

March 21, 2002

Ms. Katherine A. England
Assistant Director
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549-1001

Re: **File No. SR-NASD-2002-40 – Security Futures Rules**

Dear Ms. England:

Pursuant to Rule 19b-4, enclosed please find the above-numbered rule filing. Also enclosed is a 3-1/2" disk containing the rule filing in Microsoft Word 7.0 to facilitate production of the Federal Register release.

If you have any questions, please contact Alan Lawhead, Office of General Counsel, NASD Regulation, Inc., at (202) 728-8853; e-mail alan.lawhead@nasd.com. The fax number of the Office of General Counsel is (202) 728-8264.

Very truly yours,

Patrice M. Gliniecki
Vice President and Acting General Counsel

Enclosures

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C.

Form 19b-4

Proposed Rule Change

by

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of Proposed Rule Change

(a) Pursuant to the provisions of Section 19(b)(1) of the Securities Exchange Act of 1934 ("Exchange Act" or "Act"), the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary, NASD Regulation, Inc. ("NASD Regulation"), is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change to: (1) amend Rule 1022 (Categories of Principal Registration), Interpretive Material 1022-1 (Registered Options Principals), Interpretive Material 1022-2 (Limited Principal—General Securities Sales Supervisor), and Rule 1032 (Categories of Representative Registration) to expand several registration categories to include engaging in and supervising security futures transactions; (2) amend Interpretive Material 2110-3 (Front Running Policy) to add block trading in single stock futures to the prohibition against front running; (3) amend Rule 2210 (Communications with the Public) and create new Interpretive Material 2210-7 (Guidelines for Communications with the Public Regarding Security Futures) to regulate communications with the public regarding security futures; (4) amend Interpretive Material 2310-2 (Fair Dealing with Customers) to refer to new proposed Rule 2865 regarding security futures sales practices; (5) create new Rule 2865 to regulate security futures sales practices; (6) amend Rule 3010(b)(2) (the Taping Rule) to recognize the ability of futures regulators to expel a member for futures-related sales practice violations; (7) amend Rule 3010(e) (Supervision) to require firms to check the backgrounds of job applicants who have previously worked in the futures industry; (8) amend Rule 3050 (Transactions for or by Associated Persons) to require associated persons to notify their member firm when they open certain futures accounts; and (9)

amend Rule 3370 (Prompt Receipt and Delivery of Securities) to extend to security futures. Below is the text of the proposed rule change. Proposed new language is underlined; proposed deletions are in brackets.

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1000. Membership, Registration and Qualification Requirements

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1020. Registration of Principals

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1022. Categories of Principal Registration

(a) – (e) No change

(f) Registered Options and Security Futures Principals

(1) Every member of the Association [which] that is engaged in, or [which] that intends to engage in transactions in security futures or put or call options with the public shall have at least one Registered Options and Security Futures Principal who shall have satisfied the requirements of this subparagraph. As to options transactions, each [such] member shall also designate a Senior Registered Options Principal and a Compliance Registered Options Principal in accordance with the provisions of Rule 2860(b)(20) and identify such persons to the Association. [A member which has a Registered Options Principal qualified in either put or call options shall not engage in both put and call option transactions until such time as it has a Registered Options Principal qualified in both such options.] Every person engaged in the management of the day-to-day options or security futures activities of a member shall also be registered as a

Registered Options and Security Futures Principal. [In the event any Registered Options Principal ceases to act in such capacity, such fact shall be reported promptly to the Association together with a brief statement of the reasons therefor.]

(2) Each person required by subparagraph (f)(1) [hereof] to be a Registered Options and Security Futures Principal shall pass the appropriate Qualification Examination for Registered Options and Security Futures Principal, or an equivalent examination acceptable to the Association [Corporation], for the purpose of demonstrating an adequate knowledge of options and security futures trading generally, the Rules of the Association applicable to trading of option and security futures contracts and the rules of registered clearing agencies for options and security futures [the Options Clearing Corporation], and be registered as such before engaging in the duties or accepting the responsibilities of a Registered Options and Security Futures Principal.

[(3) A person shall not qualify as a Registered Options Principal for both put and call options unless he has passed an examination testing him with respect to both put and call options.]

~~(3)~~[(4)] Each person required to register and qualify as a Registered Options and Security Futures Principal must, prior to or concurrent with such registration, be or become qualified pursuant to the Rule 1030 Series, as either a General Securities Representative or a Limited Representative—Corporate Securities and [also be or become qualified pursuant to Rule 1032(d) as] a Registered Options and Security Futures Representative.

~~(4)~~~~(5)~~ A person registered solely as a Registered Options and Security Futures Principal shall not be qualified to function in a principal capacity with responsibility over any area of business activity not prescribed in subparagraph (1) [hereof].

~~(5)~~~~(6)~~ Any person who is registered with the Association as a Registered Options and Security Futures Principal may not supervise security futures activities unless such person has completed a firm-element continuing education requirement that addresses security futures and a principal's responsibilities for security futures. After a revised examination that includes security futures products is offered, a person associated with a member that passes such a revised Qualification Examination for Registered Options and Security Futures Principal is not required to complete a firm-element continuing education requirement that addresses security futures and a principal's responsibilities for security futures to supervise activities in such products, except as otherwise required by Rule 1120 generally or by the member firm.

(g) Limited Principal ³/₄ General Securities Sales Supervisor

(1) – (2) No change

~~(g)~~~~(3)~~ Any person who is registered with the Association as a Limited Principal—General Securities Sales Supervisor may not act in a limited principal capacity with regard to security futures products unless such person has completed a firm-element continuing education requirement that addresses security futures and a principal's responsibilities for security futures. After a revised examination that includes security futures products is offered, a person

associated with a member that passes such a revised Qualification Examination for Limited Principal—General Securities Sales Supervisor is not required to complete a firm-element continuing education requirement that addresses security futures and a principal's responsibilities for security futures to supervise such products, except as otherwise required by Rule 1120 generally or by the member firm.

IM-1022-1. Registered Options and Security Futures Principals

Members having a single Registered Options and Security Futures Principal are required promptly to notify the Association in the event such person is terminated, resigns, becomes incapacitated or is otherwise unable to perform the duties of an Options and Security Futures Principal.

Following receipt of such notification, the Association will require members to agree, in writing, to refrain from engaging in any options- or security futures-related activities [which] that would necessitate the prior or subsequent approval of an Options and Security Futures Principal including, among other things, the opening of new options or security futures accounts or the execution of discretionary orders for option or security futures contracts until such time as a new Registered Options and Security Futures Principal has been qualified.

Members failing to qualify a new Registered Options and Security Futures Principal within two weeks following the loss of their sole Registered Options and Security Futures Principal, or by the earliest available date for administration of the [Series 4] Registered Options and Security Futures Principal examination, whichever is longer, shall be required to cease doing an options and security futures business;

provided, however, they may effect closing transactions in options and offsetting transactions in security futures [in order] to reduce or eliminate existing open options or security futures positions in their own account as well as the accounts of their customers.

IM-1022-2. Limited Principal^{3/4} General Securities Sales Supervisor

Limited Principal—General Securities Sales Supervisor is an alternate category of registration designed to lessen the qualification burdens on principals of general securities firms who supervise sales. Without this category of limited registration, such principals could be required to separately qualify pursuant to the rules of the NASD, MSRB, NYSE and the options exchanges. While persons may continue to separately qualify with all relevant self-regulatory organizations, the Limited Principal—General Securities Sales Supervisor Examination permits qualification as a supervisor of sales of all securities by one examination. Persons registered as Limited Principals—General Securities Sales Supervisor may also qualify in any other category of principal registration. Persons who are already qualified in one or more categories of principal registration may supervise sales activities of all securities by also qualifying as Limited Principals—General Securities Sales Supervisor.

Functions that may be performed by Limited Principals—General Securities Sales Supervisors. Any person required to be registered as a principal who supervises sales activities in corporate, municipal and option securities, investment company products, variable contracts, [and] direct participation programs, and security futures may be registered solely as a Limited Principal—General Securities [Sale] Sales Supervisor. In addition to branch office managers, other persons such as regional and national sales managers may also be registered solely as Limited Principals—General Securities Sales

Supervisor as long as they supervise only sales activities. Qualification as a General Securities Representative is a prerequisite for registration as a Limited Principal—General Securities Sales Supervisor.

* * *

1032. Categories of Representative Registration

(a) General Securities Representative

(1) No change

(2)(A)-(D) No change

(2)(E) A person who is registered with the Association as a General Securities Representative may not act as a General Securities Representative with regard to security futures products unless such person has completed a firm-element continuing education requirement that addresses security futures products. After a revised examination or module that includes security futures products is offered, a person associated with a member who passes such a revised Qualification Examination for General Securities Representative is not required to complete a firm-element continuing education requirement that addresses security futures to act as a General Securities Representative with regard to such products, except as otherwise required by Rule 1120 generally or by the member firm. Once a revised examination or module that includes security futures becomes available, persons seeking to become a General Securities Representative will be expected to pass such revised examination to act as a General Securities Representative with regard to

security futures products. Only persons registered as a General Securities Representative prior to the time that such revised examination or module is available, will be eligible to use a firm-element continuing education program in lieu of passing the revised examination or module to engage in a security futures business.

(a)(2)(E)-(I) Renumbered accordingly

(a)(3) A person registered as a General Securities Representative shall not be qualified to function as a Registered Options and Security Futures Representative unless he or she is also qualified and registered as such pursuant to the provisions of paragraph (d) [hereof].

(b) and (c) No change

(d) Limited Representative $\frac{3}{4}$ Options and Security Futures

(1) Each person associated with a member who is included within the definition of a representative as defined in Rule 1031 may register with the Association as a Limited Representative—Options and Security Futures if:

(A) such person's activities in the investment banking or securities business of the member involve the solicitation or sale of option or security futures contracts, including option contracts on government securities as that term is defined in Section 3(a)(42)(D) of the Act, for the account of a broker, dealer or public customer; and

(B) such person passes an appropriate qualification examination for Limited Representative—Options and Security Futures.

(2) Each person seeking to register and qualify as a Limited Representative—Options and Security Futures must, concurrent with or before such registration may become effective, become registered pursuant to the Rule 1032 Series, either as a Limited Representative—Corporate Securities or Limited Representative—Government Securities.

(3) A person registered as a Limited Representative—Options and Security Futures shall not be qualified to function in any area not described in subparagraph (1)(A) [hereof].

(4) Any person who is registered with the Association as a Limited Representative—Options and Security Futures may not act as a limited representative with regard to security futures products unless such person has completed a firm-element continuing education requirement that addresses security futures. After a revised examination that includes security futures products is offered, a person associated with a member who passes such a revised Qualification Examination for Limited Representative—Options and Security Futures is not required to complete a firm-element continuing education requirement that addresses security futures to act as a limited representative with regard to such products, except as otherwise required by Rule 1120 generally or by the member firm.

(e) - (h) No change

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IM-2110-3. Front Running Policy

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- (a) an order to buy or sell an option or a security future when such member or person associated with a member causing such order to be executed has material, non-public market information concerning an imminent block transaction in the underlying security, or when a customer has been provided such material, non-public market information by the member or any person associated with a member; or
- (b) an order to buy or sell an underlying security when such member or person associated with a member causing such order to be executed has material, non-public market information concerning an imminent block transaction in an option or a security future overlying that security, or when a customer has been provided such material, non-public market information by the member or any person associated with a member;
- prior to the time information concerning the block transaction has been made publicly available.

* * *

These prohibitions also do not include situations in which a member or person associated with a member receives a customer's order of block size relating to both an option and the underlying security or both a security future and the underlying security. In such cases, the member and person associated with a member may position the other side of one or both components of the order. However, in these instances, the member and person associated with a member would not be able to cover any resulting proprietary

position(s) by entering an offsetting order until information concerning the block transaction involved has been made publicly available.

The application of this front running policy is limited to transactions that are required to be reported on the last sale reporting systems administered by Nasdaq, Consolidated Tape Association (CTA), or Option Price Reporting Authority (OPRA). The front running policy also applies to security futures transactions regardless of whether such products are reported pursuant to such systems. Information as to a block transaction shall be considered to be publicly available when it has been disseminated via the tape or high speed communications line of one of those systems, a similar system of a national securities exchange under Section 6 of the Act, an alternative trading system under Regulation ATS, or by [of] a third-party news wire service.

A transaction involving 10,000 shares or more of an underlying security, or options or security futures covering such number of shares is generally deemed to be a block transaction, although a transaction of less than 10,000 shares could be considered a block transaction in appropriate cases. A block transaction that has been agreed upon does not lose its identity as such by arranging for partial executions of the full transaction in portions which themselves are not of block size if the execution of the full transaction may have a material impact on the market. In this situation, the requirement that information concerning the block transaction be made publicly available will not be satisfied until the entire block transaction has been completed and publicly reported.

* * *

2210. Communications with the Public

(a) No change

(b) Approval and Recordkeeping

(1) Each item of advertising and sales literature shall be approved by signature or initial, prior to use or filing with the Association, by a registered principal of the member. This requirement may be met, only with respect to corporate debt and equity securities that are the subject of research reports as the term is defined in Rule 472 of the New York Stock Exchange, by the signature or initial of a supervisory analyst approved pursuant to Rule 344 of the New York Stock Exchange. This requirement may be met, only with respect to advertising and sales literature concerning security futures, by the signature or initial of a Registered Options and Security Futures Principal.

(b)(2) and (c)(1) No change

(c)(2) Advertisements concerning collateralized mortgage obligations, advertisements concerning security futures, and advertisements and sales literature concerning registered investment companies (including mutual funds, variable contracts and unit investment trusts) that include or incorporate rankings or comparisons of the investment company with other investment companies where the ranking or comparison category is not generally published or is the creation, either directly or indirectly, of the investment company, its underwriter or an affiliate, shall be filed with the Department for review at least 10 days prior to use (or such shorter period as the Department may allow in particular circumstances) for approval and, if changed by the Association, shall be withheld from publication or circulation until any changes specified by the Association have been made or, if expressly disapproved, until the advertisement has been

refiled for, and has received, Association approval. The member must provide with each filing the actual or anticipated date of first use. Any member filing any investment company advertisement or sales literature pursuant to this paragraph shall include a copy of the data, ranking or comparison on which the ranking or comparison is based.

(c)(3) – (c)(9) No Change

(d)(1) No Change

(d)(2)(A) No Change

(B)(i)a. that the member usually makes a market in the securities being recommended, or in the underlying security if the recommended security is an option or security future, or that the member or associated persons will sell to or buy from customers on a principal basis;

(B)(i)b. that the member and/or its officers or partners own options, security futures, rights or warrants to purchase any of the securities of the issuer whose securities are recommended, unless the extent of such ownership is nominal;

(B)(i)c. No Change

(B)(ii) – (B)(iv) No Change

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IM-2210-7. Guidelines for Communications with the Public Regarding Security Futures

(a) Association Approval Requirements and Review Procedures

(1) As set forth in paragraph (c)(2) of Rule 2210, all advertisements concerning security futures shall be submitted to the Advertising/Investment Companies Regulation Department of the Association at least ten days prior to use for approval and, if changed by the Association, shall be withheld from circulation until any changes specified by the Association have been made or, in the event of disapproval, until the advertisement has been refiled for, and has received, Association approval.

(2) The requirements of this paragraph (a) shall not be applicable to:

(A) advertisements submitted to another self-regulatory organization having comparable standards pertaining to such advertisements, and

(B) advertisements in which the only reference to security futures is contained in a listing of the services of a member organization.

(b) Disclosure Statement

(1) All communications concerning security futures shall be accompanied or preceded by the security futures risk disclosure statement unless they meet the following requirements:

(A) Such communications shall be limited to general descriptions of the security futures being offered.

(B) Such communications shall contain contact information for obtaining a copy of the security futures risk disclosure statement.

(C) Such communications shall not contain recommendations or past or projected performance figures, including annualized rates of return.

