

November 12, 1998

Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549
Mail Stop 10-1

Re: **File No. SR-NASD-98-52: Amendment No. 2**
Review of Incoming, Written Correspondence with the Public

Dear Ms. England:

Pursuant to Rule 19b-4, NASD Regulation, Inc. ("NASD Regulation") is submitting Amendment No. 2 to the above rule filing. A copy of the revised rule is attached as Exhibit A. A copy of the revised draft Notice to Members ("Notice") is attached as Exhibit B.

The purpose of this amendment is to respond to the public comments received by the Securities and Exchange Commission ("SEC") in response to the publication in the *Federal Register* of Notice of Filing of SR-NASD-98-52, proposing an amendment to the rules requiring members to review correspondence. The amendment also proposes revisions to the text of the rule and to the draft Notice that was filed with the proposed rule change.

The SEC received four comment letters on the proposed rule change: two in favor of the proposed rule change and two opposed to it.¹ ICI and NYLSEC state that the rule should not be adopted, arguing that the benefits of the rule are outweighed by the burdens. ICI believes that existing rules sufficiently address any problems. NASD Regulation disagrees; we believe that the proposed rule should be adopted because ensuring that firms capture all customer complaints and prevent registered

¹ See letter from Janet G. McCallen, the International Association for Financial Planning ("IAFP") to Jonathan G. Katz, Secretary, SEC, dated September 23, 1998; letter from Joseph P. Savage, the Investment Company Institute ("ICI") to Jonathan G. Katz, Secretary, SEC, dated September 24, 1998; letter from Michael L. Kerley, MML Investors Services, Inc. ("MMLISI") to Jonathan G. Katz, Secretary, SEC, dated September 18, 1998; and letter from Theodore Mathas, NYLIFE Securities Inc. ("NYLSEC"), to Jonathan G. Katz, Secretary, SEC, dated September 23, 1998.

representatives from taking cash or checks out of customer letters will provide important benefits to the investing public. Furthermore, we believe this requirement should be specified in a rule requiring supervision of correspondence because this issue is not specifically addressed in existing rules; while NASD Rules 3070 and 3110 require members to report and retain customer complaints, no NASD rule currently requires members to review correspondence to identify customer complaints or funds in the first instance. Therefore, it is appropriate to address this problem in Rule 3010.

ICI and NYLSEC further state that, even if a member's business structure permits a review of correspondence prior to use or distribution, this review should not be required and members should be able to design their own procedures to identify complaints and funds. NASD Regulation believes that the most effective procedure for properly identifying and handling customer complaints and funds is review prior to use or distribution. Accordingly, the Notice has not been revised to reflect this suggestion.

NYLSEC also suggests that where prior review is not employed, NASD Regulation should eliminate the "requirement" to forward correspondence and logs to a reviewer on a weekly basis and instead permit review on a regular basis. The draft Notice does not establish "requirements;" instead, it provides examples of alternative procedures that firms can employ to assure adequate handling of complaints and checks. NYLSEC may employ any procedures that are reasonably designed to ensure achievement of this goal.

NYLSEC asks that, if the SEC approves this proposal, the effective date of the amendments be postponed for at least six months to allow members sufficient time to implement the additional requirements. The proposed rule currently is scheduled to have an effective date 30 days following publication of the Notice to Members announcing SEC approval. The Notice to Members announcing the SEC's approval of recent changes to NASD Rule 3010 setting forth new requirements for the review of correspondence contained a provision that would have required the review of all incoming, written correspondence. This Notice to Members was issued in January 1998. Although this provision was never put into effect, members have been on notice for 10 months or more that some kind of review of incoming, written correspondence would be necessary. However, in order to provide members with more time to implement the new requirements, NASDR proposes to change the effective date set forth in the proposed rule change to 60 days following publication of the Notice to Members announcing SEC approval.

Finally, ICI states that the rules should specify that a member that does not normally receive written correspondence directed to registered representatives should

not be required to develop procedures to address such correspondence. We note that the rule specifically requires members only to develop procedures requiring the review of incoming, written correspondence directed to registered representatives (emphasis added). To the extent that any correspondence is received by registered representatives, NASD Regulation does not believe that an exclusion from the requirement is warranted. Where the volume of such correspondence is small, we believe that compliance should not be burdensome.

The other two commenters support adoption of the proposed rule, but have suggested revisions to the Notice. MMLISI suggests that the Notice be supplemented to state that firms have a legal right to review incoming mail. This statement would be similar to one the New York Stock Exchange has made in connection with its own correspondence review rule. MMLISI indicates that such a statement will be helpful in addressing concerns expressed by registered representatives who may challenge firms' legal rights and authority to open and review their mail. NASD Regulation agrees, and proposes to revise the draft Notice to include such a statement.

