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November 1, 2001

**VIA MESSENGER**

Mr. Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Room 6184, Mail Stop 6-9  
Washington, D.C. 20549

**Re: File No. SR-NASD-2001-19; Amendment No. 2 to Proposed Rule 3150,  
Reporting Requirements for Clearing Members**

Dear Mr. Katz:

The National Association of Securities Dealers, Inc. ("NASD" or "Association") hereby: (1) responds to the comment letters received by the Securities and Exchange Commission ("SEC" or "Commission") and NASD Regulation, Inc. ("NASD Regulation") in response to the publication in the *Federal Register* of Notice of Filing of SR-NASD-2001-19;<sup>1</sup> and (2) amends the above-referenced rule filing as described below and as reflected in the proposed rule language attached as Exhibit 2.

This Amendment No. 2: (1) clarifies that the proposed reporting requirement applies to both clearing and self-clearing firms and that clearing and self-clearing firms are required to report prescribed data pertaining only to the member firms (and not to non-member firms) for which they clear; (2) amends proposed Rule 3150 to eliminate the requirement that all data be reported on a daily basis; and (3) gives a member firm that is subject to proposed Rule 3150 the ability to request an exemption pursuant to the Rule 9600 Series from any or all of the reporting requirements imposed by NASD Regulation under Rule 3150.

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<sup>1</sup> Release No. 34-44251 (May 3, 2001); 66 F.R. 23750 (May 9, 2001). The public comment period announced in the Federal Register expired on May 30, 2001. This Amendment No. 2 includes responses to all commenters, including those previously responded to by NASD Regulation in Amendment No. 1, filed on June 4, 2001.

## **Issues Raised in Comment Letters**

The Commission received four comment letters on the proposed rule change. One letter was signed by six firms: Legg Mason Wood Walker, Inc.; Wachovia Securities, Inc.; BNY Clearing Services LLC; Stifel, Nicolaus & Company, Incorporated; U.S. Bankcorp Piper Jaffray; and Wells Fargo Investments (hereinafter referred to as "the Firms"). The other three comment letters were from iClearing, LLC ("iClearing"), Financial Information Forum ("FIF"), and A.G. Edwards & Sons, Inc. ("AGE"). NASD Regulation received comment letters from Nordea Securities, Inc. ("Nordea"), Wachtel & Co., Inc. ("Wachtel"), and the Securities Industry Association ("SIA").<sup>2</sup>

### **INSITE Data Element Requirements**

The authority provided under proposed Rule 3150 is sufficiently broad to allow NASD Regulation to gather data electronically from clearing and self-clearing firms that will enable NASD Regulation examiners to identify changes that are occurring in member activities and potential sales practice violations. Using sophisticated analytical software, the INSITE Surveillance system will identify changes in the pattern of member activity and member patterns that are distinctly different from their peers.

AGE commented that the existing technical specifications have definitional flaws or inconsistencies with respect to the required data elements, which make it virtually impossible for AGE to move forward with fundamental system requirements analysis, design, and programming. AGE also questioned the usefulness of the required data elements. iClearing, in turn, questioned whether members will be given sufficient time to develop and test their data collection systems, how the INSITE program will generate "exception" reports, and the consequences to a member of a late report. iClearing also questioned whether NASD Regulation considered the financial burden of the INSITE reporting requirements and whether the reporting requirements could be less intrusive.

NASD Regulation reiterates its commitment to work with its member firms to make the reporting requirements under Rule 3150 as reasonable as possible. Toward that end, NASD Regulation has engaged in, and will continue to engage in, various types of communications with clearing and self-clearing firms and their service bureaus to explain the program and answer questions. NASD Regulation staff has already conducted a series of discussions with member firms and service bureaus that have resulted in modifications to the data elements that conform to their current daily calculations. NASD Regulation will continue to have these discussions and will continue to respond to industry concerns by modifying data element requirements, as appropriate.

