

**NASD**  
**WORKSHOP FOR MEMBERS: BOOKS & RECORDS AMENDMENTS**  
**TELEPHONE TRANSCRIPT**  
**APRIL 10, 2003**  
**2:00 P.M.**

**Kyra:** Hello. Good afternoon and welcome to the Regulatory and Compliance Workshop. My name is Kyra Armstrong. I'm an attorney in Member Regulation, as are Emily Gordy and Vicky Berberi-Doumar. From NASD, we also have Patricia Albrecht from the Office of General Counsel and George Walz from our Department of Member Regulation's Examination Program Group. Today, we are also fortunate to have William Reilly, who is Chief of the Bureau of Securities Regulation of the Florida Department of Financial Services, Office of Securities and Finance.

Today's workshop is sponsored by NASD's Department of Member Regulation. We instituted this program as a forum to respond to frequently asked questions from members and, in particular, to make information more accessible to smaller firms. Our expectation is that these workshops will also provide a convenient way to keep members current regarding important regulatory developments, and to assist members with their preventive compliance efforts.

The topic today is the amendments to the Securities and Exchange Commission's (or SEC) books and records rules, which become effective on May 2, 2003.

On October 25, 2001, the SEC adopted amendments to Rules 17a-3 and 17a-4 under the Securities Exchange Act of 1934 to clarify and expand record keeping requirements in connection with purchase and sale documents, customer records, associated person records, customer complaint records, and certain other matters. The amendments also require broker/dealers to maintain or promptly produce certain records at each office to which those records relate.

Since the issuance of the SEC's Release concerning the amendments, we have received many questions. The purpose of this discussion is to address some frequently asked questions about these requirements. The presentations today will include responses to questions that have been raised by member firms regarding their compliance with these rules. Please note that Rules 17a-3 and 17a-4 are SEC rules. Accordingly, questions of interpretation or other concerns about the rules should be directed to the SEC staff. We have discussed some of these issues generally with staff from the SEC's Division of Market Regulation. However, please note that the answers discussed today are NASD staff opinions only and have not been reviewed or endorsed by NASD's Board, nor have they been approved by the SEC.

The format for today's program will be a panel discussion with Bill, Vicky, Emily, Patricia, and George, which will last for approximately an hour. There will not be a question-and-answer period today. Instead, we requested questions from members on our Web page about today's topic, and we have attempted to incorporate responses to those

questions into today's presentation. Additionally, this call will be recorded for the purpose of publishing a transcript, which will be posted on NASD's Web page soon.

As a word of caution, workshop participants should be aware that nothing in this program constitutes legal advice, but is rather educational and informational material. Members should consult a properly qualified attorney or other professional adviser regarding specific matters relating to their respective businesses.

**Kyra:** Let's begin today's session with Bill Reilly, who we are very pleased to have join us for today's discussion. Bill has been involved in the books and records project for quite some time and will provide a state perspective on the amendments. Bill, thank you for being here today. Let's start with the basics. Can you tell us what the books and records rules are?

**Bill:** Sure. In general, Rules 17a-3 and 17a-4 under the Exchange Act specify minimum requirements with respect to the records that a broker/dealer must make, and how long those records and other documents relating to a broker/dealer's business must be kept. The SEC has required that broker/dealers create and maintain records so that, among other things, the SEC, the self-regulatory organizations-like NASD, and state securities regulators may conduct effective examinations of broker/dealers.

**Kyra:** Bill, I understand that the SEC originally proposed the amendments back in 1996. It was in response to concerns raised by members of the North American Securities

Administrators Association or NASAA regarding the adequacy of those rules. Bill, can you tell us about the genesis of the amendments and what concerns the states have had regarding access to books and records?

**Bill:** Sure, Kyra. In October 1996, the National Securities Market Improvement Act of 1996 (or NSMIA) was enacted, prohibiting states from establishing books and records rules that differ from, or are more burdensome than those established by, the Commission's rules and also precluded branch office records. Prior to NSMIA, many states had their own laws or rules that required broker/dealers to make and keep certain books and records. These regulations allowed states securities regulators to conduct examinations and investigations to review for, among other things, sales practice violations—such as violations of suitability and fraud laws or federal regulations.

