

Notice to Members

JULY 2005

SUGGESTED ROUTING

Executive Representatives
Legal & Compliance
Senior Management

KEY TOPICS

Rule 3010
Taping Rule

GUIDANCE

Taping Rule

SEC Approves Amendments Relating to Taping Rule
“Opt Out” and Exemption Provisions; **Effective Date:**
August 1, 2005

Executive Summary

On May 5, 2005, the Securities and Exchange Commission approved amendments to paragraph (L) of Rule 3010(b)(2) (Taping Rule or Rule). The amendments require member firms that are seeking an exemption from the Rule to submit their exemption requests to NASD within 30 days of receiving notice from NASD or obtaining actual knowledge that they are subject to the provisions of the Rule. The amendments also clarify that firms that trigger application of the Taping Rule for the first time can elect to either avail themselves of the one-time “opt out provision” or seek an exemption from the Rule, but they may not seek both options.¹

The Rule, as amended, is set forth in Attachment A. The amendments become effective on **August 1, 2005**.

Questions/Further Information

Questions concerning this *Notice* may be directed to Afshin Atabaki, Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8902; or Courtney A. Dinsmore, Senior Attorney, Department of Member Regulation, at (202) 728-8402.

Background and Discussion

The Taping Rule, which has been in effect since 1998, is designed to ensure that members with a significant number of registered persons that previously were employed by firms that have been expelled from membership or have had their registrations revoked for sales practice violations (Disciplined Firms) have proper supervisory procedures in place relating to telemarketing activities to prevent fraudulent and improper sales practices or other customer harm.

Under the Rule, member firms that hire a specified number of registered persons from Disciplined Firms must establish, maintain, and enforce special written procedures for supervising the telemarketing activities of all their registered persons. Such procedures must include tape-recording all telephone conversations between such firms' registered persons and both existing and potential customers. The Rule provides firms up to 60 days from the date they receive notice from NASD or obtain actual knowledge that they are subject to the provisions of the Rule to establish and implement the required supervisory procedures, including installing taping systems. Such firms also are required to review the tape recordings, maintain appropriate records, and file quarterly reports with NASD.

The Taping Rule permits member firms that become subject to the Rule for the first time a one-time opportunity to adjust their staffing levels to fall below the prescribed threshold levels and thus avoid application of the Rule (often referred to as the "opt out provision"). A firm that elects this one-time option must reduce its staffing levels to fall below the applicable threshold levels within 30 days after receiving notice from NASD or obtaining actual knowledge that it is subject to the provisions of the Rule. Once a firm has made the reductions, the firm is not permitted to rehire the terminated individuals for at least 180 days.

NASD also has the authority to grant exemptions from the Rule in "exceptional circumstances." In reviewing exemption requests, NASD generally has required a firm to establish that it has alternative procedures to assure supervision at a level functionally equivalent to a taping system. Prior to these amendments to Rule 3010(b)(2)(L), the Rule was silent on the time frame for submitting an exemption request. However, because the Rule provides a firm a total of 60 days from the date it receives notice from NASD or obtains actual knowledge that it is subject to the provisions of the Rule to implement the required supervisory procedures, a firm implicitly has that 60-day period to submit an exemption request.

A firm that submits an exemption request is not required to establish and implement the required supervisory procedures, including the taping system (*i.e.*, such requirements are "tolled") while the staff is reviewing the request and during the course of any subsequent appeals to NASD's National Adjudicatory Council (NAC). NASD tolls the Taping Rule's requirements during the exemption appeal process primarily due to the significant costs involved with installing a taping system and the possibility that the staff or NAC will grant the exemption. At the same time, firms often wait until the 60th day (or shortly before) to request the exemption, which, assuming the exemption was not granted, only further prolonged the establishment and implementation of the required supervisory procedures.

To reduce these possible delays in implementation of the Taping Rule requirements, NASD has amended Rule 3010(b)(2)(L) to require firms that are seeking an exemption from the provisions of the Rule to submit their exemption requests to NASD within 30 days of receiving notice from NASD or obtaining actual knowledge that they are subject to the provisions of the Rule. Specifying a time frame for submitting an exemption request is consistent with the investor protection concerns that the Rule is intended to address, especially given that the requirement to establish and implement the appropriate supervisory procedures is tolled upon the submission of an exemption request. Moreover, based on NASD's experience, 30 days will provide ample time for firms to decide whether to seek an exemption and to submit their requests to NASD.