(2) Communications concerning security futures that meet the requirements of subparagraph (1) may have the following characteristics:

(A) the text of the communication may contain a brief description of security futures, including a statement that identifies registered clearing agencies for security futures. The text may also contain a brief description of the general attributes and method of operation of the security exchange or notice-registered securities exchange on which such security futures are traded, including a discussion of how a security future is priced;

(B) the communication may include any statement required by any state law or administrative authority; and

(C) advertising designs and devices, including borders, scrolls, arrows, pointers, multiple and combined logos and unusual type faces and lettering as well as attention-getting headlines and photographs and other graphics may be used, provided such material is not misleading.

(c) Recordkeeping

Consistent with paragraph (b)(2) of Rule 2210, a member shall keep a separate file of all advertisements and sales literature concerning security futures, including the name(s) of the person(s) who prepared them and approved their use for a period of three years from the date of each use. In addition, members shall meet the same recordkeeping requirements for all correspondence concerning security futures. In the case of sales

literature concerning security futures, a member shall record the source of any recommendation contained therein.

(d) Specific Standards

(1) The special risks attendant to security futures transactions and the complexities of certain security futures investment strategies shall be reflected in any communications that discuss the uses or advantages of security futures. Any statement referring to the potential opportunities or advantages presented by security futures shall be balanced by a statement of the corresponding risks. The risk statement shall reflect the same degree of specificity as the statement of opportunities, and broad generalities should be avoided.

(2) Security futures communications shall include a warning to the effect that security futures are not suitable for all investors and such communications shall not contain suggestions to the contrary.

(3) Security futures communications shall state that supporting documentation for any claims (including any claims made on behalf of security futures programs or the security futures expertise of sales persons), comparisons, recommendations, statistics or other technical data, will be supplied upon request.

(4) No cautionary statements or caveats, often called hedge clauses, may be used in communications with the public if they are not legible, are misleading, or are inconsistent with the content of the material.

(5) Statements suggesting the certain availability of a secondary market for security futures shall not be made.

(e) Projections

Notwithstanding the provisions of Rule 2210(d)(2)(N), security futures sales literature and correspondence may contain projected performance figures (including projected annualized rates of return), provided that:

- (1) all such sales literature and correspondence must be accompanied or preceded by the security futures risk disclosure statement;
- (2) no suggestion of certainty of future performance is made;
- (3) parameters relating to such performance figures are clearly established;
- (4) all relevant costs, including commissions, fees, and interest charges (as applicable) are disclosed and reflected in the projections;
- (5) such projections are plausible and are intended as a source of reference or a comparative device to be used in the development of a recommendation;
- (6) all material assumptions made in such calculations are clearly identified;
- (7) the risks involved in the proposed transactions are also disclosed; and
- (8) in communications relating to annualized rates of return, that such returns are not based upon any less than a sixty-day experience; any formulas used in making calculations are clearly displayed; and a statement is included to the effect that the annualized returns cited might be achieved only if the parameters described can be duplicated and that there is no certainty of doing so.

(f) Historical Performance

Security futures sales literature and correspondence may feature records and statistics that portray the performance of past recommendations or of actual transactions, provided that:

(1) all such sales literature and correspondence must be accompanied or preceded by the security futures risk disclosure statement;

(2) any such portrayal is done in a balanced manner, and consists of records or statistics that are confined to a specific "universe" that can be fully isolated and circumscribed and that covers at least the most recent 12-month period;

(3) such communications include the date of each initial recommendation or transaction, the price of each such recommendation or transaction as of such date, and the date and price of each recommendation or transaction at the end of the period or when liquidation was suggested or effected, whichever was earlier; provided that if the communications are limited to summarized or averaged records or statistics, in lieu of the complete record there may be included the number of items recommended or transacted, the number that advanced and the number that declined, together with an offer to provide the complete record upon request;

(4) such communications disclose all relevant costs, including commissions, fees, and daily margin obligations (as applicable);

(5) whenever such communications contain annualized rates of return, such communications shall disclose all material assumptions used in the process of annualization;

(6) an indication is provided of the general market conditions during the period(s) covered, and any comparison made between such records and statistics and the overall market (e.g., comparison to an index) is valid;

(7) such communications state that the results presented should not and cannot be viewed as an indicator of future performance; and

(8) a principal qualified to supervise security futures activities determines that the records or statistics fairly present the status of the recommendations or transactions reported upon and so initials the report.

(g) Security Futures Programs

In communications regarding a security futures program (i.e., an investment plan employing the systematic use of one or more security futures strategies), the cumulative history or unproven nature of the program and its underlying assumptions shall be disclosed.

(h) Standard Forms of Worksheets

Such worksheets must be uniform within a member firm. If a member has adopted a standard form of worksheet for a particular security futures strategy, nonstandard worksheets for that strategy may not be used.

(i) Recordkeeping

Communications that portray performance of past recommendations or actual transactions and completed worksheets shall be kept at a place easily accessible to the sales office for the accounts or customers involved.

* * *

IM-2310-2. Fair Dealing with Customers

(a)(1) to (e) (opening paragraph) No change

(e)(1) Security Futures

Members must comply with the Rules, regulations and procedures applicable to security futures contained in Rule 2865.

(e)(1) and (e)(2) are renumbered as (e)(2) and (e)(3) respectively.

* * *

2865. Security Futures

(a) For purposes of this Rule, the term "security future" shall have the definition specified in Section 3(a)(55) of the Act.

(b) Requirements

(1) General

(A) Applicability—This Rule shall be applicable to the trading of security futures.

(B) Paragraphs (12) and (15) shall apply only to security futures carried in securities accounts.

(C) Except to the extent that specific provisions in this Rule govern, or unless the context otherwise requires, the provisions of the By-

Laws and Rules and all other interpretations and policies of the Board of Governors shall also be applicable to the trading of security futures.

(2) Definitions

(A) The terms "Beneficial Owner," "Control," and "Controls," "Is Controlled by" or "Is Under Common Control With" shall have the same meanings as in Rule 2860.

(B) The term "principal qualified to supervise security futures activities" means a Registered Options and Security Futures Principal who, consistent with Rule 1022, has either completed a firm-element continuing education requirement that addresses security futures and a principal's responsibilities for security futures or has passed a revised qualification examination for Registered Options and Security Futures Principals that covers security futures, or a Limited Principal—General Securities Sales Supervisor who, consistent with Rule 1022, has either completed a firm-element continuing education requirement that addresses security futures and a principal's responsibilities for security futures or has passed a revised qualification examination for Limited Principal—General Securities Sales Supervisor.

(3) – (7) Reserved

(8) Restrictions on Security Futures Transactions

The Association may impose from time to time such restrictions on security futures transactions that it determines are necessary in the interest of maintaining a fair and orderly market in security futures, or in the underlying

securities covered by such security futures, or otherwise necessary in the public interest or for the protection of investors. During the period of any such restriction, no member shall effect any security futures transaction in contravention of such restriction.

(9) – (10) Reserved

(11) Delivery of Security Futures Risk Disclosure Statement

(A) Every member shall deliver the current security futures risk disclosure statement to each customer at or prior to the time such customer's account is approved for trading security futures. Thereafter, each new or revised security futures risk disclosure statement shall be distributed to every customer having an account approved for such trading or, in the alternative, shall be distributed not later than the time a confirmation of a transaction is delivered to each customer who enters into a security futures transaction. The Association will advise members when a new or revised current security futures risk disclosure statement is available.

(B) Where a broker or dealer enters its orders with another member in a single omnibus account, the member holding the account shall take reasonable steps to assure that such broker or dealer is furnished reasonable quantities of the current security futures risk disclosure statement.

(C) Where an introducing broker or dealer enters orders for its customers with, or clears transactions through, a member on a fully

disclosed basis and that member carries the accounts of such customers, the responsibility for delivering the current security futures risk disclosure statement as provided in this paragraph (b)(11) shall rest with the member carrying the accounts. However, such member may rely upon the good faith representation of the introducing broker or dealer that the current security futures risk disclosure statement has been delivered in compliance with paragraph (b)(11).

(12) Confirmations

Every member shall promptly furnish to each customer a written confirmation of each transaction in security futures for such customer's account. Each such confirmation shall show the market on which the security futures position was executed, whether the security futures position is a long or short position, the underlying security or narrow-based index, the expiration date, the quantity of the underlying security or narrow-based index, the number of security futures contracts, the amount of initial and maintenance margin required, the commission, the trade and settlement dates, whether the transaction was a purchase or a sale transaction, whether the transaction was an opening or offsetting transaction, and whether the transaction was effected on a principal or agency basis.

(13) – (14) Reserved

(15) Statements of Account

(A) Statements of account showing security and money positions, entries, interest charges, and any special charges that have been assessed

against such account during the period covered by the statement shall be sent no less frequently than once every month to each customer in whose account there has been an entry during the preceding month with respect to a security futures contract and quarterly to all customers having an open security futures position or money balance. Interest charges and any special charges assessed during the period covered by the statement need not be specifically delineated if they are otherwise accounted for on the statement and have been itemized on transaction confirmations. With respect to security futures customers having a general (margin) account, such statements shall also provide the mark-to-market price and market value of each security futures position and other security positions in the general (margin) account, the total market value of all positions in the account, the outstanding debit or credit balance in the account, and the general (margin) account equity. The statements shall bear a legend stating that further information with respect to commissions and other charges related to the execution of security futures transactions has been included in confirmations of such transactions previously furnished to the customer, and that such information will be made available to the customer promptly upon request. The statements shall also bear a legend requesting the customer promptly to advise the member of any material change in the customer's investment objectives or financial situation.

(B) For purposes of this subparagraph (15), general (margin) account equity shall be computed by subtracting the total of the "short"

security values and any debit balance from the total of the "long" security values and any credit balance.

(16) Opening of Accounts

(A) Approval Required

No member or person associated with a member shall accept an order from a customer to purchase or sell a security future, or approve the customer's account for the trading of security futures, unless the broker or dealer furnishes or has furnished to the customer the appropriate security futures risk disclosure statement and the customer's account has been approved for security futures trading in accordance with the provisions of subparagraphs (B) through (D) hereof.

(B) Diligence in Opening Accounts

In approving a customer's account for security futures trading, a member or any person associated with a member shall exercise due diligence to ascertain the essential facts relative to the customer, the customer's financial situation and investment objectives. Members shall establish specific minimum net equity requirements for initial approval and maintenance of customers' security futures accounts. Based upon such information, a principal qualified to supervise security futures activities shall specifically approve or disapprove in writing the customer's account for security futures trading. For account approvals, the written record shall include the reasons for approval.

(i) With respect to security futures customers who are natural persons, members shall seek to obtain the following information at a minimum (information shall be obtained for all participants in a joint account):

a. Investment objectives (e.g., safety of principal, income, growth, trading profits, or speculation);

b. Employment status (name of employer, self-employed, or retired);

c. Estimated annual income from all sources;

d. Estimated net worth (exclusive of family residence);

e. Estimated liquid net worth (cash, securities, or other);

f. Marital status and number of dependents;

g. Age; and,

h. Investment experience and knowledge (e.g., number of years, size, frequency and type of transactions for futures, commodities, options, stocks, bonds, and other financial instruments.

(ii) In addition, a customer's account records shall contain the following information, if applicable:

a. Source or sources of background and financial information (including estimates) concerning the customer;

b. Discretionary authorization agreement on file, name, relationship to customer, and experience of person holding trading authority;

c. Date disclosure document(s) furnished to customer;

d. Name of registered representative;

e. Name of principal approving account and date of approval; and

f. Dates of verification of currency of account information.

(iii) Members should consider using a standard account approval form to ensure the receipt of all the required information.

(iv) Refusal of a customer to provide any of the information specified in subparagraph (i) shall be so noted on the customer's records at the time the account is opened. Information provided shall be considered together with the other information available in determining whether to approve the account for security futures trading.

(v) A record of the information obtained pursuant to this subparagraph (B) and of the approval or disapproval of each account shall be maintained by the member as part of its records in accordance with paragraph (b)(17) herein.

(C) Verification of Customer Background and Financial Information

For every natural person whose account has been approved for security futures trading, the background and financial information upon which the account was approved shall be sent to the customer for verification within fifteen (15) days after the customer's account has been approved for security futures trading. This verification requirement shall not apply if the background and financial information is included in the customer's account agreement or if the member has previously verified the customer's information in connection with an options account. A copy of the background and financial information on file with a member also shall be sent to the customer for verification within fifteen (15) days after the member becomes aware of any material change in the customer's financial situation.

Members shall satisfy the initial and subsequent verification of customer background and financial information by sending to the customer the information required in paragraph (B)(i)(a) through (i)(f) hereof, as contained in the member's records and providing the customer with an opportunity to correct or complete the information. In all cases, absent advice from the customer to the contrary, the information will be deemed to be verified.

(D) Account Agreement

Within fifteen (15) days after a customer's account has been approved for security futures trading, a member shall obtain from the customer a written agreement that the customer is aware of and agrees to be bound by the Rules of the Association applicable to the trading of security futures and, that the customer has received a copy of the current security futures risk disclosure statement. In addition, the customer should indicate on such written agreement that the customer is aware of and agrees not to violate applicable security futures position limits.

(17) Maintenance of Records

(A) In addition to the requirements of Rule 3110, every member shall maintain and keep current a separate central log, index, or other file for all security futures-related complaints, through which these complaints can easily be identified and retrieved. The central file shall be located at the principal place of business of the member or such other principal office as shall be designated by the member. At a minimum, the central file shall include: (i) identification of complainant; (ii) date complaint was received; (iii) identification of registered representative servicing the account; (iv) a general description of the matter complained of; and (v) a record of what action, if any, has been taken by the member with respect to the complaint. For purposes of this subparagraph, the term "security futures-related complaint" shall mean any written statement by a customer or person acting on behalf of a customer alleging a grievance arising out

of or in connection with security futures. Each security futures-related complaint received by a branch office of a member shall be forwarded to the office in which the separate, central file is located not later than 30 days after receipt by the branch office that is the subject of the complaint. A copy of every security futures-related complaint shall also be maintained at the branch office that is the subject of the complaint.

(B) Background and financial information of customers who have been approved for security futures trading shall be maintained at both the branch office servicing the customer's account and the principal supervisory office having jurisdiction over that branch office. Copies of account statements of security futures customers shall also be maintained at both the branch office supervising the accounts and the principal supervisory office having jurisdiction over that branch for the most recent six-month period. With respect solely to the above-noted record retention requirements applicable to principal supervisory offices, however, the customer information and account statements may be maintained at a location other than the principal supervisory office if such documents and information are readily accessible and promptly retrievable. Other records necessary to the proper supervision of accounts shall be maintained at a place easily accessible both to the branch office servicing the customer's account and to the principal supervisory office having jurisdiction over that branch office.

(18) Discretionary Accounts

(A) Authorization and Approval

(i) No member or person associated with a member shall exercise any discretionary power with respect to trading in security futures in a customer's account, or accept orders for security futures for an account from a person other than the customer, except in compliance with the provisions of Rule 2510 and unless:

a. The written authorization of the customer required by Rule 2510 shall specifically authorize security futures trading in the account; and

b. the account shall have been accepted in writing by a principal qualified to supervise security futures activities.

(ii) When analyzing an account to determine if it should be approved for security futures trading, a principal qualified to supervise security futures activities shall have a reasonable basis for believing that the customer was able to understand and bear the risk of the strategies or transactions proposed, and shall maintain a record of the basis for such determination. Each discretionary order shall be approved and initialed on the day entered by the branch office manager or other principal qualified to supervise security futures activities, provided that if the branch officer is not a principal qualified to supervise security futures activities, such

approval shall be confirmed within a reasonable time by a principal qualified to supervise security futures activities. Each discretionary order shall be identified as discretionary on the order at the time of entry. Discretionary accounts shall receive frequent appropriate supervisory review. The provisions of this subparagraph (18) shall not apply to discretion as to the price at which or the time when an order given by a customer for the purchase or sale of a definite number of security futures contracts in a specified security shall be executed.

(B) Record of Transactions

A record shall be made of every transaction in security futures contracts in respect to which a member or person has exercised discretionary authority, clearly reflecting such fact and indicating the name of the customer, the designation and number of the security futures contracts, the price of the contract, and the date and time when such transaction was effected.

(C) Security Futures Programs

Where the discretionary account uses security futures programs involving the systematic use of one or more security futures strategies, the customer shall be furnished with a written explanation of the nature and risks of such programs.

