

SPECIAL NASD NOTICE TO MEMBERS 96-80

SEC Requests Comments On Proposed Amendments To SEC Rules 17a-3 And 17a-4

Suggested Routing

- ☒ Senior Management
- ☐ Advertising
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Executive Summary

The Securities and Exchange Commission (SEC) is requesting comments on proposed amendments to the broker/dealer books and records rules. The proposed amendments clarify, modify, and expand recordkeeping requirements with respect to purchase and sale documents, customer records, associated person records, customer complaints, and certain other matters. In addition, the proposed amendments specify certain types of books and records that broker/dealers must make available in their local offices.

The SEC is proposing these amendments in response to concerns raised by members of the North American Securities Administrators Association (NASAA). The proposed amendments are intended to obligate broker/dealers to make and retain additional records that would be valuable to state regulators during examination and enforcement proceedings.

Comments regarding this Notice should be submitted by December 27, 1996, in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Stop 6-9, Washington, DC 20549. Comments may also be submitted electronically to the following e-mail address: rule-comments@sec.gov. All comment letters should refer to File No. S7-27-96.

Questions regarding this Notice may be directed to Samuel Luque, Jr., Compliance Department, NASD Regulation, Inc., at (202) 728-8472, or Susan DeMando, NASD Regulation, Inc., Compliance Department, at (202) 728-8411.

Explanation Of Changes

Following is an explanation of the proposed books and records rule amendments. A more detailed dis-

cussion of these changes can be found in the October 28, 1996, *Federal Register* which follows this Notice.

The proposed amendments to Rule 17a-3 will require broker/dealers to generate local office blotters, to record supplemental information on brokerage order memoranda, to create customer account forms, and to maintain additional records concerning associated persons, customer complaints, and exceptional numerical occurrences.

The proposed amendments to Rule 17a-4 will require broker/dealers to preserve additional types of records, including advertising and marketing materials, registrations and licenses, audit and examination reports, records concerning recommended securities, and manuals relating to compliance, supervision, and procedures.

In addition, Rule 17a-4 will be amended to clarify and modify the SEC's existing requirements concerning preservation of certain correspondence and contracts. Finally, the proposed amendments to Rule 17a-4 will supplement the existing standards concerning the organization of books and records, will require broker/dealers to designate a principal to be responsible for books and records compliance, and will require broker/dealers to make certain records available in each of their local offices.

Blotters And Memoranda

Rule 17a-3(a)(1) presently specifies the SEC's requirements concerning records of purchases and sales of securities, receipts and deliveries of securities, and receipts and disbursements of cash. The proposed amendment to Rule 17a-3(a)(1) will add a requirement that records of purchases and sales of securities for customer

accounts be accessible with respect to the activities of each local office.

Existing requirements of Rule 17a-3(a)(6) specify that brokerage memoranda include information concerning the terms and conditions of the order, the account for which the order is entered, the times of entry and execution, and the execution price. The proposed amendment to Rule 17a-3(a)(6) adds a requirement that each memorandum indicate which associated person entered the order and also indicate whether the order was solicited or unsolicited.

Additional Records Concerning Associated Persons

Rule 17a-3(a)(12) currently specifies the types of records that a broker/dealer must maintain with respect to each of its associated persons. In addition to basic background information, the existing rule requires a broker/dealer to maintain records of each associated person's employment and disciplinary history.

The proposed amendments will add new Rule 17a-3(a)(20) which designates several supplementary types of associated person records that a broker/dealer must maintain. These new records include registration and licensing materials, contracts or agreements between associated persons and the broker/dealer, compensation arrangements, customer complaint information, and client trading records for each associated person.

In addition, proposed Rule 17a-3(a)(21) will add a requirement that broker/dealers maintain a list identifying each of their associated persons and designating the local office where each associated person conducts the greatest portion of his or her business. Proposed Rule 17a-3(a)(21), in conjunction with proposed Rule 17a-4(l)(1), will require all records concerning each associat-

ed person to be stored where such associated person conducts most of his or her business.

Account Forms

Proposed Rule 17a-3(a)(16) creates a new requirement that broker/dealers maintain an account form for each customer account. The required account form will include basic identification and background information about a customer, as well as a designation of the customer's investment objective(s) from a list of defined objectives and a specification of the approximate percentage of investment capital that the customer would like to allocate to speculative investments. (As the proposed amendments do not include a definition of the term *speculation*, the SEC is expressly requesting comments concerning whether a definition should be provided, and suggestions on possible definitions.) In addition, the associated person responsible for each account and a principal of the broker/dealer must sign or initial each account form to indicate approval of the contents.

Proposed Rule 17a-3(a)(16) will apply to both new and existing customer accounts. The SEC recognizes that it will be difficult for broker/dealers to prepare the required account forms for existing customers immediately upon adoption of the new Rule. Accordingly, the SEC initially proposes a one-year period from the date of adoption of the proposed Rule as an appropriate time frame for broker/dealers to comply with respect to existing customer accounts. The SEC is expressly soliciting comments concerning the feasibility of this phase-in period.