While NSMIA precluded states from adopting books and records requirements that were more burdensome than SEC rules, NSMIA requires that the SEC periodically consult with states concerning the adequacy of the Commission's books and records rules, particularly relating to the need by state securities regulators to have records readily accessible for their examinations. Basically, Congress wanted the SEC and the states to work closely together to determine what records should be maintained at home and/or at branch offices. In addition, the SEC and the states are supposed to work together to establish a mechanism so that states can require that certain records be kept in the local office, rather than at a “back office halfway across the nation.”

**Kyra:** Throughout the process of considering amendments to the rules, what were the concerns of the state regulators and were they met?

**Bill:** The amendments will certainly assist us in conducting effective and efficient sales practice examinations of activities. The amendments also enable us to adopt and enforce similar rules on the state level, and to support our examination, investigatory, and enforcement requirements. A big part of the amendments is the requirement that broker/dealers maintain and produce records at locations within a state. On the whole, I think that the final amendments balance the interests of the states in providing for customer protection. I also think that the rules will promote uniform, efficient examinations of broker/dealer home and local offices, thereby helping to protect investors from sales abuse and fraud. These rules are the result of long years of work and negotiation by the SEC, the state regulators, and members of the securities industry.

**Kyra:** Bill, thanks for giving us an overview of the background of these amendments and the states' important role in this process.

Now, let me turn to some of the specific changes to the rule. What I'd like to do is start with amendments to Rule 17a-3 that include, among other things, the information that has to be recorded on order tickets, new requirements to create certain records relating to associated persons, and collecting certain account record information regarding customers.

Let's start with Vicky Berberi-Doumar. Vicky, can you tell us about the new requirements related to order tickets?

### **ORDER TICKETS**

**Vicky:** Yes, Kyra. To begin with, as Bill mentioned, these amendments were designed to help securities regulators more efficiently determine whether certain individuals are engaged in sales practice violations. Changes to the order tickets will enable securities regulators to better focus their examinations and investigations because they will be able to focus on those activities and persons responsible for violations more easily.

Now, the final rules require that an order ticket do the following:

- Show the terms and conditions of the order or instructions, and any modification or cancellation thereof;
- Identify the account for which the order is entered;
- Identify each associated person, if any, responsible for the account and any other person who entered or accepted the order on behalf of the customer, or if a customer entered the order on an electronic system, a notation of that entry;
- Describe whether the order was entered subject to discretionary authority;
- Include, to the extent feasible, the time of execution or cancellation; and
- Identify the time the order was received, the time of entry, and the price at which it was executed.

**Kyra:** You said that the order ticket has to include the “time of entry.” What is meant by that term?

**Vicky:** According to the Adopting Release issued by the SEC, the term “time of entry” means the time when the broker or dealer transmits the order or instruction for execution.

**Kyra:** Vicky, for some transactions, the time of entry frequently is simultaneous or nearly simultaneous with the time that the order is received. When this occurs, is it okay for a firm to make one entry for the time rather than separate entries for each time?

**Vicky:** Well, in its Adopting Release, the SEC stated that, in those kinds of situations, it must be clear from the order ticket that the time of receipt was the same as the time of entry. The Commission further stated that the time recorded must be accurate and this should not be construed as an exception to allow firms to use an approximate time for one or both entries.

**Kyra:** The rule also mentions the term “to the extent feasible” with regard to the time of execution or cancellation. Some firms have asked for guidance on the meaning of this term. Does the Adopting Release address this?

**Vicky:** The Adopting Release states that the time of execution should be included on the order ticket except for situations in which it may be impossible to determine the precise time when the transaction was executed; however, in that case, the broker/dealer must

note the approximate time of execution. The Adopting Release notes that the Commission has stated that the phrase “to the extent feasible” was intended to be applicable only in exceptional circumstances where it might be actually impossible to determine the exact time of execution. However, in that case, the broker/dealer must note the approximate time of execution.

**Kyra:** Vicky, you mentioned that the order ticket must include the identity of the associated person responsible for the account or any other person who entered or accepted the order on behalf of the customer. We have gotten questions from firms that do not assign particular associated persons to an account. What should they do?

**Vicky:** The SEC recognized that some firms do not assign an associated person to an account. The Adopting Release states that firms that do not assign associated persons to an account or that allow customers to enter orders directly into a broker/dealer’s system **do not have to include** the identity of an associated person on the order ticket. That is why the language of the amendment contains the language “if any.”

**Kyra:** You also mentioned that the order ticket must contain the identity of any other person who entered or accepted the order on behalf of the customer, is that correct?

