

Grace Yeh  
Assistant General Counsel

Direct: (202) 728-6939  
Fax: (202) 728-8264

May 31, 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-2002-04, Amendment No. 1 - Amendments to the Taping Rule**

Dear Ms. England:

Pursuant to discussions with staff of the Division of Market Regulation, NASD Regulation, Inc. ("NASD Regulation") hereby submits Amendment No. 1 to SR-NASD-2002-04 (the "rule filing"). Also enclosed as Exhibit 1 is a draft Notice, which incorporates the amendments described herein to the proposed rule change, to facilitate publication in the *Federal Register*, together with a 3-1/2" disk containing Exhibit 1 in Microsoft Word 7.0 format. The amendments to the rule filing are as follows (new language is underlined and deleted text is bracketed):

1. Summary of Comments. The rule filing included as Exhibit 4 a summary of the comments received in response to Notice to Members 01-38. NASD Regulation proposes moving the discussion of the comments received from Exhibit 4 to the text of the rule filing. Item No. 5 appearing on pages 14 and 15 of the rule filing is amended as follows:

The proposed rule change was published for comment in NASD Notice to Members 01-38 (June 2001). Sixteen comments were received in response to the Notice.<sup>1</sup> A copy of the Notice to Members is attached as Exhibit 2. Copies of the comment letters received in response to the Notice[, and a brief summary of those comments,] are attached as Exhibit[s] 3 [and 4]. Of the 16 comment letters received, 12 were in favor of the proposed rule change and 4 were opposed.

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<sup>1</sup> Comments letters were received from: Anonymous; Robert Banks ("Banks"); Patricia Bartholomew, Thinkequity Partners ("Bartholomew"); Clark Dodge & Company, Inc. ("Clark Dodge"); E.E. Powell & Company Inc. ("E.E. Powell"); First Liberty Investment Group ("First Liberty"); Jerard Basmagy, First Montauk Securities Corp. ("Basmagy"); Joseph Stevens & Co., Inc. ("Joseph Stevens"); J.P. Turner & Company, LLC ("J.P. Turner"); Alexander Nova ("Nova"); Personalized Investments, Inc. ("Personalized Investments"); Rushmore Securities Corp. ("Rushmore"); Matthew Schonberg, Aegis Capital Corp. ("Schonberg"), Seth Schwartz, Washington Square Securities, Inc. ("Schwartz"); Maryanne Sylenko ("Sylenko"); and James Welch, Morgan Stanley (Fort Worth, Texas) ("Welch").

Section II(C) of Exhibit 1 appearing on page 29 of the rule filing also is amended as follows:

The proposed rule change was published for comment in NASD Notice to Members 01-38 (June 2001). Sixteen comments were received in response to the Notice.<sup>2</sup> Copies of the comment letters [and a brief summary of the comments] have been provided to the Commission. Of the 16 comment letters received, 12 were in favor of the proposed rule change and 4 were opposed.

In addition, the following text should be inserted after the amended first paragraphs of both Item No. 5 and Section II(C) of Exhibit 1.

Establishment of a 30-day Staff Adjustment Period: Generally, the commenters supported the proposal to allow member firms that become subject to the Taping Rule for the first time to make a downward adjustment of staff in order to fall below the triggering thresholds of the Rule. Nine of the commenters supported the proposal.<sup>3</sup> Three commenters opposed the proposal.<sup>4</sup> While supporting the proposal, Bartholomew believed that the staff adjustment mechanism should be based upon a facts and circumstances determination and should not be automatic. One commenter who did not support the proposal, Schonberg, noted that the representatives from Disciplined Firms, even employed for a short period of time, have the capability to teach “bad habits” to the new firm’s representatives.

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<sup>2</sup> Comments letters were received from: Anonymous; Robert Banks (“Banks”); Patricia Bartholomew, Thinkequity Partners (“Bartholomew”); Clark Dodge & Company, Inc. (“Clark Dodge”); E.E. Powell & Company Inc. (“E.E. Powell”); First Liberty Investment Group (“First Liberty”); Jerard Basmagy, First Montauk Securities Corp. (“Basmagy”); Joseph Stevens & Co., Inc. (“Joseph Stevens”); J.P. Turner & Company, LLC (“J.P. Turner”); Alexander Nova (“Nova”); Personalized Investments, Inc. (Personalized Investments”); Rushmore Securities Corp. (“Rushmore”); Matthew Schonberg, Aegis Capital Corp. (“Schonberg”), Seth Schwartz, Washington Square Securities, Inc. (“Schwartz”); Maryanne Sylenko (“Sylenko”); and James Welch, Morgan Stanley (Fort Worth, Texas) (“Welch”).