(19) Suitability

(A) No member or person associated with a member shall recommend to any customer any transaction or trading strategy for the purchase or sale of a security future unless such member or person associated with the member has reasonable grounds to believe upon the basis of information furnished by the customer after reasonable inquiry by the member or person associated with the member concerning the customer's investment objectives, financial situation and needs, and any other information known by the member or associated person, that the recommended transaction or trading strategy is not unsuitable for the customer.

(B) No member or person associated with a member shall recommend to a customer a transaction in any security future unless the person making the recommendation has a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that the customer may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the security future.

(20) Reserved

(21) Violation of By-Laws and Rules of the Association or a Registered Clearing Agency

(A) In Association disciplinary proceedings, a finding of violation of any provision of the rules, regulations, or by-laws of a registered

clearing agency under Section 17A(b)(8) of the Act by any member or person associated with a member engaged in security futures transactions cleared by such registered clearing agency, may be deemed to be conduct inconsistent with just and equitable principles of trade and a violation of Rule 2110.

(B) In Association disciplinary proceedings, a finding of violation of any provision of the Rules, regulations or By-Laws of the Association by any member or person associated with a member engaged in security futures transactions may be deemed to be conduct inconsistent with just and equitable principles of trade and a violation of Rule 2110.

(22) – (23) Reserved

(24) Security Futures Transactions and Reports by Market Makers in Listed Securities

Every member that is an off-board market maker in a security listed on a national securities exchange shall report to the Association in accordance with such procedures as may be prescribed by the Board of Governors, transactions involving 50 or more security futures contracts on such listed securities that are either directly for the benefit of (A) the member or (B) any employee, partner, officer, or director of the member who, by virtue of his or her position with the member, is directly involved in the purchase or sale of the underlying security for the firm's proprietary account(s) or is directly responsible for supervision of such persons; or who by virtue of his or her position in the firm, is authorized to, and regularly does, obtain information on the proprietary account(s) of the member in which the underlying security is traded. This subparagraph shall apply to all

security futures transactions including those executed on an exchange to which the member may belong.

(25) Trading Ahead of Customer Orders

Every member shall use due care to avoid trading ahead of a customer's security futures order that is executable at or near the market price. A member must transmit a security futures customer order that is executable at or near the market price to a securities exchange or a notice-registered securities exchange before it transmits any order in the same security future for any proprietary account, or for any account in which it or any person associated with it is directly or indirectly interested. A member must exercise the due care required by this subsection when the member has gained knowledge of or reasonably should have gained knowledge of the customer's order prior to the transmission to a securities exchange or a notice-registered securities exchange of the member's order for a proprietary account, or for any account in which it or any person associated with it is directly or indirectly interested.

* * *

3010. Supervision

(a) No change

(b)(1) – (b)(2)(ix) No change

(b)(2)(x) For purposes of this Rule, the term "disciplined firm" means either a member that, in connection with sales practices involving the offer, purchase, or sale of any security, has been expelled from membership or participation in any securities

industry self-regulatory organization or is subject to an order of the Securities and Exchange Commission revoking its registration as a broker/dealer; or a futures commission merchant or introducing broker that has been formally charged by either the Commodity Futures Trading Commission or a registered futures association with deceptive telemarketing practices or promotional material relating to security futures, those charges have been resolved, and the futures commission merchant or introducing broker has been closed down and permanently barred from the futures industry as a result of those charges; or a futures commission merchant or introducing broker that, in connection with sales practices involving the offer, purchase, or sale of security futures is subject to an order of the Securities and Exchange Commission revoking its registration as a broker or dealer.

(b)(2)(xi) No change

(c) – (d) No change

(e) Qualifications Investigated

Each member shall have the responsibility and duty to ascertain by investigation the good character, business repute, qualifications, and experience of any person prior to making such a certification in the application of such person for registration with this Association. Where an applicant for registration has previously been registered with the Association, the member shall review [obtain from the Central Registration Depository or from the applicant] a copy of the Uniform Termination Notice of Securities Industry

Registration (Form U-5) filed with the Association by such person's most recent previous NASD member employer, together with any amendments thereto that may have been filed pursuant to Article V, Section 3 of the Association's By-Laws. The member shall review [obtain] the Form U-5 as required by this Rule no later than sixty (60) days following the filing of the application for registration or demonstrate to the Association that it has made reasonable efforts to comply with the requirement. [A member receiving a Form U-5 pursuant to this Rule shall review] In conducting its review of the Form U-5 and any amendments thereto, a member [and] shall take such action as may be deemed appropriate.

Where an applicant for registration has been previously registered with a registered futures association ("RFA") member that is or has been registered as a broker/dealer pursuant to Section 15(b)(11) of the Act ("notice-registered broker/dealer") with the SEC to trade security futures, the member shall review a copy of the Notice of Termination of Associated Person (Form 8-T) filed with the RFA by such person's most recent previous RFA member employer, together with any amendments thereto. The member shall review the Form 8-T as required by this Rule no later than sixty (60) days following the filing of the application for registration or demonstrate to the Association that it has made reasonable efforts to comply with the requirement. In conducting its review of a Form 8-T and any amendments, a member shall take such action as may be deemed appropriate.

(f) and (g) No change

* * *

3050. Transactions for or by Associated Persons

(a) – (c) No change

(d) Obligations of Associated Persons Concerning an Account with a Notice-Registered Broker/Dealer, Investment Adviser, Bank, or Other Financial Institution

A person associated with a member who opens a securities account or places an order for the purchase or sale of securities with a broker/dealer that is registered pursuant to Section 15(b)(11) of the Act ("notice-registered broker/dealer"), a domestic or foreign investment adviser, bank, or other financial institution, except a member, shall:

(1) notify his or her employer member in writing, prior to the execution of any initial transactions, of the intention to open the account or place the order; and

(2) upon written request by the employer member, request in writing and assure that the notice-registered broker/dealer, investment adviser, bank, or other financial institution provides the employer member with duplicate copies of confirmations, statements, or other information concerning the account or order;

provided, however, that if an account subject to this paragraph (d) was established prior to a person's association with a member, the person shall comply with this paragraph promptly after becoming so associated.

* * *

3370. Prompt Receipt and Delivery of Securities

(a) No change

(b) Sales

(1) No change

(2) "Short Sales"

(A) Customer short sales

No member or person associated with a member shall accept a "short" sale order for any customer in any security unless the member or person associated with a member makes an affirmative determination that the member will receive delivery of the security from the customer or that the member can borrow the security on behalf of the customer for delivery by settlement date. This requirement shall not apply, however, to transactions in corporate debt securities or transactions in security futures, as defined in Section 3(a)(55) of the Act.

(B) Proprietary short sales

No member shall effect a "short" sale for its own account in any security unless the member or person associated with a member makes an affirmative determination that the member can borrow the securities or otherwise provide for delivery of the securities by the settlement date. This requirement will not apply to transactions in corporate debt securities, to transactions in security futures, as defined in Section 3(a)(55) of the Act, to bona fide market making transactions by a member in securities in which it is registered as a Nasdaq market maker, to bona fide market maker transactions in non-Nasdaq securities in which the market maker publishes a two-sided quotation in an independent quotation medium, or to transactions [which] that result in fully hedged or arbitrated positions.

(3) – (4) No change

(5)(A)(i) through (iii) No change

(iv) Short a security and long a single stock future of the underlying security.

Example: Long 1 single stock future of MNOP.

- With the circumstances as above (and assuming a contract size of 100) 100 shares would be exempt.
- Even if the expiration date for the single stock future was more than 90 calendar days, 100 shares would be exempt.

* * *

(b) Not applicable

(c) Not applicable

2. Procedures of the Self-Regulatory Organization

(a) The proposed rule change was approved by the Board of Directors of NASD Regulation at its meetings on April 25, July 25, and October 24, 2001, and in part by the Executive Committee of the NASD at its meeting on June 21, 2001, which collectively authorized the filing of the rule change with the SEC. Counsel for The Nasdaq Stock Market and NASD Dispute Resolution have been provided an opportunity to consult with respect to the proposed rule change, pursuant to the Plan of Allocation and Delegation of Functions by the NASD to its Subsidiaries ("Delegation Plan"). The NASD Board of Governors had an opportunity to review the proposed rule change at its

meetings on April 26, July 26, and October 25, 2001. No other action by NASD is necessary for the filing of the proposed rule change.

Section 1 of Article VII of the NASD By-Laws permit the Board of Governors of the NASD to adopt amendments to NASD Rules without recourse to the membership for approval.

The NASD will announce the effective dates of the proposed rule change in a *Notice to Members* to be published no later than 60 days following Commission approval. The effective date will be no less than 30 days following publication of the *Notice to Members* announcing Commission approval.

(b) Questions regarding this rule filing may be directed to Alan Lawhead, Associate General Counsel, NASD Regulation, Office of General Counsel, at (202) 728-8853.

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(a) Purpose

The Commodity Futures Modernization Act of 2000 ("CFMA") authorizes the trading of futures on individual stocks and narrow-based stock indices. Under the CFMA, security futures are defined as "securities" under Section 3(a)(10) of the Exchange Act. As a result, NASD Regulation is modifying existing rules that cover securities and developing new rules to accommodate these new securities products.¹

¹ NASD Regulation also has filed a proposed rule change to add NASD Rule 3115 and to amend NASD Rule 3340 to establish record-keeping requirements for Alternative Trading Systems ("ATs") that trade security futures, and to require ATs to coordinate trading halts with markets trading the underlying securities and markets trading related securities. (SR-NASD-2001-47). See 66 FR 41076 (Aug. 6, 2001).

The regulatory framework established by the CFMA for the markets and intermediaries trading security futures provides the SEC and Commodity Futures Trading Commission ("CFTC") with joint jurisdiction. Broker/dealers that wish to conduct a business in security futures are required to notice register as Futures Commission Merchants ("FCMs") or Introducing Brokers ("IBs") with the CFTC.² Similarly, FCMs and IBs that wish to conduct a business in security futures are required to notice register as broker/dealers with the SEC.³ FCMs and IBs that are notice-registered with the SEC do not, however, need to become members of the NASD. The NASD's proposed rules on security futures apply only to NASD members.

1. Security Futures Rule

One of the underpinnings of the CFMA is that the regulation of security futures should be comparable to the regulation of options.⁴ NASD Regulation and the National Futures Association ("NFA")⁵ are required under the CFMA to develop rules regulating activity in security futures.⁶

² 66 FR 43227 (Aug. 17, 2001).

³ 66 FR 45138 (Aug. 27, 2001).

⁴ For example, the CFMA establishes that margin requirements for security futures be consistent with comparable option contracts and that listing standards for security futures be no less restrictive than comparable listing standards for options traded on a national securities exchange or a national securities association. See Exchange Act §§7(c)(2) & 6(h)(3)(C); 15 U.S.C. §§ 78g(c)(2) & 78f(h)(3)(C).

⁵ The NFA is currently the only registered futures association under the Commodity Exchange Act ("CEA"). Under the CFMA, the NFA, as a registered futures association, may apply to the SEC for registration as a limited-purpose national securities association. The function of a limited-purpose national securities association is limited to carrying out the purposes of the securities laws applicable to securities futures and to regulating the activities of its members that have notice-registered with the SEC to trade security futures. See Exchange Act §15A(k); 15 U.S.C. §78o-3(k).

⁶ Sales practice rules for security futures, and specifically the suitability rule, are subject to the CFMA's requirement that the NFA's rules on these subjects be reasonably comparable to the NASD's rules. Exchange Act §15A(k)(2)(B)(i); 15 U.S.C. §78o-3(k)(2)(B)(i). NASD Regulation believes that it is important for the NASD's and the NFA's rules to be comparable in these areas.

The proposed securities futures rule, Rule 2865, is based principally upon the NASD's options rule, Rule 2860.⁷ For purposes of clarity, we have styled the rule as a separate, stand-alone rule from our options rule; however, to facilitate compliance by member firms that are familiar with the NASD's options rule, we have maintained the same structure and, where possible, much of the same rule text.

In reviewing our options rule and the security futures rules of the NFA, we determined that it was not necessary to replicate every provision in the options rules for security futures. Certain concepts for options are not relevant for security futures. For example, provisions pertaining to the "exercise" of options were not carried forward into the security futures rule because security futures are not "exercised" as options are. We also have eliminated sections pertaining to "Transactions with Issuers" and "Restricted Stock," and have not included provisions concerning position limits and the reporting of security futures positions, which will instead be addressed by each exchange or market trading security futures, as appropriate.

A discussion of the proposed rule change is set forth below.

The NASD's security futures rule applies to all NASD member firms. Many of these members will be broker/dealers that notice register with the CFTC as an FCM or IB. Other members will be fully registered with both the SEC and CFTC ("fully registered firms"). In a joint notice of proposed rulemaking,⁸ the SEC and CFTC requested comment on whether the application of the customer account statement and

⁷ The Commission published a group of new NFA rules and amendments to NFA rules governing security futures on September 27, 2001. See 66 FR 49439 (Sept. 27, 2001). The NFA's rules also were modeled after the NASD's options rules. In developing the NASD's security futures rule, we have sought to adopt requirements that are consistent with those of the NFA to avoid regulatory disparity between firms subject to the jurisdiction of the NFA and the NASD.

⁸ 66 FR 50786 (Oct. 4, 2001).

confirmation rules should depend on the type of account in which security futures are held (e.g., in a securities account at a broker/dealer, or a futures account at an FCM).⁹ The proposed rule change adopts what appears to be the resolution of this issue – namely, that the customer account statement and confirmation rules will apply based upon the type of account used for the security futures. Thus, the paragraphs of the security futures rule pertaining to customer account statements and confirmations apply only to security futures held in security accounts. Fully registered firms that hold security futures in an FCM account would follow the rules of the CFTC addressing customer account statements and confirmations.

Liquidation of Positions and Restrictions on Access

We propose provisions on liquidation of positions and restrictions on access that are substantively similar to those in the NASD's options rule.

Restrictions on Security Futures Transactions

We propose restrictions on security futures transactions that are substantively similar to those in the NASD's options rule.

Delivery of Security Futures Risk Disclosure Statement

The proposed rule change requires every member to deliver the security futures risk disclosure statement to each customer at or prior to the time such customer's account is approved for trading security futures. In general, the requirements for delivery of the security futures risk disclosure statement are comparable to the requirements for the delivery of the options disclosure document. The security futures risk disclosure statement discusses the risks of security futures; describes how security futures trade; and

⁹ Id. at 50791.

addresses margin for security futures, effects of leverage, settlement procedures, customer account protections, and tax consequences.

Confirmations

The proposed rule change requires each member promptly to furnish each customer with a written confirmation of each security futures transaction. The proposed rule change also specifies the items that must be included on the confirmation. In general, the provisions addressing confirmations of security futures transactions are comparable to the provisions currently in place for options.

Discretionary Accounts

The proposed rule change adopts discretionary account procedures for security futures that are comparable to those for options. Notably, as with options, the procedures require that the written authorization of the customer required by NASD Rule 2510 specifically authorize security futures trading in the account. The implication of this requirement is that all discretionary accounts, even those that are permitted to trade options, cannot trade security futures unless a new written discretionary account authorization specifically authorizing trading of security futures is on file. Although there are many similarities between options and security futures, we do not believe that existing discretionary account authorizations should be expanded to include these new products. While we recognize requiring new discretionary account forms specifically authorizing trading in security futures may be of some burden to firms, we believe that customer protections achieved by such a requirement outweigh the burden. We note that the NFA does not require discretionary accounts to have specific written authorization to

trade security futures; however, we also note that the discretionary accounts under the NFA's jurisdiction are already specifically authorized to trade other types of futures.

Statements of Account

The proposed rule change requires members to deliver a customer account statement no less frequently than each month where there has been an entry during the preceding month with respect to a security futures contract and quarterly to all customers that have an open security futures position or money balance. The proposed customer account statement provision is comparable to the existing provision for options.

Opening of Accounts

We propose an account opening rule that contains specific procedures that a member must follow to approve a customer account to trade security futures. These procedures include review by an appropriately qualified principal (a Registered Options and Security Futures Principal or a Limited Principal—General Securities Sales Supervisor), specific guidance as to what information the member must ask the customer to provide, and a requirement for the member to furnish its customer with the security futures risk disclosure statement at or before the time that the member accepts an order from the customer to purchase or sell a security future. These account-opening procedures are similar to existing procedures for options.