**Vicky:** That’s right. The rule requires that the order ticket contain the identity of any other person who entered or accepted the order on behalf of the customer or, **if** a customer entered the order on an electronic system, a **notation** of that entry. The SEC

release states that it included this phrase in response to many comments from the online brokerage community. Because most firms that accept orders through an electronic system already identify, for supervisory purposes, which orders were entered directly by a customer, it was expected that this requirement would not create much additional burden on firms. In addition, it should assist firms in identifying for securities regulatory authorities why certain tickets don't identify the associated person who received the order from the customer.

**Kyra:** Thanks, Vicky. Another question that we have received regarding order tickets relates to the applicability of the requirement to mutual funds. Does a firm have to create a record when a customer purchases mutual funds or variable annuities?

**Vicky:** The amended rule recognizes that when a customer purchases a mutual fund or a variable annuity, the customer often fills out an application that is then forwarded to the either the mutual fund or the insurance company. These applications include the information that is important for, and specifically relate to, the particular transaction. So the SEC stated that a separate record does not need to be made regarding the purchase, sale or redemption of a security on a "subscription-way basis" directly from or to the issuer (such as mutual funds or variable annuities), *if* the member, broker or dealer maintains a copy of the application or subscription document.

**Kyra:** What are firms supposed to do in these situations?

**Vicky:** In these instances, customers fill out applications or subscription agreements that the broker/dealer forwards to an issuer. The rule states that a firm can keep a copy of the application or subscription document.

In its Adopting Release, the Commission also notes that automatic dividend reinvestments are similar to the purchases of mutual funds and variable annuities and should be treated in a similar fashion.

#### **ASSOCIATED PERSONS RECORDS**

**Kyra:** Thank you, Vicky for this valuable information on order tickets. Let me move on to the next category of changes: associated persons' records. For this, I would like to turn to Patricia Albrecht. Patricia, can you tell us what the new requirements are in this area?

**Patricia:** I'd be glad to, Kyra. First, let me begin by stating that Rule 17a-3(a)(12) requires a firm to make records relating to associated persons of the firm, including information regarding the associated person's employment and disciplinary history. The amendments to this rule require a record listing all of a firm's associated persons showing every office where each associated person regularly conducts a securities business and listing all internal identification numbers or codes and the CRD number assigned to each associated person.

**Kyra:** I assume that this obligation arises out of the regulators' concerns that they be able to efficiently investigate sales practice violations, correct?

**Patricia:** That's correct. It fits right in with the reasons for the amendments because this will allow securities regulators to identify where associated persons work, and to read various records which may identify the associated persons solely through the use of identification numbers and to assist in making regulators' examinations and inquiries more efficient.

**Kyra:** Patricia, some people may not know how the term "associated person" has been redefined for 17a-3 purposes. Can you explain it?

**Patricia:** Sure. The current (or pre-amendment) Rule 17a-3(a)(12)(ii), defined "associated person" for purposes of (a)(12) as: "a partner, officer, director, salesman, trader, manager, or other employee handling funds or securities or soliciting transactions or accounts for such member, broker or dealer." The amendment to Rule 17a-3 changes the definition of "associated person."

The new definition is much broader. It has been modified to incorporate the definitions set forth in Exchange Act Sections 3(a)(18) and 3(a)(21). An associated person includes any partner, officer, director, or branch manager of a broker/dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with a broker/dealer, or

any employee of a broker/dealer. This includes order-takers. In the Adopting Release, the Commission notes that the term “associated person” includes any independent contractor, consultant, franchisee, or other person providing services to a broker/dealer equivalent to those services provided by persons specifically referenced in the Exchange Act. Excluded from the definition are persons whose functions are solely clerical or ministerial.

**Kyra:** Okay. We received a question that brought up the kinds of information that one can find about associated persons using WebCRD. This individual asked whether a firm could satisfy Rule 17a-3(a)(12)’s requirement to make records relating to its associated persons by informing a regulator that the required information about an associated person is on WebCRD in lieu of maintaining a copy of this information.

**Patricia:** No, that won’t be sufficient. As stated earlier, Rule 17a-3(a)(12) requires a firm to make records relating to its associated persons—including information about that person’s employment and disciplinary history. A firm cannot meet this requirement by telling a regulator that the information is on WebCRD. It must keep a copy of this information.