<sup>3</sup> See, e.g., Comment letters from First Liberty, Joseph Stevens, Basmagy, Personalized Investments, Bartholomew, E.E. Powell, Schwartz, Sylenko, and Clark Dodge.

<sup>4</sup> See, e.g., Comment letters from Schonberg, Welch, and Anonymous.

Short-term Employee Proposal: With respect to the proposals to exclude short-term employees from a member firm's Taping Rule calculations and to define "short-term" as a period of not more than 90 days, a slight majority of the commenters supported the proposals. Nine commenters supported the proposal regarding a firm's calculations.<sup>5</sup> Seven commenters opposed this proposal.<sup>6</sup>

A smaller group of commenters responded to the proposed definition of short-term period. Seven commenters supported the proposed definition.<sup>7</sup> Six commenters opposed the proposed definition.<sup>8</sup> First Liberty and Banks believed the time period should be 30 days while Nova believed that the period should be no longer than 14 days. Joseph Stevens did not support the proposed definition due to the fact that firms may hire consultants for periods of longer than 90 days.

Expansion of the Compliance Deadline: In general, the commenters supported the proposals to extend the compliance deadline for firms that become subject to the Taping Rule requirements and to set the deadline for compliance at 60 days. Ten commenters supported extending the compliance deadline and, with the exception of Clark Dodge, J.P. Turner and Schwartz, the same commenters stated that the 60-day period was a sufficient period of time for compliance.<sup>9</sup> Five commenters did not support the extension of the current 30-day time period.<sup>10</sup> Clark Dodge, J.P. Turner, Schwartz, and Rushmore believed that the time period should be longer with Schwartz and Rushmore stating that a 90-day period would be more appropriate and Clark Dodge suggesting 75 days. Basmagy would maintain the current 30-day period; however, he would permit firms to petition the Association for extensions of time.

Narrowing of the Exemptive Relief Authority: No comments were received on the proposal expressly to limit the exemptive provisions of the Taping Rule to "exceptional circumstances."

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<sup>5</sup> See, e.g., Comment letters from Banks, J.P. Turner, Joseph Stevens, Basmagy, Personalized Investments, E.E. Powell, Sylenko, Clark Dodge, and Rushmore. (Although Banks responded negatively to Question 2, he did express a willingness to support the proposal if the 90-day short-term period was done in the aggregate. The proposal would calculate the 90-day period in the aggregate.)

<sup>6</sup> See, e.g., Comment letters from First Liberty, Schonberg, Nova, Bartholomew, Schwartz, Welch, and Anonymous.

<sup>7</sup> See, e.g., Comment letters from Personalized Investments, Basmagy, E.E. Powell, Welch, Anonymous, Clark Dodge, and Rushmore.

<sup>8</sup> See, e.g., Comment letters from First Liberty, Schonberg, Banks, Nova, Joseph Stevens, and Schwartz.

<sup>9</sup> See, e.g., Comment letters from First Liberty, J.P. Turner, Joseph Stevens, Personalized Investments, E.E. Powell, Schwartz, Welch, Anonymous, Clark Dodge, and Rushmore.

<sup>10</sup> See, e.g., Comment letters from Schonberg, Banks, Nova, Basmagy, and Bartholomew.

Increase Duration of the Special Supervisory Requirements: No comments were received on the proposal to extend the taping requirements and special supervisory procedures from two years to three years to correspond to the look-back provisions of the Rule.

Publication of the Identity of Firms Subject to the Taping Rule: The Notice to Members sets forth two proposals for publication of the identity of firms subject to the Taping Rule. One proposal would allow an individual to receive the information that a firm is subject to the Taping Rule in response to a request for information of the firm through the CRD Public Disclosure Program (“PDP”). The other proposal would publish a list of firms subject to the Taping Rule on the NASD Regulation web site similar to the list of Disciplined Firms that is currently on the web site. The majority of commenters supported both proposals.

Thirteen commenters supported the disclosure of the information through the PDP<sup>11</sup> and of these commenters only Clark Dodge did not support posting the information on the web site. Banks and Basmagy supported the proposals since they would permit an investor to make an informed decision prior to establishing a relationship with a member firm. J.P. Turner and Rushmore did not support either proposal noting that publication of the information would be unfair to the firms. Nova supported both proposals, however he recommended that the information be put in one location in the PDP so that the public could more easily obtain the information.