Suitability

The proposed rule change includes a suitability rule that employs a heightened suitability standard that is similar to the NASD's suitability standard for options.¹⁰ This

¹⁰ See NASD Rule 2860(b)(19). In addition, we propose to add a cross-reference in the Fair Dealing with Customers Interpretative Material, IM-2310-2, which relates to the NASD's suitability rule. The cross-reference will refer readers to the suitability provision of the NASD's new security futures rule.

heightened standard recognizes that security futures carry a higher degree of risk to a customer than many other securities products. Specifically, under the proposed rules, if an associated person recommends a security futures transaction, the proposed suitability rule imposes the additional requirement that the associated person have a reasonable basis for believing "that the customer has such knowledge and experience in financial matters that the customer may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the security future."¹¹ We believe that the proposed suitability rule will require associated persons of broker/dealers to consider carefully whether to recommend a security futures transaction to a customer. In addition, NASD Regulation has expanded the security futures suitability standard to address trading strategies as well as individual trades. The expansion of the suitability standard to include a recommended "trading strategy" makes the proposed rule change consistent with the suitability standard for security futures adopted by the NFA.¹²

Security Futures Transactions and Reports by Market Makers in Listed Securities

NASD Regulation proposes a provision addressing security futures transactions and reports by market makers in listed securities that is comparable to the existing provision for options. This provision requires members that are off-board market makers in securities listed on a national securities exchange to regularly report security futures transactions involving 50 or more contracts on such listed securities that are for the

¹¹ See NASD Rule 2860(b)(19).

¹² NFA Rule 2-30(j)(4).

benefit of a member that is an off-board market maker in such securities or are for the benefit of certain associated persons of such a member.

Trading Ahead

The proposed rule change requires members to exercise due care to avoid trading ahead of customer orders. The proposed provision imposes an obligation on members not to trade ahead of customer security futures orders executable at or near the market price in a proprietary account or in any account in which the member or an associated person has an interest. The prohibition against trading ahead applies only to customer orders of which the member is aware or reasonably should be aware. This proposed provision is based on the rules that FCMs and IBs must follow regarding trading security futures ahead of customer orders.¹³

2. Advertising Rule for Security Futures

We propose amendments to the rule governing communications with the public, Rule 2210 ("Advertising Rule") to address security futures. The amendments, which are primarily contained in proposed Interpretive Material, establish advertising standards that are similar but not identical to the standards for options. The proposed rule change bases the security futures advertising provisions on the general advertising rule because we believe it will be easier for members to follow a modification of the general advertising rule rather than referring to a stand-alone security futures advertising rule.

Contrary to the requirement that a principal approves advertisements and sales literature under Rule 2210(b), however, the proposed rule specifies that advisements and sales literature concerning security futures must be approved by a Registered Options and

¹³ See NFA Rule 2-26; CFTC Regulations 155.3 & 155.4.

Security Futures Principal (Series 4). In particular, a General Securities Principal (Series 24) is not authorized to approve advertisements and sales literature concerning security futures.

The proposed rule contains a pre-use filing requirement for advertisements concerning security futures.¹⁴ As with the pre-use filing requirements for options communications, a member must file its security futures advertisements with the NASD's Advertising/Investment Companies Regulation Department ("Department") at least 10 days before the member can use the communication.¹⁵ Under the proposed rule change, the Department will review the advertisement and will either approve it, disapprove it, or specify changes that the firm must make to use the communication.

The proposed rule restricts the content of communications, which includes advertisements, sales literature, and correspondence, that are not accompanied or preceded by the security futures risk disclosure statement. Such communications may not contain statements of historical performance or projections. In addition, communications must be limited to general descriptions of security futures. These restrictions are similar to the advertising restrictions for options.

The proposed rule requires three specific disclosures about security futures. First, if the communication refers to the potential advantages of security futures, the

¹⁴ Although many of the provisions of the proposed advertising rule for security futures are similar to the options advertising rule, the definitions of "options advertisement," "educational material," and "sales literature" differ from the definitions that will apply to security futures. Because the security futures rule will follow the NASD's general advertising rule, the definition of "advertisement" is essentially material that is disseminated via mass media channels. See Rule 2210(a)(1). "Sales literature" is defined to include circulars, research reports, market letters, performance reports or summaries, form letters, telemarketing scripts, seminar texts, and reprints or excerpts of any other advertisement, sales literature, or published article that is distributed or made generally available to customers or the public. See Rule 2210(a)(2).

¹⁵ In particular circumstances, the Department may allow a shorter period than 10 days for its review.

communication must balance the mention of advantages with a reference, in the same degree of specificity, about the corresponding risks. This requirement of a closely balanced presentation of advantages and risks is a more exacting standard than is contained in the NASD's general standard for communications with the public, which prohibits exaggerated, unwarranted, or misleading statements. See Rule 2210(d)(1)(B). Second, the communication must include a warning that security futures are not suitable for all investors. We believe that the riskiness of security futures and the high leverage involved in these products makes security futures unsuitable for many investors. Third, the proposed rule requires that communications state that, upon request, the firm will provide documents that support any claims, comparisons, recommendations, statistics, or other technical data used in the communication. All three of these disclosure requirements are similar to the requirements for options communications.¹⁶

Because security futures communications will be subject to the NASD's general advertising rule, several general and specific standards will apply to security futures communications. Exaggerated, unwarranted, or misleading statements about security futures are not allowed. Communications must be based on principles of fair dealing and good faith and should provide a sound basis for evaluating the facts in regard to any security future. Moreover, no material fact or qualification may be omitted if the omission, in the light of the context of the material presented, would cause the communication to be misleading. Communications with the public cannot contain promises of specific results, exaggerated or unwarranted claims or unwarranted

¹⁶ See Rule 2220(d)(2)(A)(i) & (ii), 2220(d)(2)(D)(i).

superlatives, opinions for which there is no reasonable basis, or forecasts of future events that are unwarranted.

If a communication with the public makes a recommendation, the member must have a reasonable basis for the recommendation and must disclose, if applicable, several facts about its financial holdings in the issuer of a security related to its recommendation.

The proposed rule contains requirements for sales literature or correspondence that contain projections or historical performance information. These sections are similar to provisions in the options advertising rule and also are substantially similar to the NFA's requirement regarding communications with the public for security futures.¹⁷

3. Qualifications of Registered Persons

The securities industry has a wide array of qualification examinations that registered persons can take to qualify to engage in various aspects of the securities business. To accommodate the introduction of security futures, we propose a rule change to modify several registration categories. In general, where a registration category permits an individual to engage in an options business, we have modified the category to permit security futures. As part of this change, NASD Regulation is working with other self-regulatory organizations to develop revised qualification examinations that will test applicants on security futures-related topics. We anticipate that these revised qualification examinations will be completed by end of the third quarter of 2002.

The proposed rule change broadens the following qualifications categories to include security futures activities:

¹⁷ NFA Rule 2-29(j)(12). See 66 FR 49439 (Sept. 27, 2001)

- Registered Options Principal (Series 4) becomes Registered Options and Security Futures Principal¹⁸
- Limited Principal—General Securities Sales Supervisor (Series 9/10)
- General Securities Representative (Series 7)¹⁹
- Limited Representative—Options (Series 42) becomes Limited Representative—Options and Security Futures.²⁰

For persons who currently are registered in one of these registration categories, or who become registered in one of these registration categories prior to the implementation of new examinations addressing security futures, NASD Regulation is instituting a firm-element continuing education requirement. We will require each registered person (or persons that take certain qualification examinations prior to such examinations being updated to include security futures questions) to complete a firm-element continuing education program on security futures prior to conducting a business in security futures. NASD Regulation will, pursuant to Rule 1120(b)(4), specify the content of the continuing education program.²¹

¹⁸ The proposed rule change also deletes a few outdated concepts from the provisions of Rule 1022(f). These deletions are unrelated to security futures.

¹⁹ Specifically, for the Series 7, a separate module will be offered for registered representatives wishing to engage in a security futures business. Once the separate module is available, new applicants will choose to take either the Series 7 and the security futures module or only the Series 7. Persons taking only the Series 7 will not be permitted to engage in a security futures business. Completing a firm-element continuing education program will be an option available only for persons that are registered as a general securities representative before the separate security futures module becomes available.

²⁰ The Series 42 examination has alternative prerequisite examinations, the Limited Representative—Corporate Securities or Limited Representative—Government Securities examinations.

²¹ NASD Regulation has not previously specified the content of firm-element continuing education and does not intend to do so in the future absent extraordinary circumstances. The introduction of security futures in the United States, however, presents extraordinary circumstances because these products have been banned from trading here for more than 19 years. Under these circumstances, NASD Regulation has

NASD Regulation's proposal, in effect, allows Registered Options Principals, Limited Principals—General Securities Sales Supervisors, General Securities Representatives, and Limited Representatives—Options to be "grandfathered" so that they will not be required to retake any expanded qualification examinations to sell or supervise security futures products. The "grandfathering" privilege will be limited to associated persons who are registered as Series 4, 7, 9/10, or 42.

4. Short Sale Restrictions

To ensure consistent treatment between broker/dealers and FCMs and IBs, the CFMA exempts transactions in security futures from the short sale provisions of Section 10(a) of the Exchange Act.²² Without this exemption, sales of security futures would be subject to short sale restrictions if effected by a broker/dealer, but not if effected by an FCM or IB, because short sale restrictions are not included in the CEA, the rules of the CFTC, or the rules of futures contract markets.

To harmonize the NASD's rules with the amended short sale provision in the Exchange Act, NASD Regulation proposes to amend the affirmative determination provisions of NASD Rule 3370.²³ Rule 3370 generally requires an NASD member, prior to accepting a short sale order from a customer in any security, to make an affirmative determination that the member can borrow or otherwise provide for delivery of the security by the settlement date. We propose to amend the affirmative determination

concluded that using its authority set forth in Rule 1120(b)(4) to specify content of the firm element is appropriate.

²² See Exchange Act §10(a)(2); 15 U.S.C. §78j(a)(2).

²³ For Nasdaq National Market securities, the NASD's rules currently include an additional short sale restriction: the bid test. See Rule 3350(a). We believe that the bid test has no application to security futures, and we are not proposing any amendments to Rule 3350.

requirement to exempt security futures from the application of the rule.²⁴ The proposed amendment would eliminate a member's affirmative determination obligation with respect to any short sale of a security future.

We further propose to amend the definition of "bona fide fully hedged" positions to include certain long single stock futures positions in connection with short positions in the underlying stock. The amendment will treat long single stock futures positions similar to in-the-money call options, which are included in the categories of bone fide fully hedged positions.

5. Taping Requirement of the Supervision Rule

NASD Rule 3010(b)(2) (the "Taping Rule") requires certain NASD members to tape record "all telephone conversations between the member's registered persons and both existing and potential customers"²⁵ and maintain other special written procedures for supervising the telemarketing activities of all of its registered persons. NASD members become subject to the Taping Rule if a certain percentage of their registered persons have been employed by a disciplined firm within the last three years. The Taping Rule prevents registered persons who have been employed by disciplined firms from clustering together at a different firm. A disciplined firm is one that, in connection with sales practices involving the offer, purchase, or sale of any security, has been expelled from

²⁴ Currently, the affirmative determination requirement of Rule 3370 does not apply to options transactions.

²⁵ Rule 3010(b)(2)(iii). The NASD has pending with the Commission a separate proposed rule change to Rule 3010(b)(2) that, among other changes, would permit firms that become subject to the Taping Rule a one-time opportunity to adjust their staffing level to fall below the prescribed threshold levels and thus avoid application of the Taping Rule. See SR-NASD-2002-04 (Jan. 4, 2002) <http://www.nasdr.com/pdf-text/rf02_04.pdf>.

NASD membership, expelled from any other securities industry SRO, or is subject to an order of the SEC revoking its registration as a broker/dealer.

In the futures industry, the NFA's taping rule requires NFA members that have a certain percentage of associated persons who have been employed by disciplined firms to tape record telephone conversations between associated persons and customers. The NFA has a three-fold definition of a disciplined firm that includes the following: (1) the firm has been formally charged by either the CFTC or NFA with deceptive telemarketing practices or promotional material; (2) the charges have been resolved; and (3) the firm has been closed down and permanently barred from the industry as a result of those charges.²⁶

NASD Regulation proposes to broaden the scope of its Taping Rule to include FCMs and IBs that will be selling security futures within the group of intermediaries that can potentially meet the definition of a disciplined firm. The proposed rule change borrows the NFA's definition of a disciplined firm and adds it to the NASD's existing definition.

6. Qualifications of Job Applicants

NASD Rule 3010(e) provides that members have a responsibility to investigate the good character, business reputes, qualifications, and experience of a job applicant before the member applies to register that applicant with the NASD. When the job applicant previously has been registered with the NASD, the member must obtain a copy of the applicant's Uniform Termination Notice of Securities Industry Registration (Form U-5) that was filed by the applicant's most recent member employer.

²⁶

NFA Rule 2-9: Enhanced Supervisory Requirements – Interpretive Notice.

NASD Regulation proposes to add a requirement that would apply when a job applicant has been most recently employed by an FCM or an IB that is registered to trade securities futures, meaning the FCM or IB has notice-registered with the SEC pursuant to Section 15(b)(11) of the Exchange Act.²⁷ In such a case, the hiring firm would be required to review a copy of CFTC Form 8-T, Notice of Termination of Associated Person, NFA Associate, Branch Office Manager, Designated Supervisor or Principal. The Form 8-T asks for the same types of information as does the Form U-5.

The purpose of this proposed amendment is to modify an NASD member's obligation to review a job applicant's employment experience to include an applicant's experience while with a notice-registered broker/dealer. An individual's experience at such a firm may bear on his or her fitness to be sponsored by an NASD member. We anticipate that NASD members will be able to review the CFTC Form 8-T by requesting it from the applicant or the applicant's previous employer.

NASD Regulation is also amending Rule 3010(e) to provide members with greater flexibility in complying with its requirements. Currently, Rule 3010(e) requires members to obtain actual copies of the Form U-5 and amendments. When NASD replaced the Legacy Central Registration Depository ("CRD") system with Web CRDsm in August 1999, members received the ability to review Form U-5s and amendments via an internet connection. The Web CRD system allows members, with the applicant's consent, to review the Form U-5 by using a pre-hire search function. The proposed rule change recognizes the ability of members to use the advanced functionality of Web CRD

²⁷ 66 FR 45137 (Aug. 27, 2001).

to review Form U-5s. Members, however, will be expected to be able to demonstrate compliance with the Rule.

7. Front Running Policy

The NASD's front running policy, IM-2110-3, prohibits members and associated persons from trading options or an underlying security when they have material, non-public market information concerning an imminent block transaction in the underlying security or in the overlying option. The front running policy applies to member's proprietary accounts, accounts in which a member or an associated person has an interest, discretionary accounts, and—when the member or a person associated with a member shares material, non-public market information with a customer—the customer's account.

NASD Regulation proposes to amend the front running policy to include security futures by having the rule apply to security futures in the same manner that it applies to options. For example, when a member has material, non-public market information concerning an imminent block transaction in a stock, the member will not be able to trade the single-stock future overlying that stock in its proprietary account, other accounts in which it has an interest, or discretionary accounts. The purpose of this proposed amendment is to prohibit broker/dealers from trading security futures at a profit when they have material, non-public market information concerning a stock or from trading a stock at a profit when they have material, non-public market information concerning a security future. Once the material, non-public market information has been made publicly available, however, the restrictions of the front running policy will no longer apply.

8. Transactions for or by Associated Persons

NASD Rule 3050 requires associated persons who seek to open accounts or place securities orders with an NASD firm that is not their employer to notify both their employer firm and the executing firm before they engage in such actions. This rule allows NASD firms to monitor the securities activities of their employees for the purpose of complying with several securities laws and regulations. NASD Regulation proposes to broaden the scope of the rule to require associated persons to notify their employer firm when they open an account with an FCM or IB that is registered to trade security futures.