Proposed Rule 17a-3(a)(16) also will require that the material contents of a new or changed customer account form be sent to the customer for confirmation. To minimize burdens and

allow maximum flexibility for broker/dealers who send communications to their customers from a central location, the proposed Rule will permit a broker/dealer to send a customer an alternate document which contains the material contents of the account form, rather than a copy of the account form itself. The signatures or initials of the associated person and principal of the broker/dealer do not have to be included on any alternate document sent to a customer for confirmation.

As a customer's financial situation and investment preferences will vary over time, proposed Rule 17a-3(a)(16) includes a one-year updating requirement with respect to the investment objectives designated on each customer's account form. The SEC is aware of the potential burdens presented by the annual updating requirement. Accordingly, the SEC is expressly soliciting suggestions of less burdensome alternatives that would nevertheless provide broker/dealers and regulators with a reasonably current indication of each customer's investment objectives.

Finally, the SEC recognizes that the nature of the businesses of certain types of broker/dealers may render unnecessary the account form requirements of proposed Rule 17a-3(a)(16). Therefore, the SEC is expressly soliciting suggested standards for the exemption of categories of broker/dealers from the proposed account form requirements.

Complaints

Rules 17a-3 and 17a-4 do not currently contain any express requirements concerning oral or written customer complaints that are delivered to a broker/dealer. The proposed amendments add a new Rule 17a-3(a)(17), which will require broker/dealers to maintain files of written materials relating to customer

complaints. Note that this is already required by NASD Rule 3110 (formerly Article III, Section 21 of the NASD Rules of Fair Practice). In addition, proposed Rule 17a-3(a)(17) will require broker/dealers to make and keep written memoranda of oral customer complaints alleging certain types of fraud and theft.¹

In addition, proposed Rule 17a-3(a)(17) requires broker/dealers to provide routine notification in account statements that customers should set their complaints in writing in order to establish an independent record of the complaint.

Proposed Rule 17a-3(a)(18) would require records of all commissions, overrides, and other compensation (including any bonus) identified by each transaction. Information includes the person or persons receiving the compensation, the customer account number, the date the transaction occurred, the amount of compensation, and the name of the security involved. To the extent that compensation is based on factors other than remuneration per trade, such as a total production system or bonus system, the member must be able to demonstrate and to document, upon request, the method by which the compensation paid was earned.

Proposed Rule 17a-3(a)(19) would require activity reports to identify exceptional numerical occurrences, such as frequent trading in customer accounts, unusually high commissions, or an unusually high number of trade corrections or canceled transactions, for management's attention and information. The systems and criteria used to generate such activity reports shall be determined by each member, broker or dealer, as long as the system and its parameters are reasonably designed to monitor levels of activity in accounts that may warrant further review and analysis by management.²

The proposed amendments will also add several new items to the record-preservation requirements of Rule 17a-4. The new types of records include copies of advertisements and marketing materials, information relating to underwritten or recommended securities, registrations and licenses, audit and examination reports, and manuals relating to compliance, supervision, and procedures.

Rules 17a-4(a) and 17a-4(b) currently require broker/dealers to preserve specified types of records for six and three years, respectively. Records pertaining to proposed Rules 17a-3(a)(17), (19), and (21) would be retained for six years pursuant to 17a-4(a) and records pertaining to proposed Rule 17a-3(a)(18) would be retained for three years pursuant to Rule 17a-4(b). Changes to 17a-4 would require retention of records under (1) proposed Rule 17a-3(a)(16) for not less than six years after the close of a customer's account, while clarifying language regarding information relating to a recommendation of a security by a member, and (2) proposed Rules 17a-3(a)(12) and (a)(20) for at least three years after the "associated person" has terminated his employment and any other connection with the member. Finally, a revision to Rule 17a-4 would require preservation by the member of all Forms BD, BDW, amendments to these forms, licenses and other documentation showing registrations, and organizational documents for the life of the enterprise.

Amendments to Rule 17a-4(j) will require that requested records must be produced immediately when the records are located in the office where the request is made and within three business days if the requested records are located offsite.

Proposed Rule 17a-4(k) will require each broker/dealer to designate a principal for purposes of the books

and records rules. The designated principal's responsibilities include indicating approval of records such as outgoing correspondence and marketing materials.

Proposed Rule 17a-4(l) will adopt a new requirement that broker/dealers make available certain records in each of their local offices. Required records include certain blotters of the local office's activities, memoranda of brokerage orders, complaint and correspondence files, associated person records, and customer account forms.

In order to accommodate centralized electronic record storage systems used by some broker/dealers and to minimize the overall burden of the local office requirements, proposed Rule 17a-4(l) specifies that the ability to display the necessary records electronically in a local office and immediately produce printed copies will satisfy the Rule. The Rule also limits the local office record availability period to three years, and single-agent offices may comply if the required local office records are made available in certain other offices of the broker/dealer.

The last section of the *Federal Register*, included with this Notice, contains an Exhibit A, Model State Regulation Governing Access To Records Required To Be Kept By Broker/Dealers. This model was prepared by NASAA.

¹ Proposed Rule 17a-3(a)(17) expressly specifies that the requirement to prepare a written memorandum concerning certain oral complaints does not convert the complaint into a reportable event for purposes of Form U-4 or other reporting requirements.

² Actual copies of activity reports need not be retained by a member if the member electronically stores the data necessary to promptly create or recreate the required activity reports upon request by representatives of a securities regulatory authority.