NASD Regulation believes that the list of taping firms should not be made publicly available on the NASD Regulation web site because the requirement to tape is not a disciplinary sanction, but rather a heightened supervisory requirement not typically disclosed to the public. However, because knowing whether a firm is subject to the Taping Rule may help investors make a more informed decision about doing business with a firm, NASD Regulation would make the information available to investors who inquire about a specific firm. In addition, NASD Regulation would highlight to investors (e.g., on the NASD Regulation web site) the ability to inquire through the PDP’s toll free telephone listing whether a particular firm is subject to the Taping Rule.

Lastly, the reference to Exhibit 4 “Summary of comments received” in Item No. 9 appearing on page 15 of the rule filing should be deleted.

2. Short-term Employees – General. A firm is subject to Rule 3010(b)(2), the Taping Rule, if the number of its registered persons from Disciplined Firms (as defined in the Taping Rule) within the last three years exceeds set threshold percentages, depending on the size of the firm. The proposed rule change would allow firms to exclude certain short-term registered persons (persons who have been registered for 90 days or less with Disciplined Firms within the past three years and who have no relevant disciplinary history) from the calculations of the Taping Rule threshold levels. NASD Regulation is amending the rule filing to clarify that for purposes of such calculations, while the excluded short-term registered persons would not be included in the number of registered persons from Disciplined Firms, they would be included in the total number of registered persons at the firm. In this regard, NASD Regulation is amending the last

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<sup>11</sup> See, e.g., Comment letters from First Liberty, Schonberg, Banks, Nova, Personalized Investments, Basmagy, Bartholomew, E.E. Powell, Schwartz, Welch, Anonymous, Slenko, and Clark Dodge.

sentence of the first paragraph under the subheading “Revision Of The Criteria By Which Firms Become Subject To The Taping Rule” in Item No. 3(a) appearing on page 10 of the rule filing as follows:

Specifically, in calculating whether firms exceed the Taping Rule thresholds set forth in the Rule, registered persons who were registered with one or more Disciplined Firms for 90 days or less within the last three years and who have no relevant disciplinary history, while still included in the total number of registered persons at a firm, may be excluded from [the calculation required under the Rule] the number of registered persons at the firm from Disciplined Firms.

The same change should be made in Section II(A)(1) of Exhibit 1 appearing on page 25.

3. Short-term Employees – Disciplinary History. NASD Regulation also is amending the rule filing to clarify the revised criteria by which firms become subject to the Taping Rule. In the original rule filing, subparagraph (H) of the Taping Rule provided that in addition to being registered for an aggregate of 90 days or less with Disciplined Firms, short-term employees that are excluded from Taping Rule calculations also must have no disciplinary history as defined in IM-1011-1. IM-1011-1 defines disciplinary history with respect to a member or a principal of a member, but not a registered person. To clarify that the provisions in IM-1011-1 should be applied to registered representatives for purposes of the Taping Rule, the last line of subparagraph (H) of Rule 3010(b)(2) in Item No. 1 appearing on page 5 of the rule filing should be amended as follows:

(2) do not have a disciplinary history [as defined in IM-1011-1].

The same change should be made in Section I of Exhibit 1 appearing on page 21 of the rule filing.

A new definition of “disciplinary history” should be included as new subparagraph 3010(b)(2)(K). Current subparagraph (K) would be re-lettered. The new definition would read as follows:

(K) For purposes of this Rule, the term “disciplinary history” means a finding of a violation by a registered person in the past five years by the Securities and Exchange Commission, a self-regulatory organization, or a foreign financial regulatory authority of one or more of the provisions (or comparable foreign provision) listed in IM-1011-1 or rules or regulations thereunder.

The same change should be made in Section I of Exhibit 1 appearing on page 21 of the rule filing.

Lastly, NASD Regulation is amending the last sentence of the second paragraph under subheading “Revision Of The Criteria By Which Firms Become Subject To The Taping Rule” in Item No. 3(a) appearing on page 11 of the rule filing as follows:

To provide greater assurance that these short-term employees have not acquired the “bad habits” of concern or do not otherwise raise the concerns that the Rule is designed to address, the proposed rule change also requires that such short-term employees have no disciplinary history [as defined] by a finding of a violation of the provisions set forth in NASD IM-1011-1.

The same change should be made in Section (II)(A)(1) of Exhibit 1 appearing on page 26 of the rule filing.