(b) Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD Regulation believes that these rule changes are necessary to implement the requirements of the CFMA and to establish new regulations that allow broker/dealers, FCMs, and IBs to trade security futures consistent with the CFMA.

4. Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

6. Extension of Time Period for Commission Action

NASD Regulation does not consent at this time to an extension of the time period for Commission action specified in Section 19(b)(2) of the Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission

Pursuant to Section 15A(k)(2)(B)(i) of the Exchange Act, to qualify as a limited purpose national securities association, the NFA must have rules governing sales practices and the advertising of security futures that are reasonably comparable to the NASD's rules. Although NASD Regulation's proposed rule change is not based on the NFA's security futures rules, it is closely related to those rules.

9. Exhibits

1. Completed notice of proposed rule change for publication in the Federal Register.

Pursuant to the requirements of the Securities Exchange Act of 1934, NASD Regulation has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

NASD REGULATION, INC.

BY: _____
Patrice M. Gliniecki
Vice President and Acting General Counsel

Date: March 21, 2002

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. SR-NASD-2002-40)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to NASD Rules 1022, 1032, 2210, 3010, 3370, IM-1022-1, and IM-1022-2 and new Rules 2865 and IM-2210-7.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² notice is hereby given that on , the National Association of Securities Dealers, Inc. ("NASD" or "Association"), through its wholly owned subsidiary, NASD Regulation, Inc. ("NASD Regulation"), filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Regulation

I. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE TERMS OF SUBSTANCE OF THE PROPOSED RULE CHANGE

NASD Regulation is proposing to amend and create several rules of the NASD to prepare for the trading of security futures. Specifically, the proposed rule change: (1) amends Rule 1022 (Categories of Principal Registration), Interpretive Material 1022-1 (Registered Options Principals), Interpretive Material 1022-2 (Limited Principal—General Securities Sales Supervisor), and Rule 1032 (Categories of Representative Registration) to expand several registration categories to include engaging in and supervising security futures transactions; (2) amends Interpretive Material 2110-3 (Front Running Policy) to add block trading in single stock futures to the prohibition

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR § 240.19b-4.

against front running; (3) amends Rule 2210 (Communications with the Public) and creates new Interpretive Material 2210-7 (Guidelines for Communications with the Public Regarding Security Futures) to regulate communications with the public regarding security futures; (4) amends Interpretive Material 2310-2 (Fair Dealing with Customers) to refer to new proposed Rule 2865 regarding security futures sales practices; (5) creates new Rule 2865 to regulate security futures sales practices; (6) amends Rule 3010(b)(2) (the Taping Rule) to recognize the ability of futures regulators to expel a member for futures-related sales practice violations; (7) amends Rule 3010(e) (Supervision) to require firms to check the backgrounds of job applicants who have previously worked in the futures industry; (8) amends Rule 3050 (Transactions for or by Associated Persons) to require associated persons to notify their member firm when they open certain futures accounts; and (9) amends Rule 3370 (Prompt Receipt and Delivery of Securities) to extend to security futures. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

* * *

1000. Membership, Registration and Qualification Requirements

* * *

1020. Registration of Principals

* * *

1022. Categories of Principal Registration

(a) – (e) No change

(f) Registered Options and Security Futures Principals

(1) Every member of the Association [which] that is engaged in, or [which] that intends to engage in transactions in security futures or put or call options with the public shall have at least one Registered Options and Security Futures Principal who shall have satisfied the requirements of this subparagraph. As to options transactions, each [such] member shall also designate a Senior Registered Options Principal and a Compliance Registered Options Principal in accordance with the provisions of Rule 2860(b)(20) and identify such persons to the Association. [A member which has a Registered Options Principal qualified in either put or call options shall not engage in both put and call option transactions until such time as it has a Registered Options Principal qualified in both such options.] Every person engaged in the management of the day-to-day options or security futures activities of a member shall also be registered as a Registered Options and Security Futures Principal. [In the event any Registered Options Principal ceases to act in such capacity, such fact shall be reported promptly to the Association together with a brief statement of the reasons therefor.]

(2) Each person required by subparagraph (f)(1) [hereof] to be a Registered Options and Security Futures Principal shall pass the appropriate Qualification Examination for Registered Options and Security Futures Principal, or an equivalent examination acceptable to the Association [Corporation], for the purpose of demonstrating an adequate knowledge of options and security futures trading generally, the Rules of the Association applicable to trading of option and

security futures contracts and the rules of registered clearing agencies for options and security futures [the Options Clearing Corporation], and be registered as such before engaging in the duties or accepting the responsibilities of a Registered Options and Security Futures Principal.

[(3) A person shall not qualify as a Registered Options Principal for both put and call options unless he has passed an examination testing him with respect to both put and call options.]

~~(3)~~[(4)] Each person required to register and qualify as a Registered Options and Security Futures Principal must, prior to or concurrent with such registration, be or become qualified pursuant to the Rule 1030 Series, as either a General Securities Representative or a Limited Representative—Corporate Securities and [also be or become qualified pursuant to Rule 1032(d) as] a Registered Options and Security Futures Representative.

~~(4)~~[(5)] A person registered solely as a Registered Options and Security Futures Principal shall not be qualified to function in a principal capacity with responsibility over any area of business activity not prescribed in subparagraph (1) [hereof].

~~(5)~~[(6)] Any person who is registered with the Association as a Registered Options and Security Futures Principal may not supervise security futures activities unless such person has completed a firm-element continuing education requirement that addresses security futures and a principal's responsibilities for security futures. After a revised examination that includes security futures products is offered, a person associated with a member that passes such a revised

Qualification Examination for Registered Options and Security Futures Principal is not required to complete a firm-element continuing education requirement that addresses security futures and a principal's responsibilities for security futures to supervise activities in such products, except as otherwise required by Rule 1120 generally or by the member firm.

(g) Limited Principal ³/₄ General Securities Sales Supervisor

(1) – (2) No change

(g)(3) Any person who is registered with the Association as a Limited Principal—General Securities Sales Supervisor may not act in a limited principal capacity with regard to security futures products unless such person has completed a firm-element continuing education requirement that addresses security futures and a principal's responsibilities for security futures. After a revised examination that includes security futures products is offered, a person associated with a member that passes such a revised Qualification Examination for Limited Principal—General Securities Sales Supervisor is not required to complete a firm-element continuing education requirement that addresses security futures and a principal's responsibilities for security futures to supervise such products, except as otherwise required by Rule 1120 generally or by the member firm.

IM-1022-1. Registered Options and Security Futures Principals

Members having a single Registered Options and Security Futures Principal are required promptly to notify the Association in the event such person is terminated,

resigns, becomes incapacitated or is otherwise unable to perform the duties of an Options and Security Futures Principal.

Following receipt of such notification, the Association will require members to agree, in writing, to refrain from engaging in any options- or security futures-related activities [which] that would necessitate the prior or subsequent approval of an Options and Security Futures Principal including, among other things, the opening of new options or security futures accounts or the execution of discretionary orders for option or security futures contracts until such time as a new Registered Options and Security Futures Principal has been qualified.

Members failing to qualify a new Registered Options and Security Futures Principal within two weeks following the loss of their sole Registered Options and Security Futures Principal, or by the earliest available date for administration of the [Series 4] Registered Options and Security Futures Principal examination, whichever is longer, shall be required to cease doing an options and security futures business; provided, however, they may effect closing transactions in options and offsetting transactions in security futures [in order] to reduce or eliminate existing open options or security futures positions in their own account as well as the accounts of their customers.

IM-1022-2. Limited Principal^¾ General Securities Sales Supervisor

Limited Principal—General Securities Sales Supervisor is an alternate category of registration designed to lessen the qualification burdens on principals of general securities firms who supervise sales. Without this category of limited registration, such principals could be required to separately qualify pursuant to the rules of the NASD, MSRB, NYSE and the options exchanges. While persons may continue to separately

qualify with all relevant self-regulatory organizations, the Limited Principal—General Securities Sales Supervisor Examination permits qualification as a supervisor of sales of all securities by one examination. Persons registered as Limited Principals—General Securities Sales Supervisor may also qualify in any other category of principal registration. Persons who are already qualified in one or more categories of principal registration may supervise sales activities of all securities by also qualifying as Limited Principals—General Securities Sales Supervisor.

Functions that may be performed by Limited Principals—General Securities Sales Supervisors. Any person required to be registered as a principal who supervises sales activities in corporate, municipal and option securities, investment company products, variable contracts, [and] direct participation programs, and security futures may be registered solely as a Limited Principal—General Securities [Sale] Sales Supervisor. In addition to branch office managers, other persons such as regional and national sales managers may also be registered solely as Limited Principals—General Securities Sales Supervisor as long as they supervise only sales activities. Qualification as a General Securities Representative is a prerequisite for registration as a Limited Principal—General Securities Sales Supervisor.

* * *

1032. Categories of Representative Registration

(a) General Securities Representative

(1) No change

(2)(A)-(D) No change

(2)(E) A person who is registered with the Association as a General Securities Representative may not act as a General Securities Representative with regard to security futures products unless such person has completed a firm-element continuing education requirement that addresses security futures products. After a revised examination or module that includes security futures products is offered, a person associated with a member who passes such a revised Qualification Examination for General Securities Representative is not required to complete a firm-element continuing education requirement that addresses security futures to act as a General Securities Representative with regard to such products, except as otherwise required by Rule 1120 generally or by the member firm. Once a revised examination or module that includes security futures becomes available, persons seeking to become a General Securities Representative will be expected to pass such revised examination to act as a General Securities Representative with regard to security futures products. Only persons registered as a General Securities Representative prior to the time that such revised examination or module is available, will be eligible to use a firm-element continuing education program in lieu of passing the revised examination or module to engage in a security futures business.

(a)(2)(E)-(I) Renumbered accordingly

(a)(3) A person registered as a General Securities Representative shall not be qualified to function as a Registered Options and Security

Futures Representative unless he or she is also qualified and registered as such pursuant to the provisions of paragraph (d) [hereof].

(b) and (c) No change

(d) Limited Representative ³/₄ Options and Security Futures

(1) Each person associated with a member who is included within the definition of a representative as defined in Rule 1031 may register with the Association as a Limited Representative—Options and Security Futures if:

(A) such person's activities in the investment banking or securities business of the member involve the solicitation or sale of option or security futures contracts, including option contracts on government securities as that term is defined in Section 3(a)(42)(D) of the Act, for the account of a broker, dealer or public customer; and

(B) such person passes an appropriate qualification examination for Limited Representative—Options and Security Futures.

(2) Each person seeking to register and qualify as a Limited Representative—Options and Security Futures must, concurrent with or before such registration may become effective, become registered pursuant to the Rule 1032 Series, either as a Limited Representative—Corporate Securities or Limited Representative—Government Securities.

(3) A person registered as a Limited Representative—Options and Security Futures shall not be qualified to function in any area not described in subparagraph (1)(A) [hereof].

(4) Any person who is registered with the Association as a Limited Representative—Options and Security Futures may not act as a limited representative with regard to security futures products unless such person has completed a firm-element continuing education requirement that addresses security futures. After a revised examination that includes security futures products is offered, a person associated with a member who passes such a revised Qualification Examination for Limited Representative—Options and Security Futures is not required to complete a firm-element continuing education requirement that addresses security futures to act as a limited representative with regard to such products, except as otherwise required by Rule 1120 generally or by the member firm.

(e) - (h) No change

* * *

IM-2110-3. Front Running Policy

* * *

(a) an order to buy or sell an option or a security future when such member or person associated with a member causing such order to be executed has material, non-public market information concerning an imminent block transaction in the underlying security, or when a customer has been provided such material, non-public market information by the member or any person associated with a member; or

(b) an order to buy or sell an underlying security when such member or person associated with a member causing such order to be executed has material,

non-public market information concerning an imminent block transaction in an option or a security future overlying that security, or when a customer has been provided such material, non-public market information by the member or any person associated with a member;

prior to the time information concerning the block transaction has been made publicly available.

* * *

These prohibitions also do not include situations in which a member or person associated with a member receives a customer's order of block size relating to both an option and the underlying security or both a security future and the underlying security. In such cases, the member and person associated with a member may position the other side of one or both components of the order. However, in these instances, the member and person associated with a member would not be able to cover any resulting proprietary position(s) by entering an offsetting order until information concerning the block transaction involved has been made publicly available.

The application of this front running policy is limited to transactions that are required to be reported on the last sale reporting systems administered by Nasdaq, Consolidated Tape Association (CTA), or Option Price Reporting Authority (OPRA). The front running policy also applies to security futures transactions regardless of whether such products are reported pursuant to such systems. Information as to a block transaction shall be considered to be publicly available when it has been disseminated via the tape or high speed communications line of one of those systems, a similar system of a

national securities exchange under Section 6 of the Act, an alternative trading system under Regulation ATS, or by [of] a third-party news wire service.

A transaction involving 10,000 shares or more of an underlying security, or options or security futures covering such number of shares is generally deemed to be a block transaction, although a transaction of less than 10,000 shares could be considered a block transaction in appropriate cases. A block transaction that has been agreed upon does not lose its identity as such by arranging for partial executions of the full transaction in portions which themselves are not of block size if the execution of the full transaction may have a material impact on the market. In this situation, the requirement that information concerning the block transaction be made publicly available will not be satisfied until the entire block transaction has been completed and publicly reported.

* * *

2210. Communications with the Public

(a) No change

(b) Approval and Recordkeeping

(1) Each item of advertising and sales literature shall be approved by signature or initial, prior to use or filing with the Association, by a registered principal of the member. This requirement may be met, only with respect to corporate debt and equity securities that are the subject of research reports as the term is defined in Rule 472 of the New York Stock Exchange, by the signature or initial of a supervisory analyst approved pursuant to Rule 344 of the New York Stock Exchange. This requirement may be met, only with respect to advertising

and sales literature concerning security futures, by the signature or initial of a Registered Options and Security Futures Principal.

(b)(2) and (c)(1) No change

(c)(2) Advertisements concerning collateralized mortgage obligations, advertisements concerning security futures, and advertisements and sales literature concerning registered investment companies (including mutual funds, variable contracts and unit investment trusts) that include or incorporate rankings or comparisons of the investment company with other investment companies where the ranking or comparison category is not generally published or is the creation, either directly or indirectly, of the investment company, its underwriter or an affiliate, shall be filed with the Department for review at least 10 days prior to use (or such shorter period as the Department may allow in particular circumstances) for approval and, if changed by the Association, shall be withheld from publication or circulation until any changes specified by the Association have been made or, if expressly disapproved, until the advertisement has been refiled for, and has received, Association approval. The member must provide with each filing the actual or anticipated date of first use. Any member filing any investment company advertisement or sales literature pursuant to this paragraph shall include a copy of the data, ranking or comparison on which the ranking or comparison is based.

(c)(3) – (c)(9) No Change

(d)(1) No Change

(d)(2)(A) No Change

(B)(i)a. that the member usually makes a market in the securities being recommended, or in the underlying security if the recommended security is an option or security future, or that the member or associated persons will sell to or buy from customers on a principal basis;

(B)(i)b. that the member and/or its officers or partners own options, security futures, rights or warrants to purchase any of the securities of the issuer whose securities are recommended, unless the extent of such ownership is nominal;

(B)(i)c. No Change

(B)(ii) – (B)(iv) No Change

* * *

IM-2210-7. Guidelines for Communications with the Public Regarding Security Futures

(a) Association Approval Requirements and Review Procedures

(1) As set forth in paragraph (c)(2) of Rule 2210, all advertisements concerning security futures shall be submitted to the Advertising/Investment Companies Regulation Department of the Association at least ten days prior to use for approval and, if changed by the Association, shall be withheld from circulation until any changes specified by the Association have been made or, in the event of disapproval, until the advertisement has been refiled for, and has received, Association approval.

(2) The requirements of this paragraph (a) shall not be applicable to:

(A) advertisements submitted to another self-regulatory organization having comparable standards pertaining to such advertisements, and

(B) advertisements in which the only reference to security futures is contained in a listing of the services of a member organization.

(b) Disclosure Statement

(1) All communications concerning security futures shall be accompanied or preceded by the security futures risk disclosure statement unless they meet the following requirements:

(A) Such communications shall be limited to general descriptions of the security futures being offered.