The SIA and AGE questioned whether the INSITE data requirements duplicate existing regulatory data collections. SIA asked whether the requirements mirror

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<sup>2</sup> See the List of Commenters attached as Exhibit 1.

information already provided by clearing and self-clearing firms through FOCUS Reports and NASD's Automated Confirmation Transaction Service ("ACT") and Order Audit Trail System ("OATS"). Data reported through OATS will not be duplicated, since that data pertains to orders, and the INSITE data pertains to transaction and account data. Likewise, information reported through ACT does not provide the detail required by the INSITE program regarding cancellations and rebills.

Certain of the required data duplicates information required to be reported in FOCUS Reports. The difference is the frequency with which information regarding unsecured customer debits, aggregate net liquidating value of firm proprietary accounts, and aggregate margin debits in customer accounts will be reported. This information, which can change very rapidly and which can have a significant impact on a firm's capital, will be reported through the INSITE program on a daily basis,<sup>3</sup> giving NASD Regulation the opportunity to discover capital problems almost as they occur, whereas FOCUS Reports are filed on a monthly and quarterly basis. Furthermore, the data elements also provide valuable insights into potential sales practice issues as they arise.

#### NASD Regulation Will Operate the INSITE Program in Close Coordination With Member Firms

NASD Regulation has created an INSITE Web site from which member firms may obtain information. Members may review the proposed Firm Data Filing Technical Specifications that will be required under Rule 3150<sup>4</sup> and a bullet point presentation of the INSITE Exam Program, which describes the program in detail. The Web site will also feature questions asked by clearing and self-clearing firms and NASD Regulation's answers to their questions. NASD Regulation will continue to report modifications and/or clarifications of the reporting requirements on the INSITE Web site.

Starting in June 2001, NASD Regulation conducted a series of workshops with clearing and self-clearing firms around the country. The purpose of these workshops was, among other things, to explain the data elements that firms will be required to report under proposed Rule 3150, to answer the firms' questions about the reporting process, and to gather additional information about the firms' capability to report required information. NASD Regulation will continue to modify the reporting requirements as necessary based on the information it has received, and continues to receive, from its member firms and service bureaus. As suggested by the SIA, NASD Regulation is currently meeting with a specially-formed committee ("SIA Committee") comprised of technology, compliance,

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<sup>3</sup> The INSITE Program may, in the future, require firms to report certain data elements less frequently. NASD Regulation will publish any change in the daily reporting requirements well in advance of the date on which that change will occur.

<sup>4</sup> Currently, NASD members may review the Firm Data Elements on NASD Regulation's web site, <http://www.nasdr.com/insite.htm>, at pages 16-18. In the initial implementation of the INSITE program, no new data elements will be added, and some data elements may be eliminated. NASD Regulation does not anticipate materially expanding the data element requirements.

operations, and legal professionals to discuss such issues as the data elements, the implementation schedule for firm filings, and reports to member firms. NASD Regulation staff expects to have an on-going relationship with the Group as a means of obtaining industry input.

NASD Regulation also is in the process of conducting a pilot program with three clearing firms. These firms are electronically reporting on a daily basis a portion of the firm data elements (aggregate net liquidating equity, exchange and non-exchange trade counts, unsecured customer debits, canceled and as-of trade counts, and various data regarding trade cancellations), and they have not reported any significant problems in collecting and reporting this data. The pilot program has helped NASD Regulation to identify and resolve any technical problems experienced by these firms. NASD Regulation expects, as with any new program or technology, that systems failures may arise. When that happens, firms will be expected to report these failures to NASD Regulation, correct them as expeditiously as possible, and restart the reporting process. Generally, a system failure that has happened in the normal course of doing business, and which a firm is attempting to correct, will not be viewed as a disciplinary matter.

Although NASD Regulation did not conduct a cost comparison study, the proposed reporting program has been designed to require firms to provide summaries of information that they already collect, including, among other things, aggregate net liquidating equity, exchange and non-exchange transactions, options transactions, debt transactions, customer accounts, short interest, unsecured customer debts, trade cancellations and as-of trades summaries and detail. NASD Regulation is specifying the file formats. Firms may report this data via NASD Regulation's Form Filing Web site or, for firms with connectivity to the NASD OATS private network, through that file transfer protocol. NASD Regulation recognizes that firms may have to make some programming changes in order to create the daily summaries required by the INSITE program. The information required to establish these programs is currently being made available on the INSITE Web site, and firms subject to proposed Rule 3150 should have ample time to prepare for their participation in the program. Members are advised on the Web site that NASD Business and Technology Support Services is the primary source of information about INSITE, and that it can be used as a source for answers to questions about reporting responsibilities, technical specifications for reporting to the NASD, deadlines, and more.