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4. Manner of Applying Amended Taping Rule Following Any SEC Approval of Proposed Rule Change. NASD Regulation believes that firms that, as of the effective date of the proposed rule change, have a pending exemption request (or related appeal before the National Adjudicatory Council (“NAC”)) from the Taping Rule, or for which the time period in which to seek an applicable exemption (or related appeal to the NAC) has not yet expired, may elect to comply with the Taping Rule as amended by the proposed rule change in lieu of complying with the current requirements of the Taping Rule. Firms that, as of the effective date of the proposed rule change, either are actively taping or are required to be actively taping (because, for instance, the time period in which to request any applicable exemption has expired; or they have been denied an exemption by the staff and the decision has been affirmed by the NAC; or the time for appeal of the decision to the NAC has expired) would remain subject to the current provisions of the Taping Rule. In this regard, NASD Regulation is amending the second paragraph of the introduction to Item No. 3(a) appearing on page 9 of the rule filing by adding a new third sentence as follows:

Firms that, as of the effective date of the proposed rule change, have a pending exemption request from the Taping Rule requirements (or related appeal before the National Adjudicatory Council (“NAC”)), or for which the time period in which to seek an applicable exemption (or related appeal to the NAC) has not yet expired, may elect to comply with the Taping Rule as amended by the proposed rule change in lieu of complying with the current requirements under the Rule.

The same change should be made in Section II(A)(1) of Exhibit 1 appearing on page 24 of the rule filing.

If you have any questions, please contact me at (202) 728-6939.

Very truly yours,

Grace Yeh  
Assistant General Counsel

cc: Andrew Shipe

**EXHIBIT 1**

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34- ; File No. SR-NASD-2002-04)

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1  
Thereby by National Association of Securities Dealers, Inc. Relating to Amendments to Rule  
3010(b)(2) and IM-8310-2

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule  
19b-4 thereunder,<sup>2</sup> notice is hereby given that on , the National Association  
of Securities Dealers, Inc. (“NASD”), 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. On , the NASD Regulation filed  
Amendment No. 1 to the proposed rule change.<sup>3</sup> The Commission is publishing this notice to  
solicit comments on the proposed rule change from interested persons.

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

NASD Regulation is proposing to amend NASD Rule 3010(b)(2), also known as the  
“Taping Rule,” and NASD IM-8310-2. The proposed amendments to the Taping Rule generally  
would: (1) permit firms that become subject to the Taping Rule a one time opportunity to adjust  
their staffing levels to fall below the prescribed threshold levels and thus avoid application of the  
Rule; (2) revise the criteria by which firms become subject to the Taping Rule by not including

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR § 240.19b-4.

<sup>3</sup> This 19b-4 filing represents Amendment No. 1 to File No. SR-NASD-2002-04.

certain short-term employees of disciplined firms into the calculations of the Taping Rule threshold levels; (3) expand the compliance deadline from 30 to 60 days for firms subject to the Taping Rule to install taping systems; (4) clarify the staff's authority to grant exemptions from the Rule pursuant to the Rule 9600 Series only in exceptional cases; and (5) extend the taping requirements from two years to three years to eliminate conflicting time periods in the Taping Rule. In addition, NASD Regulation proposes amendments to NASD IM-8310-2 to permit, upon request, public disclosure of whether a particular firm is subject to the Taping Rule. Below is the text of the proposed rule change as filed with the Commission on January 4, 2002 and as modified by Amendment No. 1. Proposed new language is underlined; proposed deletions are in brackets.

### **3010. Supervision**

(a) No Change.

#### **(b) Written Procedures**

(1) No Change.

(2) Tape recording of conversations

(A)[(i)] Each member that either is notified by NASD Regulation or otherwise has actual knowledge that it meets one of the criteria in paragraph (b)(2)(H)[(viii)] relating to the employment history of its registered persons at a Disciplined Firm as defined in paragraph (b)(2)(J)[(x)] shall establish, maintain, and enforce special written procedures for supervising the telemarketing activities of all of its registered persons.

(B)[(ii)] The member must establish and implement the supervisory procedures required by this paragraph within [30] 60 days of receiving notice from NASD Regulation or obtaining actual knowledge that it is subject to the provisions of this paragraph.

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

(C) [(iii)] The procedures required by this paragraph shall include tape-recording all telephone conversations between the member's registered persons and both existing and potential customers.

(D) [(iv)] The member shall establish reasonable procedures for reviewing the tape recordings made pursuant to the requirements of this paragraph to ensure compliance with applicable securities laws and regulations and applicable rules of [this] the Association. The procedures must be appropriate for the member's business, size, structure, and customers.

(E) [(v)] All tape recordings made pursuant to the requirements of this paragraph shall be retained for a period of not less than three years from the date the tape was created, the first two years in an easily accessible place. Each member shall catalog the retained tapes by registered person and date.

(F) [(vi)] Such procedures shall be maintained for a period of [two] three years from the date that the member establishes and implements the procedures required by the provisions of this paragraph.

(G) [(vii)] By the 30th day of the month following the end of each calendar quarter, each member firm subject to the requirements of this paragraph shall submit to the Association a report on the member's supervision of the telemarketing activities of its registered persons.