(B) Such communications shall contain contact information for obtaining a copy of the security futures risk disclosure statement.

(C) Such communications shall not contain recommendations or past or projected performance figures, including annualized rates of return.

(2) Communications concerning security futures that meet the requirements of subparagraph (1) may have the following characteristics:

(A) the text of the communication may contain a brief description of security futures, including a statement that identifies registered clearing agencies for security futures. The text may also contain a brief description of the general attributes and method of operation of the security exchange

or notice-registered securities exchange on which such security futures are traded, including a discussion of how a security future is priced;

(B) the communication may include any statement required by any state law or administrative authority; and

(C) advertising designs and devices, including borders, scrolls, arrows, pointers, multiple and combined logos and unusual type faces and lettering as well as attention-getting headlines and photographs and other graphics may be used, provided such material is not misleading.

(c) Recordkeeping

Consistent with paragraph (b)(2) of Rule 2210, a member shall keep a separate file of all advertisements and sales literature concerning security futures, including the name(s) of the person(s) who prepared them and approved their use for a period of three years from the date of each use. In addition, members shall meet the same recordkeeping requirements for all correspondence concerning security futures. In the case of sales literature concerning security futures, a member shall record the source of any recommendation contained therein.

(d) Specific Standards

(1) The special risks attendant to security futures transactions and the complexities of certain security futures investment strategies shall be reflected in any communications that discuss the uses or advantages of security futures. Any statement referring to the potential opportunities or advantages presented by security futures shall be balanced by a statement of the corresponding risks. The

risk statement shall reflect the same degree of specificity as the statement of opportunities, and broad generalities should be avoided.

(2) Security futures communications shall include a warning to the effect that security futures are not suitable for all investors and such communications shall not contain suggestions to the contrary.

(3) Security futures communications shall state that supporting documentation for any claims (including any claims made on behalf of security futures programs or the security futures expertise of sales persons), comparisons, recommendations, statistics or other technical data, will be supplied upon request.

(4) No cautionary statements or caveats, often called hedge clauses, may be used in communications with the public if they are not legible, are misleading, or are inconsistent with the content of the material.

(5) Statements suggesting the certain availability of a secondary market for security futures shall not be made.

(e) Projections

Notwithstanding the provisions of Rule 2210(d)(2)(N), security futures sales literature and correspondence may contain projected performance figures (including projected annualized rates of return), provided that:

(1) all such sales literature and correspondence must be accompanied or preceded by the security futures risk disclosure statement;

(2) no suggestion of certainty of future performance is made;

(3) parameters relating to such performance figures are clearly established;

(4) all relevant costs, including commissions, fees, and interest charges (as applicable) are disclosed and reflected in the projections;

(5) such projections are plausible and are intended as a source of reference or a comparative device to be used in the development of a recommendation;

(6) all material assumptions made in such calculations are clearly identified;

(7) the risks involved in the proposed transactions are also disclosed; and

(8) in communications relating to annualized rates of return, that such returns are not based upon any less than a sixty-day experience; any formulas used in making calculations are clearly displayed; and a statement is included to the effect that the annualized returns cited might be achieved only if the parameters described can be duplicated and that there is no certainty of doing so.

(f) Historical Performance

Security futures sales literature and correspondence may feature records and statistics that portray the performance of past recommendations or of actual transactions, provided that:

(1) all such sales literature and correspondence must be accompanied or preceded by the security futures risk disclosure statement;

(2) any such portrayal is done in a balanced manner, and consists of records or statistics that are confined to a specific "universe" that can be fully isolated and circumscribed and that covers at least the most recent 12-month period;

(3) such communications include the date of each initial recommendation or transaction, the price of each such recommendation or transaction as of such date, and the date and price of each recommendation or transaction at the end of the period or when liquidation was suggested or effected, whichever was earlier; provided that if the communications are limited to summarized or averaged records or statistics, in lieu of the complete record there may be included the number of items recommended or transacted, the number that advanced and the number that declined, together with an offer to provide the complete record upon request;

(4) such communications disclose all relevant costs, including commissions, fees, and daily margin obligations (as applicable);

(5) whenever such communications contain annualized rates of return, such communications shall disclose all material assumptions used in the process of annualization;

(6) an indication is provided of the general market conditions during the period(s) covered, and any comparison made between such records and statistics and the overall market (e.g., comparison to an index) is valid;

(7) such communications state that the results presented should not and cannot be viewed as an indicator of future performance; and

(8) a principal qualified to supervise security futures activities determines that the records or statistics fairly present the status of the recommendations or transactions reported upon and so initials the report.

(g) Security Futures Programs

In communications regarding a security futures program (i.e., an investment plan employing the systematic use of one or more security futures strategies), the cumulative history or unproven nature of the program and its underlying assumptions shall be disclosed.

(h) Standard Forms of Worksheets

Such worksheets must be uniform within a member firm. If a member has adopted a standard form of worksheet for a particular security futures strategy, nonstandard worksheets for that strategy may not be used.

(i) Recordkeeping

Communications that portray performance of past recommendations or actual transactions and completed worksheets shall be kept at a place easily accessible to the sales office for the accounts or customers involved.

* * *

IM-2310-2. Fair Dealing with Customers

(a)(1) to (e) (opening paragraph) No change

(e)(1) Security Futures

Members must comply with the Rules, regulations and procedures applicable to security futures contained in Rule 2865.

(e)(1) and (e)(2) are renumbered as (e)(2) and (e)(3) respectively.

* * *

2865. Security Futures

(a) For purposes of this Rule, the term "security future" shall have the definition specified in Section 3(a)(55) of the Act.

(b) Requirements

(1) General

(A) Applicability—This Rule shall be applicable to the trading of security futures.

(B) Paragraphs (12) and (15) shall apply only to security futures carried in securities accounts.

(C) Except to the extent that specific provisions in this Rule govern, or unless the context otherwise requires, the provisions of the By-Laws and Rules and all other interpretations and policies of the Board of Governors shall also be applicable to the trading of security futures.

(2) Definitions

(A) The terms "Beneficial Owner," "Control," and "Controls," "Is Controlled by" or "Is Under Common Control With" shall have the same meanings as in Rule 2860.

(B) The term "principal qualified to supervise security futures activities" means a Registered Options and Security Futures Principal who, consistent with Rule 1022, has either completed a firm-element continuing education requirement that addresses security futures and a principal's responsibilities for security futures or has passed a revised qualification examination for Registered Options and Security Futures

Principals that covers security futures, or a Limited Principal—General Securities Sales Supervisor who, consistent with Rule 1022, has either completed a firm-element continuing education requirement that addresses security futures and a principal's responsibilities for security futures or has passed a revised qualification examination for Limited Principal—General Securities Sales Supervisor.

(3) – (7) Reserved

(8) Restrictions on Security Futures Transactions

The Association may impose from time to time such restrictions on security futures transactions that it determines are necessary in the interest of maintaining a fair and orderly market in security futures, or in the underlying securities covered by such security futures, or otherwise necessary in the public interest or for the protection of investors. During the period of any such restriction, no member shall effect any security futures transaction in contravention of such restriction.

(9) – (10) Reserved

(11) Delivery of Security Futures Risk Disclosure Statement

(A) Every member shall deliver the current security futures risk disclosure statement to each customer at or prior to the time such customer's account is approved for trading security futures. Thereafter, each new or revised security futures risk disclosure statement shall be distributed to every customer having an account approved for such trading or, in the alternative, shall be distributed not later than the time a

confirmation of a transaction is delivered to each customer who enters into a security futures transaction. The Association will advise members when a new or revised current security futures risk disclosure statement is available.

(B) Where a broker or dealer enters its orders with another member in a single omnibus account, the member holding the account shall take reasonable steps to assure that such broker or dealer is furnished reasonable quantities of the current security futures risk disclosure statement.

(C) Where an introducing broker or dealer enters orders for its customers with, or clears transactions through, a member on a fully disclosed basis and that member carries the accounts of such customers, the responsibility for delivering the current security futures risk disclosure statement as provided in this paragraph (b)(11) shall rest with the member carrying the accounts. However, such member may rely upon the good faith representation of the introducing broker or dealer that the current security futures risk disclosure statement has been delivered in compliance with paragraph (b)(11).

(12) Confirmations

Every member shall promptly furnish to each customer a written confirmation of each transaction in security futures for such customer's account. Each such confirmation shall show the market on which the security futures position was executed, whether the security futures position is a long or short

position, the underlying security or narrow-based index, the expiration date, the quantity of the underlying security or narrow-based index, the number of security futures contracts, the amount of initial and maintenance margin required, the commission, the trade and settlement dates, whether the transaction was a purchase or a sale transaction, whether the transaction was an opening or offsetting transaction, and whether the transaction was effected on a principal or agency basis.

(13) – (14) Reserved

(15) Statements of Account

(A) Statements of account showing security and money positions, entries, interest charges, and any special charges that have been assessed against such account during the period covered by the statement shall be sent no less frequently than once every month to each customer in whose account there has been an entry during the preceding month with respect to a security futures contract and quarterly to all customers having an open security futures position or money balance. Interest charges and any special charges assessed during the period covered by the statement need not be specifically delineated if they are otherwise accounted for on the statement and have been itemized on transaction confirmations. With respect to security futures customers having a general (margin) account, such statements shall also provide the mark-to-market price and market value of each security futures position and other security positions in the general (margin) account, the total market value of all positions in the

account, the outstanding debit or credit balance in the account, and the general (margin) account equity. The statements shall bear a legend stating that further information with respect to commissions and other charges related to the execution of security futures transactions has been included in confirmations of such transactions previously furnished to the customer, and that such information will be made available to the customer promptly upon request. The statements shall also bear a legend requesting the customer promptly to advise the member of any material change in the customer's investment objectives or financial situation.

(B) For purposes of this subparagraph (15), general (margin) account equity shall be computed by subtracting the total of the "short" security values and any debit balance from the total of the "long" security values and any credit balance.

(16) Opening of Accounts

(A) Approval Required

No member or person associated with a member shall accept an order from a customer to purchase or sell a security future, or approve the customer's account for the trading of security futures, unless the broker or dealer furnishes or has furnished to the customer the appropriate security futures risk disclosure statement and the customer's account has been approved for security futures trading in accordance with the provisions of subparagraphs (B) through (D) hereof.

(B) Diligence in Opening Accounts

In approving a customer's account for security futures trading, a member or any person associated with a member shall exercise due diligence to ascertain the essential facts relative to the customer, the customer's financial situation and investment objectives. Members shall establish specific minimum net equity requirements for initial approval and maintenance of customers' security futures accounts. Based upon such information, a principal qualified to supervise security futures activities shall specifically approve or disapprove in writing the customer's account for security futures trading. For account approvals, the written record shall include the reasons for approval.

(i) With respect to security futures customers who are natural persons, members shall seek to obtain the following information at a minimum (information shall be obtained for all participants in a joint account):

a. Investment objectives (e.g., safety of principal, income, growth, trading profits, or speculation);

b. Employment status (name of employer, self-employed, or retired);

c. Estimated annual income from all sources;

d. Estimated net worth (exclusive of family residence);

e. Estimated liquid net worth (cash, securities, or other);

f. Marital status and number of dependents;

g. Age; and,

h. Investment experience and knowledge (e.g., number of years, size, frequency and type of transactions) for futures, commodities, options, stocks, bonds, and other financial instruments.

(ii) In addition, a customer's account records shall contain the following information, if applicable:

a. Source or sources of background and financial information (including estimates) concerning the customer;

b. Discretionary authorization agreement on file, name, relationship to customer, and experience of person holding trading authority;

c. Date disclosure document(s) furnished to customer;

d. Name of registered representative;

e. Name of principal approving account and date of approval; and

f. Dates of verification of currency of account information.

(iii) Members should consider using a standard account approval form to ensure the receipt of all the required information.

(iv) Refusal of a customer to provide any of the information specified in subparagraph (i) shall be so noted on the customer's records at the time the account is opened. Information provided shall be considered together with the other information available in determining whether to approve the account for security futures trading.

(v) A record of the information obtained pursuant to this subparagraph (B) and of the approval or disapproval of each account shall be maintained by the member as part of its records in accordance with paragraph (b)(17) herein.

(D) Verification of Customer Background and Financial Information

For every natural person whose account has been approved for security futures trading, the background and financial information upon which the account was approved shall be sent to the customer for verification within fifteen (15) days after the customer's account has been approved for security futures trading. This verification requirement shall not apply if the background and financial information is included in the customer's account agreement or if the member has previously verified the customer's information in connection with an options account. A copy of the background and financial information on file with a member also shall be sent to the customer for verification within fifteen (15) days after the

member becomes aware of any material change in the customer's financial situation.

Members shall satisfy the initial and subsequent verification of customer background and financial information by sending to the customer the information required in paragraph (B)(i)(a) through (i)(f) hereof, as contained in the member's records and providing the customer with an opportunity to correct or complete the information. In all cases, absent advice from the customer to the contrary, the information will be deemed to be verified.

(D) Account Agreement

Within fifteen (15) days after a customer's account has been approved for security futures trading, a member shall obtain from the customer a written agreement that the customer is aware of and agrees to be bound by the Rules of the Association applicable to the trading of security futures and, that the customer has received a copy of the current security futures risk disclosure statement. In addition, the customer should indicate on such written agreement that the customer is aware of and agrees not to violate applicable security futures position limits.

(17) Maintenance of Records

(A) In addition to the requirements of Rule 3110, every member shall maintain and keep current a separate central log, index, or other file for all security futures-related complaints, through which these complaints can easily be identified and retrieved. The central file shall be located at

the principal place of business of the member or such other principal office as shall be designated by the member. At a minimum, the central file shall include: (i) identification of complainant; (ii) date complaint was received; (iii) identification of registered representative servicing the account; (iv) a general description of the matter complained of; and (v) a record of what action, if any, has been taken by the member with respect to the complaint. For purposes of this subparagraph, the term "security futures-related complaint" shall mean any written statement by a customer or person acting on behalf of a customer alleging a grievance arising out of or in connection with security futures. Each security futures-related complaint received by a branch office of a member shall be forwarded to the office in which the separate, central file is located not later than 30 days after receipt by the branch office that is the subject of the complaint. A copy of every security futures-related complaint shall also be maintained at the branch office that is the subject of the complaint.

(B) Background and financial information of customers who have been approved for security futures trading shall be maintained at both the branch office servicing the customer's account and the principal supervisory office having jurisdiction over that branch office. Copies of account statements of security futures customers shall also be maintained at both the branch office supervising the accounts and the principal supervisory office having jurisdiction over that branch for the most recent six-month period. With respect solely to the above-noted record retention

requirements applicable to principal supervisory offices, however, the customer information and account statements may be maintained at a location other than the principal supervisory office if such documents and information are readily accessible and promptly retrievable. Other records necessary to the proper supervision of accounts shall be maintained at a place easily accessible both to the branch office servicing the customer's account and to the principal supervisory office having jurisdiction over that branch office.

(18) Discretionary Accounts

(A) Authorization and Approval

(i) No member or person associated with a member shall exercise any discretionary power with respect to trading in security futures in a customer's account, or accept orders for security futures for an account from a person other than the customer, except in compliance with the provisions of Rule 2510 and unless:

a. The written authorization of the customer required by Rule 2510 shall specifically authorize security futures trading in the account; and

b. the account shall have been accepted in writing by a principal qualified to supervise security futures activities.

(ii) When analyzing an account to determine if it should be approved for security futures trading, a principal qualified to

supervise security futures activities shall have a reasonable basis for believing that the customer was able to understand and bear the risk of the strategies or transactions proposed, and shall maintain a record of the basis for such determination. Each discretionary order shall be approved and initialed on the day entered by the branch office manager or other principal qualified to supervise security futures activities, provided that if the branch officer is not a principal qualified to supervise security futures activities, such approval shall be confirmed within a reasonable time by a principal qualified to supervise security futures activities. Each discretionary order shall be identified as discretionary on the order at the time of entry. Discretionary accounts shall receive frequent appropriate supervisory review. The provisions of this subparagraph (18) shall not apply to discretion as to the price at which or the time when an order given by a customer for the purchase or sale of a definite number of security futures contracts in a specified security shall be executed.