#### **CUSTOMER ACCOUNT RECORDS**

**Kyra:** Thanks for the clarification.

Patricia, let’s talk about another change in the books and records rules. There is a new requirement regarding customer account records. Can you tell us what its primary purpose is and tell us about the new rule?

**Patricia:** Yes, I can. The customer account records portion of the books and records rule is a new requirement. This provision requires broker/dealers to create an account record for customers with certain minimum information about each customer. Here again, the primary purpose is to provide regulators, particularly state securities regulators, with access to books and records, which will enable them to review for compliance with suitability rules.

**Kyra:** Bill, given Patricia's reference to the state securities regulators, are there any other purposes for this rule that you can tell us about?

**Bill:** Sure. I would like to add that this rule is not just for state securities regulators. This will also be a valuable tool for broker/dealers to ensure that their registered representatives are accurately reflecting new account information for customers. This may prevent suitability and other concerns being raised by customers due to the "negative consent" requirement.

**Kyra:** That's a good point. Now, Patricia, what information is required regarding customer account records?

**Patricia:** The information required under this rule includes the customer's or owner's name, tax identification number, address, telephone number, date of birth, employment status (including occupation and whether the customer is an associated person of a broker

or dealer), annual income, net worth (excluding the value of a primary residence), and the account's investment objectives.

**Kyra:** What kind of information must be maintained if an account has more than one owner?

**Patricia:** Good question. If an account has more than one owner, the record must include personal information for each owner of the account who is a natural person. However, as the Adopting Release explains, it is acceptable for firms to combine joint owners' financial information rather than obtaining and maintaining such information separately for each owner. The Adopting Release also notes that the record should reflect the investment objectives for the account *and not* the individual investment objectives for each joint owner named on the account.

**Kyra:** Okay. What information must a firm obtain from a customer with a discretionary account?

**Patricia:** In addition to the required information I just mentioned such as the customer's name and address, for discretionary accounts, firms must obtain the dated signature of each customer granting the discretionary authority and the dated signature of each natural person to whom discretionary authority was granted.

**Kyra:** Patricia, are there other requirements for customer account records?

**Patricia:** Yes, there are. First, let me mention that the account record must indicate whether it has been signed by the associated person responsible for the account, and approved or accepted by a principal of the firm.

**Kyra:** This begs the question: what if no one is assigned to the account?

**Patricia:** The SEC notes in the Adopting Release that the phrase “if any” was added to the requirement that the account record must indicate whether it has been signed by an associated person. The release does note that the account record must indicate whether a principal has approved it.

**Kyra:** Thanks, for that explanation. Now, I’d like to bring up some questions that we have received about “natural persons.”

Are corporations, partnerships, or limited liability corporations “natural persons” under the rule?

**Patricia:** No, corporations, partnerships, and limited liability corporations are not “natural persons” under the rule.

**Kyra:** What about trusts? Are they “natural persons” under the rule?

**Patricia:** We can't answer that question. The legal definition of a trust, and whether it would meet the definition of natural person, varies by jurisdiction and is determined by state laws. I think it is important that members understand that the books and records rules are SEC rules. NASD does not have the authority to interpret these provisions. For these reasons, we can't say whether a trust is a natural person for purposes of the rule.

**Kyra:** Thanks, Patricia.

Now, let me turn to Emily Gordy to discuss another important aspect of the rule, that is, furnishing the account record information. Emily, I understand that the new rule requires firms to furnish customers with account records information. Can you tell us about that?

**Emily:** I'd be happy to do so. Rule 17a-3(a)(17) requires that broker/dealers periodically furnish each customer or owner with a copy of the account record (or an alternate document containing all of the required information), generally within 30 days of opening the account and at least every 36 months thereafter and when certain information is changed. For accounts in existence before May 2, 2003, broker/dealers have three years from May 2, 2003, to obtain and furnish customers with the account record information.

The rule also requires that the firm include with the account record or alternate document an explanation of any terms regarding investment objectives. In addition, the account record or alternate document should include or be accompanied by prominent statements

that the customer or owner should mark any corrections and return the account record or alternate document to the firm and that the customer or owner should notify the firm of any future changes to the information contained in the account record.

**Kyra:** What's the purpose of this particular requirement?

**Emily:** The new requirement allows customers to review the information regarding the account that the firm has on file and from which the associated person or the firm is making investment recommendations or suitability determinations for the account. This requirement is designed to protect both firms and customers by reducing the number of misunderstandings between customers and broker/dealers regarding the customer's situation or investment objectives. The SEC's Adopting Release notes that firms may elect to provide this information more frequently in order to coincide with other mailings.