(H) [(viii)] The following members shall be required to adopt special supervisory procedures over the telemarketing activities of their registered persons:

- A firm with at least five but fewer than ten registered persons, where 40% or more of its registered persons have been [employed by] associated with one or more Disciplined Firms in a registered capacity within the last three years;
- A firm with at least ten but fewer than twenty registered persons, where four or more of its registered persons have been [employed by] associated with one or more Disciplined Firms in a registered capacity within the last three years;
- A firm with at least twenty registered persons, where 20% or more of its registered persons have been [employed by] associated with one or more Disciplined Firms in a registered capacity within the last three years.

For purposes of the calculations required in subparagraph (H), firms should not include registered persons who:

(1) have been registered for an aggregate total of 90 days or less with one or more Disciplined Firms within the past three years; and

(2) do not have a disciplinary history.

(I)[(ix)] For purposes of this Rule, the term “registered person” means any person registered with the Association as a representative, principal, or assistant representative pursuant to the Rule 1020, 1030, 1040, and 1110 Series or pursuant to Municipal Securities Rulemaking Board (“MSRB”) Rule G-3.

(J)[(x)] For purposes of this Rule, the term "disciplined firm" means 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.

(K)[(xi)] For purposes of this Rule, the term “disciplinary history” means a finding of a violation by a registered person in the past five years by the Securities and Exchange Commission, a self-regulatory organization, or a foreign financial regulatory authority of one or more of the provisions (or comparable foreign provision) listed in IM-1011-1 or rules or regulations thereunder.

(L) Pursuant to the Rule 9600 Series, the Association may in exceptional circumstances, taking into consideration all relevant factors, exempt any member unconditionally or on specified terms and conditions from the requirements of this paragraph [upon satisfactory showing that the member’s supervisory procedures ensure compliance with applicable securities laws and regulations and applicable rules of the Association].

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**IM-8310-2. Release of Disciplinary [Information] and Other Information Through the Public Disclosure Program**

(a) In response to a written inquiry, electronic inquiry, or telephonic inquiry via a toll-free telephone listing, the Association shall release certain information contained in the Central Registration Depository regarding a current or former member, an associated person, or a person who was associated with a member within the preceding two years, through the Public Disclosure Program. Such information shall include:

- (1) the person's employment history and other business experience required to be reported on Form U-4;
  - (2) currently approved registrations for the member or associated person;
  - (3) the main office, legal status, and type of business engaged in by the member;
- and
- (4) an event or proceeding—
    - (A) required to be reported under Item 23 on Form U-4;
    - (B) required to be reported under Item 11 on Form BD; or
    - (C) reported on Form U-6.

The Association also shall make available through the Public Disclosure Program certain arbitration decisions against a member involving a securities or commodities dispute with a public customer. In addition, the Association shall make available in response to telephonic inquiries via the Public Disclosure Program's toll-free telephone listing whether a particular member is subject to the provisions of Rule 3010(b)(2). The Association shall not release through the Public Disclosure Program social security numbers, residential history information, or physical

description information, or information that the Association is otherwise prohibited from releasing under Federal law.

(b) through (l) No Change.

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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 Taping Rule, which was adopted in 1998, is designed to ensure that members with a large number of registered persons from firms that have been expelled from membership or have had their registration revoked ("Disciplined Firms") have proper supervisory procedures over telemarketing activities to prevent fraudulent and improper sales practices or other customer harm. Under the Rule, firms that hire a significant number of employees from Disciplined Firms must establish, maintain, and enforce special written procedures for supervising the telemarketing activities of all their registered persons. In addition, such firms are required to install taping systems to record all telephone conversations between all of their registered persons and both existing and potential customers, review the tape recordings, and file quarterly reports with NASD Regulation.

Based upon staff's experience with the Taping Rule and input from the National Adjudicatory Council and NASD Regulation Committees, the staff proposes several amendments to the Rule. Generally, the proposed amendments are intended to refine the application of the Taping Rule and to provide additional flexibility to assist member firms in meeting their compliance obligations under the Rule. Firms that, as of the effective date of the proposed rule change, have a pending exemption request from the Taping Rule requirements (or related appeal before the National Adjudicatory Council ("NAC")), or for which the time period in which to seek an applicable exemption (or related appeal to the NAC) has not yet expired, may elect to comply with the Taping Rule as amended by the proposed rule change in lieu of complying with the current requirements under the Rule.