(B) Record of Transactions

A record shall be made of every transaction in security futures contracts in respect to which a member or person has exercised discretionary authority, clearly reflecting such fact and indicating the name of the customer, the designation and number of the security futures

contracts, the price of the contract, and the date and time when such transaction was effected.

(C) Security Futures Programs

Where the discretionary account uses security futures programs involving the systematic use of one or more security futures strategies, the customer shall be furnished with a written explanation of the nature and risks of such programs.

(19) Suitability

(A) No member or person associated with a member shall recommend to any customer any transaction or trading strategy for the purchase or sale of a security future unless such member or person associated with the member has reasonable grounds to believe upon the basis of information furnished by the customer after reasonable inquiry by the member or person associated with the member concerning the customer's investment objectives, financial situation and needs, and any other information known by the member or associated person, that the recommended transaction or trading strategy is not unsuitable for the customer.

(B) No member or person associated with a member shall recommend to a customer a transaction in any security future unless the person making the recommendation has a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that the customer may

reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the security future.

(20) Reserved

(21) Violation of By-Laws and Rules of the Association or a Registered Clearing Agency

(A) In Association disciplinary proceedings, a finding of violation of any provision of the rules, regulations, or by-laws of a registered clearing agency under Section 17A(b)(8) of the Act by any member or person associated with a member engaged in security futures transactions cleared by such registered clearing agency, may be deemed to be conduct inconsistent with just and equitable principles of trade and a violation of Rule 2110.

(B) In Association disciplinary proceedings, a finding of violation of any provision of the Rules, regulations or By-Laws of the Association by any member or person associated with a member engaged in security futures transactions may be deemed to be conduct inconsistent with just and equitable principles of trade and a violation of Rule 2110.

(22) – (23) Reserved

(24) Security Futures Transactions and Reports by Market Makers in Listed Securities

Every member that is an off-board market maker in a security listed on a national securities exchange shall report to the Association in accordance with such procedures as may be prescribed by the Board of Governors, transactions

involving 50 or more security futures contracts on such listed securities that are either directly for the benefit of (A) the member or (B) any employee, partner, officer, or director of the member who, by virtue of his or her position with the member, is directly involved in the purchase or sale of the underlying security for the firm's proprietary account(s) or is directly responsible for supervision of such persons; or who by virtue of his or her position in the firm, is authorized to, and regularly does, obtain information on the proprietary account(s) of the member in which the underlying security is traded. This subparagraph shall apply to all security futures transactions including those executed on an exchange to which the member may belong.

(25) Trading Ahead of Customer Orders

Every member shall use due care to avoid trading ahead of a customer's security futures order that is executable at or near the market price. A member must transmit a security futures customer order that is executable at or near the market price to a securities exchange or a notice-registered securities exchange before it transmits any order in the same security future for any proprietary account, or for any account in which it or any person associated with it is directly or indirectly interested. A member must exercise the due care required by this subsection when the member has gained knowledge of or reasonably should have gained knowledge of the customer's order prior to the transmission to a securities exchange or a notice-registered securities exchange of the member's order for a proprietary account, or for any account in which it or any person associated with it is directly or indirectly interested.

* * *

3010. Supervision

(b) No change

(b)(1) – (b)(2)(ix) No change

(b)(2)(x) For purposes of this Rule, the term "disciplined firm" means either a member that, in connection with sales practices involving the offer, purchase, or sale of any security, has been expelled from membership or participation in any securities industry self-regulatory organization or is subject to an order of the Securities and Exchange Commission revoking its registration as a broker/dealer; or a futures commission merchant or introducing broker that has been formally charged by either the Commodity Futures Trading Commission or a registered futures association with deceptive telemarketing practices or promotional material relating to security futures, those charges have been resolved, and the futures commission merchant or introducing broker has been closed down and permanently barred from the futures industry as a result of those charges; or a futures commission merchant or introducing broker that, in connection with sales practices involving the offer, purchase, or sale of security futures is subject to an order of the Securities and Exchange Commission revoking its registration as a broker or dealer.

(b)(2)(xi) No change

(c) – (d) No change

(e) Qualifications Investigated

Each member shall have the responsibility and duty to ascertain by investigation the good character, business repute, qualifications, and experience of any person prior to making such a certification in the application of such person for registration with this Association. Where an applicant for registration has previously been registered with the Association, the member shall review [obtain from the Central Registration Depository or from the applicant] a copy of the Uniform Termination Notice of Securities Industry Registration (Form U-5) filed with the Association by such person's most recent previous NASD member employer, together with any amendments thereto that may have been filed pursuant to Article V, Section 3 of the Association's By-Laws. The member shall review [obtain] the Form U-5 as required by this Rule no later than sixty (60) days following the filing of the application for registration or demonstrate to the Association that it has made reasonable efforts to comply with the requirement. [A member receiving a Form U-5 pursuant to this Rule shall review] In conducting its review of the Form U-5 and any amendments thereto, a member [and] shall take such action as may be deemed appropriate.

Where an applicant for registration has been previously registered with a registered futures association ("RFA") member that is or has been registered as a broker/dealer pursuant to Section 15(b)(11) of the Act ("notice-registered broker/dealer") with the SEC to trade security futures, the member shall review a copy of the Notice of Termination of Associated Person (Form 8-T) filed with the RFA by such person's most recent previous RFA member employer, together with any amendments thereto. The

member shall review the Form 8-T as required by this Rule no later than sixty (60) days following the filing of the application for registration or demonstrate to the Association that it has made reasonable efforts to comply with the requirement. In conducting its review of a Form 8-T and any amendments, a member shall take such action as may be deemed appropriate.

(f) and (g) No change

* * *

3050. Transactions for or by Associated Persons

(a) – (c) No change

(d) Obligations of Associated Persons Concerning an Account with a Notice-Registered Broker/Dealer, Investment Adviser, Bank, or Other Financial Institution

A person associated with a member who opens a securities account or places an order for the purchase or sale of securities with a broker/dealer that is registered pursuant to Section 15(b)(11) of the Act ("notice-registered broker/dealer"), a domestic or foreign investment adviser, bank, or other financial institution, except a member, shall:

(1) notify his or her employer member in writing, prior to the execution of any initial transactions, of the intention to open the account or place the order; and

(2) upon written request by the employer member, request in writing and assure that the notice-registered broker/dealer, investment adviser, bank, or other financial institution provides the employer member with duplicate copies of confirmations, statements, or other information concerning the account or order;

provided, however, that if an account subject to this paragraph (d) was established prior to a person's association with a member, the person shall comply with this paragraph promptly after becoming so associated.

* * *

3370. Prompt Receipt and Delivery of Securities

(a) No change

(b) Sales

(1) No change

(2) "Short Sales"

(A) Customer short sales

No member or person associated with a member shall accept a "short" sale order for any customer in any security unless the member or person associated with a member makes an affirmative determination that the member will receive delivery of the security from the customer or that the member can borrow the security on behalf of the customer for delivery by settlement date. This requirement shall not apply, however, to transactions in corporate debt securities or transactions in security futures, as defined in Section 3(a)(55) of the Act.

(B) Proprietary short sales

No member shall effect a "short" sale for its own account in any security unless the member or person associated with a member makes an affirmative determination that the member can borrow the securities or otherwise provide for delivery of the securities by the settlement date.

This requirement will not apply to transactions in corporate debt securities, to transactions in security futures, as defined in Section 3(a)(55) of the Act, to bona fide market making transactions by a member in securities in which it is registered as a Nasdaq market maker, to bona fide market maker transactions in non-Nasdaq securities in which the market maker publishes a two-sided quotation in an independent quotation medium, or to transactions [which] that result in fully hedged or arbitrated positions.

(3) – (4) No change

(5)(A)(i) through (iii) No change

(iv) Short a security and long a single stock future of the underlying security.

Example: Long 1 single stock future of MNOP.

- With the circumstances as above (and assuming a contract size of 100) 100 shares would be exempt.
- Even if the expiration date for the single stock future was more than 90 calendar days, 100 shares would be exempt.

* * *

II. SELF-REGULATORY ORGANIZATION'S STATEMENT OF THE PURPOSE OF, AND STATUTORY BASIS FOR, THE PROPOSED RULE CHANGE

In its filing with the Commission, NASD Regulation included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be

examined at the places specified in Item IV below. NASD Regulation has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(1) Purpose

The Commodity Futures Modernization Act of 2000 ("CFMA") authorizes the trading of futures on individual stocks and narrow-based stock indices. Under the CFMA, security futures are defined as "securities" under Section 3(a)(10) of the Exchange Act. As a result, NASD Regulation is modifying existing rules that cover securities and developing new rules to accommodate these new securities products.³

The regulatory framework established by the CFMA for the markets and intermediaries trading security futures provides the SEC and Commodity Futures Trading Commission ("CFTC") with joint jurisdiction. Broker/dealers that wish to conduct a business in security futures are required to notice register as Futures Commission Merchants ("FCMs") or Introducing Brokers ("IBs") with the CFTC.⁴ Similarly, FCMs and IBs that wish to conduct a business in security futures are required to notice register as broker/dealers with the SEC.⁵ FCMs and IBs that are notice-registered with the SEC do not, however, need to become members of the NASD. The NASD's proposed rules on security futures apply only to NASD members.

³ NASD Regulation also has filed a proposed rule change to add NASD Rule 3115 and to amend NASD Rule 3340 to establish record-keeping requirements for Alternative Trading Systems ("ATs") that trade security futures, and to require ATs to coordinate trading halts with markets trading the underlying securities and markets trading related securities. (SR-NASD-2001-47). See 66 FR 41076 (Aug. 6, 2001).

⁴ 66 FR 43227 (Aug. 17, 2001).

⁵ 66 FR 45138 (Aug. 27, 2001).

1. Security Futures Rule

One of the underpinnings of the CFMA is that the regulation of security futures should be comparable to the regulation of options.⁶ NASD Regulation and the National Futures Association ("NFA")⁷ are required under the CFMA to develop rules regulating activity in security futures.⁸

The proposed securities futures rule, Rule 2865, is based principally upon the NASD's options rule, Rule 2860.⁹ For purposes of clarity, we have styled the rule as a separate, stand-alone rule from our options rule; however, to facilitate compliance by member firms that are familiar with the NASD's options rule, we have maintained the same structure and, where possible, much of the same rule text.

In reviewing our options rule and the security futures rules of the NFA, we determined that it was not necessary to replicate every provision in the options rules for security futures. Certain concepts for options are not relevant for security futures. For

⁶ For example, the CFMA establishes that margin requirements for security futures be consistent with comparable option contracts and that listing standards for security futures be no less restrictive than comparable listing standards for options traded on a national securities exchange or a national securities association. See Exchange Act §§7(c)(2) & 6(h)(3)(C); 15 U.S.C. §§ 78g(c)(2) & 78f(h)(3)(C).

⁷ The NFA is currently the only registered futures association under the Commodity Exchange Act ("CEA"). Under the CFMA, the NFA, as a registered futures association, may apply to the SEC for registration as a limited-purpose national securities association. The function of a limited-purpose national securities association is limited to carrying out the purposes of the securities laws applicable to securities futures and to regulating the activities of its members that have notice-registered with the SEC to trade security futures. See Exchange Act §15A(k); 15 U.S.C. §78o-3(k).

⁸ Sales practice rules for security futures, and specifically the suitability rule, are subject to the CFMA's requirement that the NFA's rules on these subjects be reasonably comparable to the NASD's rules. Exchange Act §15A(k)(2)(B)(i); 15 U.S.C. §78o-3(k)(2)(B)(i). NASD Regulation believes that it is important for the NASD's and the NFA's rules to be comparable in these areas.

⁹ The Commission published a group of new NFA rules and amendments to NFA rules governing security futures on September 27, 2001. See 66 FR 49439 (Sept. 27, 2001). The NFA's rules also were modeled after the NASD's options rules. In developing the NASD's security futures rule, we have sought to adopt requirements that are consistent with those of the NFA to avoid regulatory disparity between firms subject to the jurisdiction of the NFA and the NASD.

example, provisions pertaining to the "exercise" of options were not carried forward into the security futures rule because security futures are not "exercised" as options are. We also have eliminated sections pertaining to "Transactions with Issuers" and "Restricted Stock," and have not included provisions concerning position limits and the reporting of security futures positions, which will instead be addressed by each exchange or market trading security futures, as appropriate.

A discussion of the proposed rule change is set forth below.

The NASD's security futures rule applies to all NASD member firms. Many of these members will be broker/dealers that notice register with the CFTC as an FCM or IB. Other members will be fully registered with both the SEC and CFTC ("fully registered firms"). In a joint notice of proposed rulemaking,¹⁰ the SEC and CFTC requested comment on whether the application of the customer account statement and confirmation rules should depend on the type of account in which security futures are held (e.g., in a securities account at a broker/dealer, or a futures account at an FCM).¹¹ The proposed rule change adopts what appears to be the resolution of this issue – namely, that the customer account statement and confirmation rules will apply based upon the type of account used for the security futures. Thus, the paragraphs of the security futures rule pertaining to customer account statements and confirmations apply only to security futures held in security accounts. Fully registered firms that hold security futures in an FCM account would follow the rules of the CFTC addressing customer account statements and confirmations.

¹⁰ 66 FR 50786 (Oct. 4, 2001).

¹¹ Id. at 50791.

Liquidation of Positions and Restrictions on Access

We propose provisions on liquidation of positions and restrictions on access that are substantively similar to those in the NASD's options rule.

Restrictions on Security Futures Transactions

We propose restrictions on security futures transactions that are substantively similar to those in the NASD's options rule.

Delivery of Security Futures Risk Disclosure Statement

The proposed rule change requires every member to deliver the security futures risk disclosure statement to each customer at or prior to the time such customer's account is approved for trading security futures. In general, the requirements for delivery of the security futures risk disclosure statement are comparable to the requirements for the delivery of the options disclosure document. The security futures risk disclosure statement discusses the risks of security futures; describes how security futures trade; and addresses margin for security futures, effects of leverage, settlement procedures, customer account protections, and tax consequences.

Confirmations

The proposed rule change requires each member promptly to furnish each customer with a written confirmation of each security futures transaction. The proposed rule change also specifies the items that must be included on the confirmation. In general, the provisions addressing confirmations of security futures transactions are comparable to the provisions currently in place for options.

Discretionary Accounts

The proposed rule change adopts discretionary account procedures for security futures that are comparable to those for options. Notably, as with options, the procedures require that the written authorization of the customer required by NASD Rule 2510 specifically authorize security futures trading in the account. The implication of this requirement is that all discretionary accounts, even those that are permitted to trade options, cannot trade security futures unless a new written discretionary account authorization specifically authorizing trading of security futures is on file. Although there are many similarities between options and security futures, we do not believe that existing discretionary account authorizations should be expanded to include these new products. While we recognize requiring new discretionary account forms specifically authorizing trading in security futures may be of some burden to firms, we believe that customer protections achieved by such a requirement outweigh the burden. We note that the NFA does not require discretionary accounts to have specific written authorization to trade security futures; however, we also note that the discretionary accounts under the NFA's jurisdiction are already specifically authorized to trade other types of futures.

Statements of Account

The proposed rule change requires members to deliver a customer account statement no less frequently than each month where there has been an entry during the preceding month with respect to a security futures contract and quarterly to all customers that have an open security futures position or money balance. The proposed customer account statement provision is comparable to the existing provision for options.

Opening of Accounts

We propose an account opening rule that contains specific procedures that a member must follow to approve a customer account to trade security futures. These procedures include review by an appropriately qualified principal (a Registered Options and Security Futures Principal or a Limited Principal—General Securities Sales Supervisor), specific guidance as to what information the member must ask the customer to provide, and a requirement for the member to furnish its customer with the security futures risk disclosure statement at or before the time that the member accepts an order from the customer to purchase or sell a security future. These account-opening procedures are similar to existing procedures for options.