As suggested by the SIA, NASD Regulation is committed to developing a system on its Web site that will permit members to review the information that has been reported by firms, directly or on their behalf by clearing firms or service bureaus. NASD Regulation will work with its member firms to develop a useful format. NASD Regulation expects this system to be fully functional in the latter part of 2002.

Applicability to Clearing Firms, Self-Clearing Firms, and Service Bureaus: Phase-In Schedule

The Firms, iClearing, AGE, and the SIA raised questions about the data element requirements. The Firms stated that they have no issues with the goals of NASD Regulation and its plans to use information gathered under proposed Rule 3150 to better monitor firms. Their concerns focus on the implementation of proposed Rule 3150. The Firms stated that the service bureau systems used by most of the self-clearing firms do not process the data as currently described in NASD Regulation's proposed list of elements and that the data that the service bureaus have may be misleading. The Firms also stated that not all clearing firms have the data that will be required by NASD Regulation in an automated format that can be retrieved without major burden. They proposed that NASD Regulation survey the self-clearing firms and their service bureaus to determine which of the proposed data elements are currently calculated and available for nightly delivery, and to consider this information when planning INSITE's scheduled implementation. The Firms stated that they are concerned that providing data under proposed Rule 3150 at the same time that they are responding to other industry initiatives such as TRACE, order handling rules, and T+1 requirements will place an undue burden on their systems resources.

It is NASD Regulation's goal to implement reporting requirements under proposed Rule 3150 in as reasonable a manner as possible in order to give clearing firms, self-clearing firms, and service bureaus sufficient time to prepare. NASD Regulation plans to begin requiring reporting under proposed Rule 3150 as of December 10, 2001. The three member firms (Bear, Stearns & Co. Inc., Pershing Trading Company, L.P., and Wexford Clearing Services Incorporated, a division of Prudential Securities Incorporated) that have been participating in the pilot program will be phased in first. All three firms will be reporting the published Firm Data Elements under Rule 3150 by mid-January 2002. NASD Regulation will phase in all other members in several stages. NASD Regulation is working with the SIA Committee and FIF to establish these dates. NASD Regulation will publish the schedule of phase-ins as soon as it has been established, but in no event will NASD Regulation give member firms less than six-months notice of their start-up date.

NASD Regulation is also proposing to amend proposed Rule 3150 to eliminate the requirement that all data be reported on a daily basis. This will give NASD Regulation the flexibility it needs to require that certain data elements be reported less frequently. As with the current data elements, NASD Regulation will announce any change in the reporting requirements well in advance of their implementation.

FIF suggests that it would be unrealistic to expect broker-dealers using service bureaus to be ready to implement INSITE reporting in the initial phase. FIF asks that member firms be given additional time to work with their service bureaus to identify the INSITE reporting process that is appropriate to their particular business profile and systems

arrangement. In this regard, NASD Regulation will take into account broker-dealers' relationships with service bureaus in establishing the phase-in schedules. We are working closely with FIF in establishing the implementation schedule.

#### Authority to Grant Exemptive Relief

Nordea and Wachtel suggest that Rule 3150 include a provision for exemptive relief from its reporting requirements. These commenters suggest that such relief might be based on the nature of a firm's activities, its risk factors, and/or the size of its capital reserves. Wachtel requests that NASD Regulation consider firm size in formulating such exemptions in light of the financial burden placed on small, self-clearing firms to create and implement the computer programs necessary for compliance with proposed Rule 3150. AGE questioned whether imposing Rule 3150 reporting requirements on self-clearing firms would impose excessive and unnecessary burdens.

In response to these commenters and other member firms that have expressed similar concerns, NASD Regulation has decided to include a provision in proposed Rule 3150 that will permit broker-dealers to request an exemption from the reporting requirements of proposed Rule 3150 pursuant to the Rule 9600 Series.<sup>5</sup> As stated in proposed Rule 3150(b), exemptions from any or all of the Rule 3150 reporting requirements will be granted only under exceptional and unusual circumstances. The size of a firm will not be the determinative factor in deciding whether to grant such exemptions, since wholesale exemptions based solely on the size of a firm could jeopardize the strength of the INSITE program.