1. Establishment Of A 30-Day Staff Adjustment Period

NASD Regulation is concerned that some firms may inadvertently or unintentionally become subject to the Taping Rule due, for example, to sudden turnover among registered persons or other events beyond the firm's control. As a means to address these types of occurrences, NASD Regulation is proposing to provide all firms that trigger application of the Taping Rule (for the first time) a one-time opportunity to obtain relief from the Taping Rule requirements by adjusting their staffing levels.

In particular, NASD Regulation proposes to permit firms, within 30 days after receiving the notice that they are subject to the Taping Rule or obtaining actual knowledge that they are subject to the Rule (and have promptly notified the Department of Member Regulation that they are subject to the Rule), to reduce their staffing levels to fall below the threshold levels contained in paragraph (b)(2)(viii) of the Taping Rule and thus avoid application of the Taping Rule. Under the proposed rule change, firms would not be permitted to hire additional registered

representatives to fall below the stated thresholds but rather would be required to reduce their number of registered representatives from Disciplined Firms. Once a firm has made the reductions, the firm would not be permitted to rehire the terminated individuals for a period of at least 180 days. Under the proposed rule change, firms may elect, but are not required, to make reductions to their staffing levels. If a firm chooses not to make the adjustment, then it will be required to comply with the Taping Rule requirements.

A firm would be permitted to adjust its staffing levels only when it becomes subject to the Taping Rule for the first time. If the firm re-triggers the Taping Rule at any point in the future, then the firm automatically would become subject to its provisions. While a new entity resulting from a restructuring (by a merger, acquisition, or otherwise) would be allowed to make a staff adjustment to avoid application of the Taping Rule even if one of the participating members in the restructuring had previously adjusted its staff level pursuant to the proposed rule change, this would not be the case for an entity that was restructured in an effort to avoid compliance with the Rule.

2. Revision Of The Criteria By Which Firms Become Subject To The Taping Rule

NASD Regulation is proposing to revise the criteria for determining whether a firm is subject to the Taping Rule by excluding from the firm's calculations registered persons who were associated with a Disciplined Firm for only a short period of time. Specifically, in calculating whether firms exceed the Taping Rule thresholds set forth in the Rule, registered persons who were registered with one or more Disciplined Firms for 90 days or less within the last three years and who have no relevant disciplinary history, while still included in the total number of registered persons at a firm, may be excluded from the number of registered persons at the firm from Disciplined Firms.

NASD Regulation believes that the proposed rule change is consistent with the intent of the Taping Rule. The proposed rule change recognizes that persons registered with Disciplined Firms for a short period of time (i.e., an aggregate total of 90 days or less) are far less likely to have acquired the “bad habits” from the Disciplined Firms that the Taping Rule seeks to redress. Moreover, it is anticipated that these individuals will receive the proper training and supervision at their new firms. To provide greater assurance that these short-term employees have not acquired the “bad habits” of concern or do not otherwise raise the concerns that the Rule is designed to address, the proposed rule change also requires that such short-term employees have no disciplinary history by a finding of a violation of the provisions set forth in NASD IM-1011-1.

In addition, the proposed rule change would clarify that the calculation of registered representatives from Disciplined Firms includes independent contractors previously registered with a Disciplined Firm. NASD Regulation proposes to make a technical amendment to the current rule language by substituting “associated with one or more Disciplined Firms in a registered capacity” for “employed by one or more Disciplined Firms” in subparagraph (b)(2)(viii) of the Taping Rule.

### 3. Expansion Of The Compliance Deadline From 30 To 60 Days

Under the current Taping Rule, firms are obligated to implement the special supervisory procedures, including the installation of taping systems within 30 days of receiving notice from the NASD (or obtaining actual knowledge) that they are subject to the Taping Rule. Most of the firms that have become subject to the Taping Rule have requested extensions of time to complete the installation of a taping system. In light of these requests and the staff’s understanding that firms typically require greater than 30 days to install an appropriate taping system, the proposed rule change would extend the time for firms to install the taping system from 30 days to 60 days.

Based on the staff's experience, 60 days should provide adequate time for firms to install the taping systems and would alleviate the need for firms to request extensions of time.

4. Clarification Of The Exemptive Relief Authority

Currently, paragraph (b)(2)(xi) of the Taping Rule permits member firms that become subject to the Taping Rule to apply for exemptive relief under the Rule 9600 Series "upon satisfactory showing that the member's supervisory procedures ensure compliance with applicable securities laws and regulations and applicable rules of the Association." In reviewing exemptive requests, NASD Regulation generally has required a firm to establish that it has alternative procedures to assure supervision at a level functionally equivalent to a taping system.

Notwithstanding this high standard, the staff has received a substantial number of applications for exemptive relief, all but one of which have been denied.

