

# NASD Notice to Members 98-67

## SEC Approves Amendment To Rule On Fidelity Bonding Requirements; Effective September 15, 1998

### Suggested Routing

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### Executive Summary

On July 14, 1998, the Securities and Exchange Commission (SEC) approved an amendment to the National Association of Securities Dealers, Inc. (NASD<sup>®</sup>) Rule 3020 (the Rule) governing member fidelity bonding requirements. The amendment grants authority to NASD staff to adjust a member's fidelity bonding requirement under certain circumstances. The amendment will take effect on September 15, 1998.

Questions regarding this *Notice* may be directed to John M. Ramsay, Vice President and Deputy General Counsel, Office of General Counsel, NASD Regulation, Inc. (NASD Regulation<sup>SM</sup>), (202) 728-8159, or Elliott R. Curzon, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8451.

### Background

The Rule specifies that members are required to maintain fidelity bonds to insure against certain losses and the potential effect of such losses on firm capital. The Rule applies to all members with employees who are required to join the Securities Investor Protection Corporation and who are not covered by the fidelity bond requirements of a national securities exchange. The required amount of a member's coverage is linked to the member's required net capital under SEC Rule 15c3-1. Paragraph (c) of the Rule requires each member to review the adequacy of its fidelity bond coverage annually and maintain coverage that is adequate to cover its highest net capital requirement during the preceding 12 months. For example, if a self-clearing member changes its business to become a correspondent firm clearing through another member so that it no longer holds customer funds or securities, the Rule would still require the member to

maintain bond coverage at the level that applied during the preceding year.

The amendment to the Rule will permit the staff of NASD Regulation to adjust the fidelity bond requirements to reflect changes in a member's business and will allow members to be relieved from maintaining unnecessarily high fidelity bond coverage without compromising investor protection. Requests for exemption would be considered under recently adopted Procedures for Exemption in the 9600 Series of Rules in the NASD Code of Procedure. Under the Procedures, NASD Regulation staff will issue a written determination that is subject to review by the National Adjudicatory Council.

In considering an application, NASD Regulation will apply a "good cause" standard that will require a member to demonstrate that a modification from the bonding requirement is justified by the level of loss exposure that may be expected from the member. In addition, NASD Regulation will apply this authority only when it is clear that an exemption will not have any unintended impact on the insurance pool, and the modified coverage will adequately protect the member against potential losses. (The premiums for the insurance pool are changed from time to time to reflect changes in loss experience and to ensure that sufficient funds are available to pay any losses reported to the insurer.) In addition, NASD Regulation will include conditions in any exemption to ensure that any subsequent increase in capital requirements is accompanied by a corresponding increase in coverage.

## Text of Amendment to Rule 3020

(Note: New language is underlined.)

### 3020. Fidelity Bonds

(a) - (b) No Change

(c) Annual Review of Coverage

(1) - (3) No Change

(4) Any member subject to the requirements of this paragraph (c) may apply for an exemption from the requirements of this paragraph (c). The application shall be made pursuant to Rule 9610 of the Code of Procedure. The exemption may be granted upon a showing of good cause, including a substantial change in the circumstances or nature of the member's business that results in a lower net capital require-

ment. The NASD may issue an exemption subject to any condition or limitation upon a member's bonding coverage that is deemed necessary to protect the public and serve the purposes of this Rule.

(d) - (e) No Change

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