the employment history of its registered persons at a Disciplined Firm as defined in paragraph (b)(2)(x) shall establish, maintain, and enforce special written procedures for supervising the telemarketing activities of all of its registered persons.

(ii) The member must establish the supervisory procedures required by

this paragraph within 30 days of receiving notice from NASD Regulation or obtaining actual knowledge that it is subject to the provisions of this paragraph.

(iii) The procedures required by this paragraph shall include tape-recording all telephone conversations between the member's registered persons and both existing and potential customers.

(iv) The member shall establish reasonable procedures for reviewing the tape recordings made pursuant to the requirements of this paragraph to ensure compliance with applicable securities laws and regulations and applicable rules of this Association. The procedures must be appropriate for the member's business, size, structure, and customers.

(v) All tape recordings made pursuant to the requirements of this paragraph shall be retained for a period of not less than three years from the date the tape was created, the first two years in an easily accessible place. Each member shall catalog the retained tapes by registered person and date.

(vi) Such procedures shall be maintained for a period of two years from the date that the member establishes the procedures required by the provisions of this paragraph.

(vii) By the 30th day of the month following the end of each calendar quarter, each member firm subject to the requirements of this paragraph shall submit to the Association a report on the member's supervision of the telemarketing activities of its registered persons.

(viii) The following members shall be required to adopt special supervisory procedures over the telemarketing activities of their registered persons:

- A firm with at least five but fewer than ten registered persons, where 40% or more of its registered persons have been employed by one or more Disciplined Firms within the last three years;

- A firm with at least ten but fewer than twenty registered persons, where four or more of its registered persons have been employed by one or more Disciplined Firms within the last three years;

- A firm with at least twenty registered persons, where 20% or more of its registered persons have been employed by one or more Disciplined Firms within the last three years.

(ix) For purposes of this Rule, the term "registered person" means any person registered with the Association as a representative, principal, or assistant representative pursuant to the Rule 1020, 1030, 1040, and 1110 Series or pursuant to Municipal Securities Rulemaking Board ("MSRB") Rule G-3.

(x) For purposes of this Rule, the term "disciplined firm" means a member that, in connection with sales practices involving the offer, purchase, or sale of any security, has been expelled from membership or participation in any securities industry self-regulatory organization or is subject to an order of the Securities and Exchange Commission revoking its registration as a broker/dealer.

(xi) Pursuant to the Rule 9600 Series, the Association may exempt any member unconditionally or on specified terms and conditions from the requirements of this paragraph upon a satisfactory showing that the member's supervisory procedures ensure compliance with applicable securities laws and regulations and applicable rules of the Association.

(3)(2) No change to text

(4)(3) No change to text

(c) through (g) No change

Text Of Amendments To Rule 9610

(Note: New language is underlined.)

Rule 9600. Procedures for Exemptions

Rule 9610. Application

(a) File With General Counsel

A member seeking an exemption from Rule 1021, 1022, 1070, 2210, 2340, 2520, 2710, 2720, 2810, 2850, 2851, 2860. Interpretive Material 2860-1, 3010(b)(2), 3350, 11870, or 11900, Interpretive Material 2110-1, or Rule G-37 shall file a written application with the appropriate department or staff of the Association and provide a copy of the application to the Office of General Counsel of NASD Regulation.

Disciplined Firms⁶

A. R. Baron & Co., Inc.
Banc Street Securities, Inc.
Beacon Securities, Inc.
Capital Investment Managers, Inc.
Coastline Financial, Inc.
Escalator Securities, Inc.
Euro-Atlantic Securities Inc.
F.N. Wolf & Co., Inc.
Feltman & Co.
H. L. Camp & Company, Inc.

Hibbard Brown & Co., Inc.
Jaron Equities Corp.
Johnston Kent Securities, Inc.
Kinlaw Securities Corporation
L. C. Wegard & Co., Inc.
M. H. Novick & Co., Inc.
M. Rimson & Co., Inc.
M.G.S.I. Securities, Inc.
Penn Capital Financial Services, Inc.
Prime Investors, Inc.
Retirement Investment Group
Selheimer & Co.
Shaner & Company, Inc.
Stratton Oakmont Inc.
Townsend Associates & Company, Inc.
U.S. Securities Corporation of Washington, D.C.
Westcap Securities, L.P.

Endnotes

¹ 63 FR 20232 (April 23, 1998). *See also* correction in Release No. 34-39883A (April 23, 1998), 63 FR 24202 (May 1, 1998).

² Staffs of the NASD, New York Stock Exchange (NYSE), North American Securities Administrators Association (NASAA), and the Office of Compliance Inspections and Examinations, SEC, *Joint Regulatory Sales Practice Sweep: A Review of the Sales Practice Activities of Selected Registered Representatives and the Hiring, Retention, and Supervisory Practices of the Brokerage Firms Employing Them* (March 1996). The *Sweep* was an initiative involving the staffs of the NASD, the SEC, the NYSE, and representatives of NASAA to review the sales practice activities of selected registered representatives and the hiring, retention, and supervisory practices of the brokerage firms employing them in order to

identify possible problem registered representatives, review their sales practices, and assess whether adequate hiring, retention, and supervisory mechanisms were in place. The *Sweep Report* was released on March 18, 1996.

³ 18 U.S.C. § 2519 *et seq.*

⁴ In one-party statute states, the only issue is whether the registered person knows of and consents to the tape recording. The recording requirement would run to the firm, and the equipment would be the firm's. Therefore, it would be necessary for the firm to ensure that the person has notice and consents to the tape recording of his or her telephone conversations. This could be accomplished through a clause in an employment agreement or employee handbook or other written notice to the registered person.

⁵ In two-party statute states, it would be necessary to insert on the firm's telephone line a recording stating that all telephone conversations are being taped, similar to customer service lines in other industries. Some states require a system of beeps or buzzers that sound throughout the conversation. Some states also have a "business use exception" to the two-party statute consent requirement, but it is worded and applied differently in each state.

⁶ This list is comprised of firms that were disciplined within the last three years and was compiled based on information available as of June 15, 1998.

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