#### **Proposed Additional Amendments**

The language of the proposed rule change provides that each member that is a clearing firm shall be required to report prescribed data to the Association. As stated in the "Purpose" section of the rule filing, the term "clearing firms" in the proposed rule applies to both self-clearing firms and clearing firms (that clear for introducing brokers that are NASD members). NASD Regulation believes that amending the rule language explicitly to refer to both clearing firms and self-clearing firms will clarify that all clearing firms are subject to the rule's requirements.

NASD Regulation is also proposing to amend the rule language to clarify that the Association will only require its member clearing and self-clearing firms to report prescribed data pertaining to the member and any member broker-dealer for which it clears.<sup>6</sup> This will exclude from the parameters of proposed Rule 3150 any broker-dealer that is not registered with the NASD.

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<sup>5</sup> NASD Regulation is also proposing a rule change to Rule 9610 that will add Rule 3150 to the rules under which members can seek exemptive relief.

<sup>6</sup> When a clearing firm files data for its own business, NASD Regulation will treat it as a self-clearing

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If you have any questions, please contact Shirley H. Weiss, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8844; e-mail Shirley.Weiss@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

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cc: Florence Harmon  
Lisa Jones

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firm for purposes of INSITE reporting requirements. On that basis, for example, a clearing firm is not required to report its own aggregate net liquidating equity. (See page 16 of the INSITE Firm Data Technical Specifications, which states that a self-clearing firm may report its aggregate net liquidating equity as NULL, or no value.)

**EXHIBIT 1**

**LIST OF COMMENTERS ON PROPOSED REPORTING REQUIREMENTS FOR  
CLEARING MEMBERS**

1. Legg Mason Wood Walker, Inc.; Wachovia Securities, Inc.; BNY Clearing Services LLC; Stifel, Nicolaus & Company, Incorporated; U.S. Bankcorp Piper Jaffray; and Wells Fargo Investments (May 17, 2001)
2. iClearing, LLC (June 7, 2001)
3. Nordea Securities, Inc. (June 8, 2001)
4. Financial Information Forum (June 28, 2001)
5. A.G. Edwards & Song, Inc. (June 28, 2001)
6. Wachtel & Co., Inc. (June 29, 2001)
7. Securities Industry Association (July 19, 2001)



**EXHIBIT 2**

Below is the text of the proposed rule change. The original proposed new language is underlined; the new proposed language is double underlined; proposed deletions are in brackets.

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**3100. BOOKS AND RECORDS, AND FINANCIAL CONDITION**

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**3150. Reporting Requirements for Clearing Firms**

(a) Each member that is a clearing firm or self-clearing firm shall be required to report to the Association [on a daily basis and] in such format as the Association may require, prescribed data pertaining to the member and any member broker-dealer for which it clears. A clearing firm or self-clearing firm may enter into an agreement with a third party pursuant to which the third party agrees to fulfill the [clearing firm's] obligations of a clearing firm or self-clearing firm under this Rule. Notwithstanding the existence of such an agreement, each clearing firm or self-clearing firm remains responsible for complying with the requirements of this Rule.

(b) Pursuant to the Rule 9600 Series, the Association may in exceptional and unusual circumstances, taking into consideration all relevant factors, exempt a member or class of members unconditionally or on specified terms from any or all of the provisions of this Rule that it deems appropriate.

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## **9600. PROCEDURES FOR EXEMPTIONS**

### **9601. Application**

#### **(a) Where to File**

A member seeking exemptive relief as permitted under Rules 1021, 1070, 2210, 2320, 2340, 2520, 2710, 2720, 2850, 2851, 2860, Interpretive Material 2860-1, 3010(b)(2), 3020, 3150, 3210, 3230, 3350, 8211, 8212, 8213, 11870, or 11900, Interpretive Material 2110-1, or Municipal Securities Rulemaking Board 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.

**(b) and (c)** No change