**Kyra:** Thanks, Emily. What triggers this requirement?

**Emily:** The release notes four things that trigger the requirement: 1) the opening of a new account; 2) the periodic updating of an account that must occur at least once every 36 months; 3) a change of customer name or address; and 4) a change of other customer information.

Another important point to note is that the requirement to periodically update customer records does not affect a firm's obligations under any SRO "know your customer" rules.

It may be appropriate in certain circumstances for broker/dealers to obtain updated information from customers more often than once every 36 months.

**Kyra:** We got a question that asked the following: When the account information is sent to the customers, does it have to be in a particular form?

**Emily:** That's a good question. The rule does not specify that the information has to be in a specific form. Rather it requires that the customer or owner receive a copy of the account record or alternate document with all of the required information. For those of you interested in the citation, it is Rule 17a-3(a)(17)(i)(A). So, we have been responding to this question by saying that the account record or alternate document does not have to be in particular format.

It is also important to point out that the rule states that a broker/dealer **is not required** to include the customer's tax identification number and date of birth with the information provided to the customer. The Adopting Release notes that several commenters suggested that unauthorized access to such information could facilitate the perpetration of fraud against the customer.

**Kyra:** Does this provision require a separate mailing of the customer account record information?

**Emily:** No, the Adopting Release states that this rule does not require a separate mailing of the customer account record information. Firms may combine this mailing with other mailings. Or the account record information may be printed on the customer's account statement.

**Kyra:** What happens if there is a change in the customer's income? Does that trigger the requirement to send the customer a copy of the account record?

**Emily:** A change in the customer's income would be part of the periodic updating of an account that has to occur at least once every 36 months. This is distinguishable from a change in the account's investment objectives. A change of the investment objectives would require the broker/dealer to furnish each customer or owner, and associated person responsible, if any, for the account a copy of the updated account record information within **30 days** after receiving notice of the change.

**Kyra:** Great. Another question we received is the following: when the information is sent, does the firm need to get something back from the customer saying that he or she agrees with the information?

**Emily:** No, there is no requirement that the customer send something back to the firm agreeing with the information. However, if the customer receives the information and has a correction, which he or she sends back to the firm, the firm must then send the amended information back to the customer.

**Kyra:** Emily, another question we received concerns investment objectives, which the amendments require firms to define for customers. Is there a standard definition of investment objectives that firms can use to send to clients?

**Emily:** No, there are not standard definitions published by SROs or the SEC for this sub-provision. The Adopting Release recognized that firms ascribe different meanings to investment objective terms. The varying interpretations by firms, among other things, create confusion for customers. Therefore, the amendments require that firms must define these terms when furnishing the account record to customers. At the time that a customer is opening an account, the customer has the opportunity to question the meaning of the investment objective terms. However, when the customer receives a copy of the account record at home, the customer may have forgotten or misunderstood the meaning of those terms. The requirement to describe investment objective terminology should help ensure that the customer and the firm have a mutual understanding of each term.

**Kyra:** Okay. Another question concerns the requirement under Rule 17a-3(a)(17) to obtain the customer's net worth (excluding the value of a primary residence) and annual income. This question asks whether this information can be provided in the form of ranges. It offers the following examples—for annual income: under \$25,000, \$25,000-\$39,999; \$40,000-\$99,999; over \$100,000; and for net worth--less than \$75,000;

\$75,001-\$200,000; \$200,001-\$500,000; and over \$500,000. Are ranges like this sufficient?

**Emily:** The rule does not address this. There is nothing that requires that this information be in ranges and there is nothing that precludes this. However, as a general matter, ranges for these issues may be okay if they are reasonable and considered in light of suitability concerns.

**Kyra:** Emily, another topic I'd like to raise is what happens when a customer neglects, refuses, or is unable to give a firm the required information?

**Emily:** As adopted, Rule 17a-3(a) (17) does not require firms to include in its records an explanation of the customer's neglect, refusal, or inability to provide the required information. However, a broker/dealer is expected to make a good faith effort to collect the required customer information. If the account record information does not have the required information, the broker/dealer would bear the burden of explaining why this information was not available. The Adopting Release notes that this is specifically limited in application to paragraph (a) (17) of the rule, and does not apply to any other federal or SRO rules regarding collections of information.