Based on its experience administering exemptive requests, the staff believes that the exemption provisions should be explicitly drafted to be available in "exceptional circumstances" only. The staff believes that clearly articulating a high standard for an exemption will save firms and the staff the time and expense involved in the vast majority of unmeritorious exemption applications the staff has reviewed to date. Further, the additional flexibility created by the proposed rule change, particularly the one-time ability to reduce staffing levels to avoid application of the Rule, should significantly reduce any need to seek an exemption.

5. Increase Duration Of The Special Supervisory Requirements

The proposed rule change would extend the time period for which firms must maintain taping systems from two years to three years. NASD Regulation believes that this proposed change will reduce confusion concerning the application of the Taping Rule. Currently, the Taping Rule requires firms to install the taping systems for a period of two years; however, the

Taping Rule also requires firms to look back three years for the employment history of their registered representatives to calculate the threshold levels under paragraph (b)(2)(viii) of the Taping Rule. Equalizing these two time periods to three years would eliminate the confusion and would alleviate any problems in the calculations for the Taping Rule thresholds.

In addition, the proposed rule change would clarify that the period for which firms are required to maintain the taping system begins from the date that the member establishes its special supervisory procedures and implements the taping system. The proposed rule change further would clarify in paragraph (b)(2)(ii) of the Taping Rule that a firm is required to both establish and implement the taping system within the time period set forth in such paragraph.

#### Publication of the Identity of Firms Subject to the Taping Rule

Since the inception of the Taping Rule, the staff has received requests from regulators, consumer groups, and investor representatives, to make the identity of firms subject to the Taping Rule publicly available. After careful consideration of the issue, NASD Regulation believes that public disclosure of the identity of firms subject to the Taping Rule in circumstances where information is being sought regarding a particular firm is appropriate and consistent with the objectives of the Taping Rule. As a result, the proposed rule change would enable investors and the general public to ascertain, upon request, whether an identified firm is subject to the Taping Rule.

#### (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 require, among other things, that the Association's rules must 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 the proposed rule change provides firms with more flexibility to comply with the Rule while still requiring firms that hire a significant number of registered persons from Disciplined Firms to adopt enhanced supervisory procedures to protect investors and prevent fraudulent and manipulative sales practices.

(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

The proposed rule change was published for comment in NASD Notice to Members 01-38 (June 2001). Sixteen comments were received in response to the Notice.<sup>4</sup> Copies of the comment letters have been provided to the Commission. Of the 16 comment letters received, 12 were in favor of the proposed rule change and 4 were opposed.

Establishment of a 30-day Staff Adjustment Period: Generally, the commenters supported the proposal to allow member firms that become subject to the Taping Rule for the first time to make a downward adjustment of staff in order to fall below the triggering thresholds of the Rule. Nine of the commenters supported the proposal.<sup>5</sup> Three commenters opposed the proposal.<sup>6</sup>

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<sup>4</sup> Comments letters were received from: Anonymous; Robert Banks ("Banks"); Patricia Bartholomew, Thinkquity Partners ("Bartholomew"); Clark Dodge & Company, Inc. ("Clark Dodge"); E.E. Powell & Company Inc. ("E.E. Powell"); First Liberty Investment Group ("First Liberty"); Jerard Basmagy, First Montauk Securities Corp. ("Basmagy"); Joseph Stevens & Co., Inc. ("Joseph Stevens"); J.P. Turner & Company, LLC ("J.P. Turner"); Alexander Nova ("Nova"); Personalized Investments, Inc. (Personalized Investments"); Rushmore Securities Corp. ("Rushmore"); Matthew Schonberg, Aegis Capital Corp. ("Schonberg"); Seth Schwartz, Washington Square Securities, Inc. ("Schwartz"); Maryanne Sylenko ("Sylenko"); and James Welch, Morgan Stanley (Fort Worth, Texas) ("Welch").

<sup>5</sup> See, e.g., Comment letters from First Liberty, Joseph Stevens, Basmagy, Personalized Investments, Bartholomew, E.E. Powell, Schwartz, Sylenko, and Clark Dodge.

While supporting the proposal, Bartholomew believed that the staff adjustment mechanism should be based upon a facts and circumstances determination and should not be automatic. One commenter who did not support the proposal, Schonberg, noted that the representatives from Disciplined Firms, even employed for a short period of time, have the capability to teach “bad habits” to the new firm’s representatives.