NASD also received inquiries from some firms as to whether they could elect to use the "opt out" while simultaneously seeking an exemption, with the goal being that the firm would be granted an exemption and be able to immediately rehire the persons whose employment was terminated as part of the "opt out" (rather than waiting the requisite 180 days). However, firms may not pursue these two alternatives simultaneously. A core purpose of the "opt out provision" is to provide relief to those firms that may have inadvertently or unintentionally become subject to the Taping Rule for the first time due, for example, to sudden turnover among registered persons or other events beyond the firm's control. In contrast, exemptions, which are granted only in "exceptional circumstances," are for those situations where the firm has demonstrated that it has supervisory procedures that are equivalent to a taping system or is otherwise in a truly unique situation. It would be inconsistent with the purposes of these two provisions to permit a firm to pursue both options with NASD, either simultaneously or one after the other.

Accordingly, NASD has amended Rule 3010(b)(2)(L) to clarify that firms that trigger application of the Taping Rule for the first time must elect to either avail themselves of the one-time "opt out provision" (*i.e.*, make the staff adjustment to fall below the thresholds of the Rule) or seek an exemption from the Rule, but they may not elect to do both. Pursuant to the amended Rule, firms that become subject to the Taping Rule for the first time have 30 days to decide between the above options.

Endnote

- 1 See Securities Exchange Act Release No. 51658 (May 5, 2005), 70 FR 24848 (May 11, 2005) (Order Granting Approval of Proposed Rule Change Relating to Taping Rule "Opt Out" and Exemption Provisions; File No. SR-NASD-2005-033).

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ATTACHMENT A

New language is underlined; deleted language is in brackets.

3010. Supervision

(a) No Change.

(b) Written Procedures

(1) No Change.

(2) Tape recording of conversations

(A) 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)(H) relating to the employment history of its registered persons at a Disciplined Firm as defined in paragraph (b)(2)(J) shall establish, maintain, and enforce special written procedures for supervising the telemarketing activities of all of its registered persons.

(B) The member must establish and implement the supervisory procedures required by this paragraph within 60 days of receiving notice from NASD [Regulation] or obtaining actual knowledge that it is subject to the provisions of this paragraph.

A member that meets one of the criteria in paragraph (b)(2)(H) for the first time may reduce its staffing levels to fall below the threshold levels within 30 days after receiving notice from NASD [Regulation] pursuant to the provisions of paragraph (b)(2)(A) or obtaining actual knowledge that it is subject to the provisions of the paragraph, provided the firm promptly notifies the Department of Member Regulation, NASD [Regulation], in writing of its becoming subject to the Rule. Once the member has reduced its staffing levels to fall below the threshold levels, it shall not rehire a person terminated to accomplish the staff reduction for a period of 180 days. On or prior to reducing staffing levels pursuant to this paragraph, a member must provide the Department of Member Regulation, NASD [Regulation] with written notice, identifying the terminated person(s).

(C) No Change.

(D) 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 [the Association] NASD. The procedures must be appropriate for the member's business, size, structure, and customers.

(E) through (F) No Change.

(G) 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] NASD a report on the member's supervision of the telemarketing activities of its registered persons.

(H) No Change.

(I) For purposes of this Rule, the term "registered person" means any person registered with [the Association] NASD 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.

(J) through (K) No Change.

(L) Pursuant to the Rule 9600 Series, [the Association] NASD may in exceptional circumstances, taking into consideration all relevant factors, exempt any member unconditionally or on specified terms and conditions from the requirements of this paragraph. A member seeking an exemption must file a written application pursuant to the Rule 9600 Series within 30 days after receiving notice from NASD or obtaining actual knowledge that it meets one of the criteria in paragraph (b)(2)(H). A member that meets one of the criteria in paragraph (b)(2)(H) for the first time may elect to reduce its staffing levels pursuant to the provisions of paragraph (b)(2)(B) or, alternatively, to seek an exemption pursuant to paragraph (b)(2)(L), as appropriate; such a member may not seek relief from the Rule by both reducing its staffing levels pursuant to paragraph (b)(2)(B) and requesting an exemption.

(3) through (4) No Change.

(c) through (g) No Change.