IAFP has recommended revisions to the procedures suggested in the draft Notice for complying with the proposed rule when an office structure does not permit an independent review of a registered representative's incoming written correspondence. NASD Regulation agrees with IAFP's suggestions, and proposes the following revisions: a clarification that a registered representative can forward opened mail; inserting the word "securities" before the word "products" to clarify that, for purposes of this Rule, the log should include only such products; and informing customers that they can contact a central office of the broker/dealer firm for any issue, including filing a complaint.

NASD Regulation also proposes several clarifying changes to Rule 3010(d)(2): clarify in the first sentence that "written" means "non-electronic;" change the word "non-electronic" to "written" to make the second sentence consistent with the rest of the rule; add the phrase "and related to the member's investment banking or securities business" to clarify that only such correspondence must be reviewed; and make other revisions to clarify that the member's written procedures for the review of correspondence must include procedures for reviewing incoming, written correspondence to identify and handle customer complaints and funds. NASD Regulation also proposes to make several minor, clarifying changes to the draft Notice.

Katherine A. England
November 12, 1998
Page 4

If you have any questions about this amendment, please contact me at (202) 728-8203.

Sincerely yours,

Mary N. Revell

cc: Deborah L. Flynn

CONDUCT RULES

(Note: new text is underlined; deletions are bracketed.)

Rule 3010. Supervision

(a) through (c) No change

(d) Review of Transactions and Correspondence

(1) No change

(2) Review of correspondence. Each member shall develop written procedures that are appropriate to its business, size, structure, and customers for the review of incoming and outgoing written (i.e., non-electronic) and electronic correspondence with the public relating to its investment banking or securities business, including procedures to review incoming, written correspondence directed to registered representatives and related to the member's investment banking or securities business to properly identify and handle customer complaints and to ensure that customer funds and securities are handled in accordance with firm procedures. [*The procedures should include review of incoming, non-electronic correspondence directed to registered representatives for purposes of properly identifying and handling customer complaints and funds.*] Where such procedures for the review of correspondence do not require [pre-use] review of all *correspondence prior to use or distribution*, they must include provision for the education and training of associated persons as to the firm's procedures governing correspondence; documentation of such education and training; and surveillance and follow-up to ensure that such procedures are implemented and adhered to.

(3) No change

Katherine A. England
November 12, 1998
Page 2

(e) through (g) No change

DRAFT: November 12, 1998

(Note: new text is underlined; deletions are bracketed.)

Notice to Members 98-__

Review of Incoming, Non-electronic Correspondence with the Public

Executive Summary

On _____, the Securities and Exchange Commission (SEC) approved amendments to NASD Rule 3010, which states that firms must [should] review incoming, written [non-electronic] correspondence to identify customer complaints and funds and ensure they are properly handled. The rule amendments will be effective on _____. This amendment revises rule changes that became effective on April 7, 1998. The text of the amended Rule and the *Federal Register* version of the SEC Release are attached. This Notice to Members is being issued to provide guidance on how to implement this rule.

Questions concerning this Notice should be directed to Joseph Price, Counsel, Office of Disclosure and Investor Protection, NASD Regulation, Inc. (NASD Regulation), at (202) 728-8877 or Mary N. Revell, Associate General Counsel, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8203.

Background

In December 1997, the Securities and Exchange Commission (SEC) approved rule amendments and a Notice to Members that were designed to allow firms to develop flexible supervisory procedures for the review of correspondence with the public. The amendments were intended to recognize the growing use of correspondence sent and received in electronic format (i.e., "e-mail" and facsimile) [electronic communications such as "e-mail"] while still providing for effective supervision. Notice to Members 98-11, issued in January 1998, provided guidance to firms on how to implement these rules. Subsequent to SEC approval of the amendments, but before the amended rules went into effect, the SEC received 14 comment letters objecting to certain provisions in the new rules, primarily from members in the insurance industry. The commenters primarily objected to a provision in Notice to Members 98-11, which states that firms will be required to review all incoming correspondence received in non-electronic format directed to registered representatives and related to a member's investment banking or securities business. NASD Regulation [, Inc. (NASDR)] added this provision to Notice to Members 98-11 to address two regulatory concerns raised by the SEC: (1) ensuring that firms capture all customer complaints; and (2) preventing registered representatives from taking cash or checks out of customer letters.