**Kyra:** Okay. Let's move on to another topic: exemptions. Emily, is there an exemption from the account record information requirements?

**Emily:** That's a good question. The Adopting Release notes that many firms argued for an exemption contending that the rule was intended to allow examiners to review for suitability, but that firms are not subject to SRO suitability requirements for all of their accounts. The SEC decided to create an exemption for certain accounts. The rule states that the account record and furnishing requirements of Rule 17a-3(a)(17) will only apply to accounts for which a firm is, or has within the past 36 months been, required to make a suitability determination under the federal securities laws or under the requirements of a self-regulatory organization of which it is a member.

The Adopting Release emphasizes, however, that the obligation to collect and record suitability information may arise under SRO rules and interpretations. If, after the account is opened, the firm or its associated persons engage in conduct that would subject the firm to suitability requirements, the firm must obtain the information before making such a recommendation. The firm would also have to comply thereafter with the requirement to furnish customers with a copy of their account records for verification, under the Rule, but the account could re-qualify for the exemption if suitability determinations were no longer required of the firm.

**Kyra:** You mention SRO rules. Which ones are implicated here?

**Emily:** We're talking about NASD Rules 2310 and 2860(b)(16)(B), which deal with, respectively, making recommendations to customers and member's suitability obligations, and with diligence in opening customer accounts for options trading, where

due diligence must be exercised in ascertaining essential facts about a customer, his or her financial status and investment objectives. Firms should also be aware of other SRO rules such as NYSE Rule 723, Chicago Board Options Exchange Rule 9.9 and the MSRB Rule G-19. In addition, it is important to note that the term “suitability determination” in this context should be interpreted broadly. A firm may have an obligation to perform a suitability determination under the Exchange Act (like in Sections 10(b) and 15(c)), Commission Rules (such as Rules 10b-5 and 15c1-2, 15g-1-15g-9), SRO Rules or common law.

**Kyra:** Thanks, Emily for this explanation. Let me bring Vicky back into the discussion to discuss some additional requirements. Vicky, must firms create account records under Rule 17a-3(a)(17) for all accounts?

**Vicky:** Kyra, Rule 17a-3(a) (17) requires firms to create an account record for both new and existing accounts. For accounts opened on or after May 2, 2003, the firm must obtain the account record information required under Rule 17a-3(a) (17) (i) (A) when the account is opened.

**Kyra:** Vicky, do firms have a grace period for obtaining the required information?

**Vicky:** For accounts existing before May 2, 2003, firms will have **36** months to obtain the required information for the account record. A new 36-month furnishing cycle under

Rule 17a-3(a) (17) will begin when the firm obtains the account record information within the initial 36-month grace period.

**Kyra:** Vicky, do firms have to provide customers with copies of written customer agreements?

**Vicky:** The release states that each broker/dealer is required to create a record for each account indicating that each customer was furnished with a copy of any written agreement entered into on or after the effective date of the rule **pertaining to that account**, and that if requested by the customer or owner, the customer or owner was furnished with a fully executed copy of each agreement. This will enable customers to review the terms of agreements to which they are subject, and to better understand their rights and responsibilities under these agreements.

### **COMPLAINTS**

**Kyra:** Thanks. Vicky, now let me ask you about the topic of complaints. Does a firm have to create a record of customer complaints it receives concerning associated persons?

**Vicky:** Yes, new Rule 17a-3(a) (18) requires firms to make a record of every written customer complaint they receive about an associated person. The purpose of this rule is to allow securities regulators the ability to quickly identify any trends and focus examinations.

**Kyra:** What are the specific requirements?

**Vicky:** The record must include the following information:

- The complainant's name, address, and account number;
- The date the complaint was received;
- The name of each associated person identified in the complaint;
- A description of the nature of the complaint; and
- The disposition of the complaint.

It is important to note that the record must include complaints received electronically from customers.

In terms of how to comply, firms have the option to comply with this rule by keeping the original complaint along with a record of the disposition of the complaint, if kept by name of the associated person. This recognizes that firms are already required to keep originals of incoming written complaints.

Finally, firms are required to make a record indicating that each customer has been provided with a notice of the address and telephone number of the department of the firm to which complaints may be directed. This will assist both customers and broker/dealers to ensure that complaints reach the proper person or department so that they can be properly recorded, reported (if necessary), and answered.