Short-term Employee Proposal: With respect to the proposals to exclude short-term employees from a member firm’s Taping Rule calculations and to define “short-term” as a period of not more than 90 days, a slight majority of the commenters supported the proposals. Nine commenters supported the proposal regarding a firm’s calculations.<sup>7</sup> Seven commenters opposed this proposal.<sup>8</sup>

A smaller group of commenters responded to the proposed definition of short-term period. Seven commenters supported the proposed definition.<sup>9</sup> Six commenters opposed the proposed definition.<sup>10</sup> First Liberty and Banks believed the time period should be 30 days while Nova believed that the period should be no longer than 14 days. Joseph Stevens did not support the proposed definition due to the fact that firms may hire consultants for periods of longer than 90 days.

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<sup>6</sup> See, e.g., Comment letters from Schonberg, Welch, and Anonymous.

<sup>7</sup> See, e.g., Comment letters from Banks, J.P. Turner, Joseph Stevens, Basmagy, Personalized Investments, E.E. Powell, Sylenko, Clark Dodge, and Rushmore. (Although Banks responded negatively to Question 2, he did express a willingness to support the proposal if the 90-day short-term period was done in the aggregate. The proposal would calculate the 90-day period in the aggregate.)

<sup>8</sup> See, e.g., Comment letters from First Liberty, Schonberg, Nova, Bartholomew, Schwartz, Welch, and Anonymous.

<sup>9</sup> See, e.g., Comment letters from Personalized Investments, Basmagy, E.E. Powell, Welch, Anonymous, Clark Dodge, and Rushmore.

<sup>10</sup> See, e.g., Comment letters from First Liberty, Schonberg, Banks, Nova, Joseph Stevens, and Schwartz.

Expansion of the Compliance Deadline: In general, the commenters supported the proposals to extend the compliance deadline for firms that become subject to the Taping Rule requirements and to set the deadline for compliance at 60 days. Ten commenters supported extending the compliance deadline and, with the exception of Clark Dodge, J.P. Turner and Schwartz, the same commenters stated that the 60-day period was a sufficient period of time for compliance.<sup>11</sup> Five commenters did not support the extension of the current 30-day time period.<sup>12</sup> Clark Dodge, J.P. Turner, Schwartz, and Rushmore believed that the time period should be longer with Schwartz and Rushmore stating that a 90-day period would be more appropriate and Clark Dodge suggesting 75 days. Basmagy would maintain the current 30-day period; however, he would permit firms to petition the Association for extensions of time.

Narrowing of the Exemptive Relief Authority: No comments were received on the proposal expressly to limit the exemptive provisions of the Taping Rule to “exceptional circumstances.”

Increase Duration of the Special Supervisory Requirements: No comments were received on the proposal to extend the taping requirements and special supervisory procedures from two years to three years to correspond to the look-back provisions of the Rule.

Publication of the Identity of Firms Subject to the Taping Rule: The Notice to Members sets forth two proposals for publication of the identity of firms subject to the Taping Rule. One proposal would allow an individual to receive the information that a firm is subject to the Taping Rule in response to a request for information of the firm through the CRD Public Disclosure Program (“PDP”). The other proposal would publish a list of firms subject to the Taping Rule on

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<sup>11</sup> See, e.g., Comment letters from First Liberty, J.P. Turner, Joseph Stevens, Personalized Investments, E.E. Powell, Schwartz, Welch, Anonymous, Clark Dodge, and Rushmore.

the NASD Regulation web site similar to the list of Disciplined Firms that is currently on the web site. The majority of commenters supported both proposals.

Thirteen commenters supported the disclosure of the information through the PDP<sup>13</sup> and of these commenters only Clark Dodge did not support posting the information on the web site. Banks and Basmagy supported the proposals since they would permit an investor to make an informed decision prior to establishing a relationship with a member firm. J.P. Turner and Rushmore did not support either proposal noting that publication of the information would be unfair to the firms. Nova supported both proposals, however he recommended that the information be put in one location in the PDP so that the public could more easily obtain the information.

NASD Regulation believes that the list of taping firms should not be made publicly available on the NASD Regulation web site because the requirement to tape is not a disciplinary sanction, but rather a heightened supervisory requirement not typically disclosed to the public. However, because knowing whether a firm is subject to the Taping Rule may help investors make a more informed decision about doing business with a firm, NASD Regulation would make the information available to investors who inquire about a specific firm. In addition, NASD Regulation would highlight to investors (e.g., on the NASD Regulation web site) the ability to inquire through the PDP's toll-free telephone listing whether a particular firm is subject to the Taping Rule.

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<sup>12</sup> See, e.g., Comment letters from Schonberg, Banks, Nova, Basmagy, and Bartholomew.

<sup>13</sup> See, e.g., Comment letters from First Liberty, Schonberg, Banks, Nova, Personalized Investments, Basmagy, Bartholomew, E.E. Powell, Schwartz, Welch, Anonymous, Slenko, and Clark Dodge.

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