The commenters stated that it will be very difficult or impossible for a registered principal to conduct a pre-distribution review of all incoming, non-electronic correspondence, particularly correspondence received by registered representatives in small, one- or two-person offices. In

response to these concerns, the effective date of the requirement to review all incoming, non-electronic correspondence was delayed to allow NASD Regulation time to develop an alternative, workable procedure for the review of incoming, non-electronic correspondence that addresses the regulatory concerns about preventing misappropriation of customer funds and diversion of customer complaints. The rule amendments and all other provisions in the Notice became effective on April 7, 1998.

Amended Rule

NASD Regulation has received SEC approval of amendments to Rule 3010 (“Supervision”). See Securities Exchange Act Release No. _____, ____ FR ____ (), attached. Rule 3010(d)(2) requires each member to develop written policies and procedures for review of correspondence with the public relating to its investment banking or securities business tailored to its structure and the nature and size of its business and customers. The rule has been amended to state that these procedures must [should] also include the review of incoming, written [non-electronic] correspondence directed to registered representatives and related to the member’s investment banking or securities business to properly identify and handle customer complaints and to ensure that customer funds and securities are handled in accordance with firm procedures. [for purposes of properly identifying and handling customer complaints and funds.]

The method used for [In] conducting reviews of incoming, written [non-electronic] correspondence to identify customer complaints and funds may vary depending on the firm’s office structure. [, where] Where the office structure permits review of all correspondence, members should designate a registered or associated person to open and review correspondence prior to use or distribution to identify customer complaints and funds. The designated person must not be supervised or under the control of the registered person whose correspondence is opened and reviewed. Unregistered persons who have received sufficient training to enable them to identify complaints and checks would be permitted to review correspondence.

It is the understanding and view of NASD Regulation that member firms possess the legal capacity to insist that mail addressed to their offices be deemed to be related to their business, even if marked to the attention of a particular associated person, if they advise associated persons that personal correspondence should not be received at the firm. Members are reminded that SEC Rule 17a-4(b)(4) requires that “originals of all communications received . . . by such member, broker or dealer, relating to its business as such . . .” must be preserved for not less than three years. NASD Regulation has determined after careful examination of this matter that these suggested procedures do not conflict with existing postal regulations and do not interfere with asserted rights to privacy.

Where the office structure does not permit the review of correspondence prior to use or distribution [this arrangement], the firm would have to employ alternative procedures reasonably

designed to assure adequate handling of complaints and checks. Procedures that could be adopted include the following:

after opening his or her own mail, the registered representative can forward [forwarding] opened incoming, written correspondence related to the firm's investment banking or securities business to an Office of Supervisory Jurisdiction [(OSJ)] or a branch manager for review on a weekly basis;

maintainance of a separate log for all checks received and securities products sold, which is forwarded to the supervising branch on a weekly basis;

communication to clients that they can contact the broker/dealer directly for any matter, including the filing of a complaint, and provides them with an address and telephone number of a central office of the broker/dealer for this purpose; [communication to clients that informs them that questions and complaints can be sent directly to the compliance department and provides them with the compliance department's address and phone number]; and

branch examination verification that the procedures are being followed.

Regardless of the method used for initial review of incoming, written [non-electronic] correspondence, as with other types of correspondence, Rule 3010(d)(1) would still require review by a registered principal of some of each registered representative's correspondence with the public relating to the member's investment banking or securities business.

Notice to Members 98-11

As stated above, Notice to Members 98-11 stated that firms would be required to review all incoming correspondence received in non-electronic format directed to registered representatives and related to a member's investment banking or securities business. That requirement is no longer applicable and has been superseded by the amendment to Rule 3010(d)(2) and the guidance provided in this Notice.

Text of Rule Amendments

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

Rule 3010. Supervision

(a) through (c) No change

(d) Review of Transactions and Correspondence

(1) No change

(2) Review of correspondence. Each member shall develop written procedures that are appropriate to its business, size, structure, and customers for the review of incoming and outgoing written (i.e., non-electronic) and electronic correspondence with the public relating to its investment banking or securities business, including procedures to review incoming, written correspondence directed to registered representatives and related to the member's investment banking or securities business to properly identify and handle customer complaints and to ensure that customer funds and securities are handled in accordance with firm procedures. Where such procedures for the review of correspondence do not require [pre-use] review of all correspondence prior to use or distribution, they must include provision for the education and training of associated persons as to the firm's procedures governing correspondence; documentation of such education and training; and surveillance and follow-up to ensure that such procedures are implemented and adhered to.

(3) No change

(e) through (g) No change