**Kyra:** Bill, I know that you wanted to add something about a local office requirement for complaints.

**Bill:** Yes, I did. The local office may maintain the complaint letter and disposition. In lieu of the complaint letter the local office may maintain a record or a log of each written complaint received against each registered representative at the local office. The complaint log should include the complainant's name, address, account number, and description of the complaint and disposition. Should the log be maintained, the original copies of the complaints must be maintained at the home office, which must provide copies of the original documents to a regulator upon request.

**Kyra:** Thanks, Bill.

Now, Vicky, let me ask you about this requirement in the context of introducing and clearing firms. How do these firms handle the complaint requirement?

**Vicky:** The release discusses this and notes that to the extent not otherwise required, this should be a matter of negotiation between the introducing firm and clearing firm. If contact information is provided for both firms, the notification should clearly state which firm the customer should contact and for what purposes.

**Kyra:** Do firms have any flexibility in providing this notice to customers?

**Vicky:** Yes, firms have flexibility concerning how to deliver this notice to customers—and the Adopting Release notes that inserting the notice on a customer statement is an acceptable option.

### **COMPENSATION**

**Kyra:** Vicky, do firms have to maintain records regarding an associated person's compensation?

**Vicky:** Yes. New Rule 17a-3(a) (19) requires firms to make a record concerning each associated person, listing each purchase and sale of a security attributable, for compensation purposes, to that associated person. The record must include the amount of compensation (if monetary) and a description of the compensation (if non-monetary).

Under this requirement, firms must make records of all commissions, concessions, overrides, and other compensation to the extent they are earned or accrued for transactions. In addition, if the compensation is non-monetary, that description should include an estimate of its value.

**Kyra:** How is “non-monetary compensation” defined?

**Vicky:** The term “non-monetary compensation” includes compensation such as sales incentives, gifts, or trips that would be provided to associated persons if certain sales goals were achieved. Such non-monetary compensation should be recorded if directly

related to sales. Non-monetary compensation does not include items of little value distributed by the firm.

**Kyra:** Must firms maintain records of their agreements with associated persons under the amended rules?

**Vicky:** Firms must maintain a record of all agreements pertaining to the relationship between each associated person and the broker/dealer. This includes a summary of each associated person's compensation arrangement or plan. In addition, to the extent that compensation is based on factors other than remuneration on a per trade basis, the firm must make a record that describes the method by which compensation is to be determined. This requirement includes verbal agreements and records, such as commission schedules, which may change on a periodic basis.

#### **COMPLIANCE WITH REQUIREMENTS FOR COMMUNICATIONS WITH THE PUBLIC**

**Kyra:** Vicky, what records must a firm keep regarding communications with the public?

**Vicky:** New Rule 17a-3(a)(20) requires each firm to make a record documenting that the firm has complied with, or adopted policies and procedures reasonably designed to establish compliance with, applicable federal regulations and SRO rules, which require that a principal approve any advertisements, sales literature, or other communications with the public.

**Kyra:** Another requirement relates to persons who can explain records and their content, right, Vicky?

**Vicky:** Yes, Kyra. Rule 17a-3(a)(21) requires a record for each office listing, by name, or title, each person at that office who, without delay, can explain the types of records the firm maintains at that office and the information contained in those records.

**Kyra:** And Vicky—can you tell us about the requirement for a record listing the principals of the firm?

**Vicky:** Sure. Rule 17a-3(a)(22) also requires firms to make a record listing each principal of the firm responsible for establishing policies and procedures that are reasonably designed to ensure compliance with any applicable federal requirements or rules of a SRO of which the firm is a member that require acceptance or approval of a record by a principal.

**Kyra:** Vicky, thanks for describing all of that information.

Now, Bill, is there anything that you'd like to add to this broad discussion concerning associated persons records, customer account records, compensation, complaints, or compliance with communications with the public?

**BILL:** Yes, Kyra. During my tenure of working on these amended rules with the industry and SEC, people indicated the rules were needed solely by state securities regulators in order to conduct examinations at branch or local office locations. Although I agree the amended rules will assist in this process, I believe one of the cornerstones of the amended rules relates to the customer new account information. During this process, I was informed that broker/dealers who required either customer signatures in new account cards or sent this information to their customers for verification, indicated substantial error rates (approaching 30%) ranging from inaccurate investment experience/objectives and net worth to the transposition of numbers in social security numbers and home addresses. The requirement to provide the account information to customers, via “negative consent” letters, along with a “plain English” explanation of the investment objectives will provide broker/dealers with an effective means to correct these problems at the time an account is opened or updated, as well as identifying problems registered representatives who, inadvertently or intentionally, place incorrect information on new account documentation.