Suitability

The proposed rule change includes a suitability rule that employs a heightened suitability standard that is similar to the NASD's suitability standard for options.¹² This heightened standard recognizes that security futures carry a higher degree of risk to a customer than many other securities products. Specifically, under the proposed rules, if an associated person recommends a security futures transaction, the proposed suitability rule imposes the additional requirement that the associated person have a reasonable basis for believing "that the customer has such knowledge and experience in financial matters that the customer may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended

¹² See NASD Rule 2860(b)(19). In addition, we propose to add a cross-reference in the Fair Dealing with Customers Interpretative Material, IM-2310-2, which relates to the NASD's suitability rule. The cross-reference will refer readers to the suitability provision of the NASD's new security futures rule.

position in the security future."¹³ We believe that the proposed suitability rule will require associated persons of broker/dealers to consider carefully whether to recommend a security futures transaction to a customer. In addition, NASD Regulation has expanded the security futures suitability standard to address trading strategies as well as individual trades. The expansion of the suitability standard to include a recommended "trading strategy" makes the proposed rule change consistent with the suitability standard for security futures adopted by the NFA.¹⁴

Security Futures Transactions and Reports by Market Makers in Listed Securities

NASD Regulation proposes a provision addressing security futures transactions and reports by market makers in listed securities that is comparable to the existing provision for options. This provision requires members that are off-board market makers in securities listed on a national securities exchange to regularly report security futures transactions involving 50 or more contracts on such listed securities that are for the benefit of a member that is an off-board market maker in such securities or are for the benefit of certain associated persons of such a member.

Trading Ahead

The proposed rule change requires members to exercise due care to avoid trading ahead of customer orders. The proposed provision imposes an obligation on members not to trade ahead of customer security futures orders executable at or near the market price in a proprietary account or in any account in which the member or an associated person has an interest. The prohibition against trading ahead applies only to customer

¹³ See NASD Rule 2860(b)(19).

¹⁴ NFA Rule 2-30(j)(4).

orders of which the member is aware or reasonably should be aware. This proposed provision is based on the rules that FCMs and IBs must follow regarding trading security futures ahead of customer orders.¹⁵

2. Advertising Rule for Security Futures

We propose amendments to the rule governing communications with the public, Rule 2210 ("Advertising Rule") to address security futures. The amendments, which are primarily contained in proposed Interpretive Material, establish advertising standards that are similar but not identical to the standards for options. The proposed rule change bases the security futures advertising provisions on the general advertising rule because we believe it will be easier for members to follow a modification of the general advertising rule rather than referring to a stand-alone security futures advertising rule.

Contrary to the requirement that a principal approves advertisements and sales literature under Rule 2210(b), however, the proposed rule specifies that advisements and sales literature concerning security futures must be approved by a Registered Options and Security Futures Principal (Series 4). In particular, a General Securities Principal (Series 24) is not authorized to approve advertisements and sales literature concerning security futures.

The proposed rule contains a pre-use filing requirement for advertisements concerning security futures.¹⁶ As with the pre-use filing requirements for options

¹⁵ See NFA Rule 2-26; CFTC Regulations 155.3 & 155.4.

¹⁶ Although many of the provisions of the proposed advertising rule for security futures are similar to the options advertising rule, the definitions of "options advertisement," "educational material," and "sales literature" differ from the definitions that will apply to security futures. Because the security futures rule will follow the NASD's general advertising rule, the definition of "advertisement" is essentially material that is disseminated via mass media channels. See Rule 2210(a)(1). "Sales literature" is defined to include circulars, research reports, market letters, performance reports or summaries, form letters, telemarketing

communications, a member must file its security futures advertisements with the NASD's Advertising/Investment Companies Regulation Department ("Department") at least 10 days before the member can use the communication.¹⁷ Under the proposed rule change, the Department will review the advertisement and will either approve it, disapprove it, or specify changes that the firm must make to use the communication.

The proposed rule restricts the content of communications, which includes advertisements, sales literature, and correspondence, that are not accompanied or preceded by the security futures risk disclosure statement. Such communications may not contain statements of historical performance or projections. In addition, communications must be limited to general descriptions of security futures. These restrictions are similar to the advertising restrictions for options.

The proposed rule requires three specific disclosures about security futures. First, if the communication refers to the potential advantages of security futures, the communication must balance the mention of advantages with a reference, in the same degree of specificity, about the corresponding risks. This requirement of a closely balanced presentation of advantages and risks is a more exacting standard than is contained in the NASD's general standard for communications with the public, which prohibits exaggerated, unwarranted, or misleading statements. See Rule 2210(d)(1)(B). Second, the communication must include a warning that security futures are not suitable for all investors. We believe that the riskiness of security futures and the high leverage involved in these products makes security futures unsuitable for many investors. Third,

scripts, seminar texts, and reprints or excerpts of any other advertisement, sales literature, or published article that is distributed or made generally available to customers or the public. See Rule 2210(a)(2).

the proposed rule requires that communications state that, upon request, the firm will provide documents that support any claims, comparisons, recommendations, statistics, or other technical data used in the communication. All three of these disclosure requirements are similar to the requirements for options communications.¹⁷

Because security futures communications will be subject to the NASD's general advertising rule, several general and specific standards will apply to security futures communications. Exaggerated, unwarranted, or misleading statements about security futures are not allowed. Communications must be based on principles of fair dealing and good faith and should provide a sound basis for evaluating the facts in regard to any security future. Moreover, no material fact or qualification may be omitted if the omission, in the light of the context of the material presented, would cause the communication to be misleading. Communications with the public cannot contain promises of specific results, exaggerated or unwarranted claims or unwarranted superlatives, opinions for which there is no reasonable basis, or forecasts of future events that are unwarranted.

If a communication with the public makes a recommendation, the member must have a reasonable basis for the recommendation and must disclose, if applicable, several facts about its financial holdings in the issuer of a security related to its recommendation.

The proposed rule contains requirements for sales literature or correspondence that contain projections or historical performance information. These sections are similar

¹⁷ In particular circumstances, the Department may allow a shorter period than 10 days for its review.

¹⁸ See Rule 2220(d)(2)(A)(i) & (ii), 2220(d)(2)(D)(i).

to provisions in the options advertising rule and also are substantially similar to the NFA's requirement regarding communications with the public for security futures.¹⁹

3. Qualifications of Registered Persons

The securities industry has a wide array of qualification examinations that registered persons can take to qualify to engage in various aspects of the securities business. To accommodate the introduction of security futures, we propose a rule change to modify several registration categories. In general, where a registration category permits an individual to engage in an options business, we have modified the category to permit security futures. As part of this change, NASD Regulation is working with other self-regulatory organizations to develop revised qualification examinations that will test applicants on security futures-related topics. We anticipate that these revised qualification examinations will be completed by end of the third quarter of 2002.

The proposed rule change broadens the following qualifications categories to include security futures activities:

- Registered Options Principal (Series 4) becomes Registered Options and Security Futures Principal²⁰
- Limited Principal—General Securities Sales Supervisor (Series 9/10)
- General Securities Representative (Series 7)²¹

¹⁹ NFA Rule 2-29(j)(12). See 66 FR 49439 (Sept. 27, 2001)

²⁰ The proposed rule change also deletes a few outdated concepts from the provisions of Rule 1022(f). These deletions are unrelated to security futures.

²¹ Specifically, for the Series 7, a separate module will be offered for registered representatives wishing to engage in a security futures business. Once the separate module is available, new applicants will choose to take either the Series 7 and the security futures module or only the Series 7. Persons taking only the Series 7 will not be permitted to engage in a security futures business. Completing a firm-element continuing education program will be an option available only for persons that are registered as a general securities representative before the separate security futures module becomes available.

- Limited Representative—Options (Series 42) becomes Limited Representative—Options and Security Futures.²²

For persons who currently are registered in one of these registration categories, or who become registered in one of these registration categories prior to the implementation of new examinations addressing security futures, NASD Regulation is instituting a firm-element continuing education requirement. We will require each registered person (or persons that take certain qualification examinations prior to such examinations being updated to include security futures questions) to complete a firm-element continuing education program on security futures prior to conducting a business in security futures. NASD Regulation will, pursuant to Rule 1120(b)(4), specify the content of the continuing education program.²³

NASD Regulation's proposal, in effect, allows Registered Options Principals, Limited Principals—General Securities Sales Supervisors, General Securities Representatives, and Limited Representatives—Options to be "grandfathered" so that they will not be required to retake any expanded qualification examinations to sell or supervise security futures products. The "grandfathering" privilege will be limited to associated persons who are registered as Series 4, 7, 9/10, or 42.

²² The Series 42 examination has alternative prerequisite examinations, the Limited Representative—Corporate Securities or Limited Representative—Government Securities examinations.

²³ NASD Regulation has not previously specified the content of firm-element continuing education and does not intend to do so in the future absent extraordinary circumstances. The introduction of security futures in the United States, however, presents extraordinary circumstances because these products have been banned from trading here for more than 19 years. Under these circumstances, NASD Regulation has concluded that using its authority set forth in Rule 1120(b)(4) to specify content of the firm element is appropriate.

4. Short Sale Restrictions

To ensure consistent treatment between broker/dealers and FCMs and IBs, the CFMA exempts transactions in security futures from the short sale provisions of Section 10(a) of the Exchange Act.²⁴ Without this exemption, sales of security futures would be subject to short sale restrictions if effected by a broker/dealer, but not if effected by an FCM or IB, because short sale restrictions are not included in the CEA, the rules of the CFTC, or the rules of futures contract markets.

To harmonize the NASD's rules with the amended short sale provision in the Exchange Act, NASD Regulation proposes to amend the affirmative determination provisions of NASD Rule 3370.²⁵ Rule 3370 generally requires an NASD member, prior to accepting a short sale order from a customer in any security, to make an affirmative determination that the member can borrow or otherwise provide for delivery of the security by the settlement date. We propose to amend the affirmative determination requirement to exempt security futures from the application of the rule.²⁶ The proposed amendment would eliminate a member's affirmative determination obligation with respect to any short sale of a security future.

We further propose to amend the definition of "bona fide fully hedged" positions to include certain long single stock futures positions in connection with short positions in the underlying stock. The amendment will treat long single stock futures positions

²⁴ See Exchange Act §10(a)(2); 15 U.S.C. §78j(a)(2).

²⁵ For Nasdaq National Market securities, the NASD's rules currently include an additional short sale restriction: the bid test. See Rule 3350(a). We believe that the bid test has no application to security futures, and we are not proposing any amendments to Rule 3350.

²⁶ Currently, the affirmative determination requirement of Rule 3370 does not apply to options transactions.

similar to in-the-money call options, which are included in the categories of bone fide fully hedged positions.

5. Taping Requirement of the Supervision Rule

NASD Rule 3010(b)(2) (the "Taping Rule") requires certain NASD members to tape record "all telephone conversations between the member's registered persons and both existing and potential customers"²⁷ and maintain other special written procedures for supervising the telemarketing activities of all of its registered persons. NASD members become subject to the Taping Rule if a certain percentage of their registered persons have been employed by a disciplined firm within the last three years. The Taping Rule prevents registered persons who have been employed by disciplined firms from clustering together at a different firm. A disciplined firm is one that, in connection with sales practices involving the offer, purchase, or sale of any security, has been expelled from NASD membership, expelled from any other securities industry SRO, or is subject to an order of the SEC revoking its registration as a broker/dealer.

In the futures industry, the NFA's taping rule requires NFA members that have a certain percentage of associated persons who have been employed by disciplined firms to tape record telephone conversations between associated persons and customers. The NFA has a three-fold definition of a disciplined firm that includes the following: (1) the firm has been formally charged by either the CFTC or NFA with deceptive telemarketing practices or promotional material; (2) the charges have been resolved; and (3) the firm

²⁷ Rule 3010(b)(2)(iii). The NASD has pending with the Commission a separate proposed rule change to Rule 3010(b)(2) that, among other changes, would permit firms that become subject to the Taping Rule a one-time opportunity to adjust their staffing level to fall below the prescribed threshold levels and thus avoid application of the Taping Rule. See SR-NASD-2002-04 (Jan. 4, 2002) <http://www.nasdr.com/pdf-text/rf02_04.pdf>.

has been closed down and permanently barred from the industry as a result of those charges.²⁸

NASD Regulation proposes to broaden the scope of its Taping Rule to include FCMs and IBs that will be selling security futures within the group of intermediaries that can potentially meet the definition of a disciplined firm. The proposed rule change borrows the NFA's definition of a disciplined firm and adds it to the NASD's existing definition.

6. Qualifications of Job Applicants

NASD Rule 3010(e) provides that members have a responsibility to investigate the good character, business repute, qualifications, and experience of a job applicant before the member applies to register that applicant with the NASD. When the job applicant previously has been registered with the NASD, the member must obtain a copy of the applicant's Uniform Termination Notice of Securities Industry Registration (Form U-5) that was filed by the applicant's most recent member employer.

NASD Regulation proposes to add a requirement that would apply when a job applicant has been most recently employed by an FCM or an IB that is registered to trade securities futures, meaning the FCM or IB has notice-registered with the SEC pursuant to Section 15(b)(11) of the Exchange Act.²⁹ In such a case, the hiring firm would be required to review a copy of CFTC Form 8-T, Notice of Termination of Associated Person, NFA Associate, Branch Office Manager, Designated Supervisor or Principal. The Form 8-T asks for the same types of information as does the Form U-5.

²⁸ NFA Rule 2-9: Enhanced Supervisory Requirements – Interpretive Notice.

²⁹ 66 FR 45137 (Aug. 27, 2001).

The purpose of this proposed amendment is to modify an NASD member's obligation to review a job applicant's employment experience to include an applicant's experience while with a notice-registered broker/dealer. An individual's experience at such a firm may bear on his or her fitness to be sponsored by an NASD member. We anticipate that NASD members will be able to review the CFTC Form 8-T by requesting it from the applicant or the applicant's previous employer.

NASD Regulation is also amending Rule 3010(e) to provide members with greater flexibility in complying with its requirements. Currently, Rule 3010(e) requires members to obtain actual copies of the Form U-5 and amendments. When NASD replaced the Legacy Central Registration Depository ("CRD") system with Web CRDsm in August 1999, members received the ability to review Form U-5s and amendments via an internet connection. The Web CRD system allows members, with the applicant's consent, to review the Form U-5 by using a pre-hire search function. The proposed rule change recognizes the ability of members to use the advanced functionality of Web CRD to review Form U-5s. Members, however, will be expected to be able to demonstrate compliance with the Rule.

7. Front Running Policy

The NASD's front running policy, IM-2110-3, prohibits members and associated persons from trading options or an underlying security when they have material, non-public market information concerning an imminent block transaction in the underlying security or in the overlying option. The front running policy applies to member's proprietary accounts, accounts in which a member or an associated person has an interest,

discretionary accounts, and—when the member or a person associated with a member shares material, non-public market information with a customer—the customer's account.

NASD Regulation proposes to amend the front running policy to include security futures by having the rule apply to security futures in the same manner that it applies to options. For example, when a member has material, non-public market information concerning an imminent block transaction in a stock, the member will not be able to trade the single-stock future overlying that stock in its proprietary account, other accounts in which it has an interest, or discretionary accounts. The purpose of this proposed amendment is to prohibit broker/dealers from trading security futures at a profit when they have material, non-public market information concerning a stock or from trading a stock at a profit when they have material, non-public market information concerning a security future. Once the material, non-public market information has been made publicly available, however, the restrictions of the front running policy will no longer apply.

8. Transactions for or by Associated Persons

NASD Rule 3050 requires associated persons who seek to open accounts or place securities orders with an NASD firm that is not their employer to notify both their employer firm and the executing firm before they engage in such actions. This rule allows NASD firms to monitor the securities activities of their employees for the purpose of complying with several securities laws and regulations. NASD Regulation proposes to broaden the scope of the rule to require associated persons to notify their employer firm when they open an account with an FCM or IB that is registered to trade security futures.

(2) Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that the Association's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD Regulation believes that these rule changes are necessary to implement the requirements of the CFMA and to establish new regulations that allow broker/dealers, FCMs, and IBs to trade security futures consistent with the CFMA.

(B) Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

Written comments were neither solicited nor received.

III. DATE OF EFFECTIVENESS OF THE PROPOSED RULE CHANGE AND TIMING FOR COMMISSION ACTION

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. by order approve such proposed rule change, or

B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. SOLICITATION OF COMMENTS

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by [insert date 21 days from the date of publication].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

Jonathan G. Katz
Secretary