**Kyra:** Those are some excellent points and interesting to note. Thanks, Bill.

### **OFFICE RECORDS**

**Kyra:** Now, let me turn to the topic of office records. Bill, I’d like to get your perspective on this area because I know the states were very involved in this issue. Once again, could you tell us a little more about this particular rule before we get into the specific requirements?

**Bill:** Sure, Kyra. These requirements were designed to assist securities regulators when conducting sales practice examinations at particular offices. The state securities regulators supported a requirement that records regarding a particular office be maintained at that office, even if it was only done electronically. State securities regulators had encountered various delays when conducting exams because records were kept at other offices. Although we found that firms had the records available in local offices, the firms preferred to funnel all records requested by examiners through their centralized compliance departments in order to assure accuracy, anticipate any potential violations, review material or applicable privileges, and make a record of documents reviewed by regulators. While the state regulators, such as here in Florida, have the power to impose fines and penalties on firms that fail to timely produce records, the delays resulted in unnecessary and wasted examination time at firms waiting for the records production. This delay is costly for us as regulators, particularly when examiners travel to remote areas to do surprise examinations at an office where they may spend numerous days waiting for the records.

Of course, the firms were opposed to this requirement—mainly because they thought it would be costly and burdensome and they claimed it would decentralize their recordkeeping, which would compromise their controls on recordkeeping and supervisory practices.

After much consideration, the SEC came up with the amendments, which address the concerns of the various regulators and the broker/dealers.

**Kyra:** Thanks, Bill for that background.

Let me turn to some of the specific requirements. Emily, can you please tell us how “office” is defined?

**Emily:** I’d be happy to do so. The amended rules define “office” to include any location where an associated person regularly conducts business. However, an office would *not* include a customer's office that an associated person visits on a regular basis.

Under the rules, a broker/dealer is not required to produce records at an office that is a private residence, provided that:

1. only one associated person, or multiple associated persons who reside at that location and are members of the same immediate family, regularly conduct business at the office;
2. the office is not held out to the public as an office; and
3. neither customer funds nor securities are handled at that office.

Instead, records pertaining to private residences may either be maintained at some other location within the same state as that office as the broker/dealer chooses, or be promptly produced at an agreed upon location.

**Kyra:** What records must be maintained for each office?

**Emily:** Firms are required to make and keep current, separately for each office, certain books and records that reflect the activities of the office. This includes blotters, order tickets, customer account records, records with respect to associated persons, customer complaints, records evidencing compliance with SRO rules with regard to communications with the public, records of persons who can explain the information in the broker/dealer's records, and records of each principal responsible for establishing recordkeeping compliance procedures.

**Kyra:** How long must firms maintain records at office locations?

**Emily:** The requirement to maintain certain records at office locations is two years. The amended rules also provide that if a broker/dealer does not maintain records at an office, but instead chooses to produce the records upon request, the broker/dealer must produce the records "promptly."

**Kyra:** I have to bring Bill back into this discussion. Bill, a lot of attention has been placed on the word "promptly." How is "promptly" defined?

**Bill:** That's a good question. The word "promptly" has deliberately not been defined in the rule. In general, requests for records, which are readily available at the office (either

on-site or electronically), should be provided immediately upon request. If a request is unusually large or complex, then the firm should discuss with the regulator a mutually agreeable time frame for production.

**Kyra:** Bill, what if a firm does not produce it within the agreed upon time frame? Is there a good reason that regulators will accept for a delay in the production of records?

**Bill:** Well, what I can say is that valid reasons for delays in producing the requested records *do not include* the need to send the records to the firm's compliance office for review *prior* to providing the records.

**Kyra:** Bill, you are not suggesting, though, that records cannot be reviewed by compliance prior to being produced to the regulators, only that such review cannot be a reason for delay in production, correct?

**Bill:** That's correct. Such review will not be a valid reason for failing to "promptly" produce records to the regulators.

**Kyra:** What if the firm has a foreign office?

**Bill:** The rule states that broker/dealer must make certain records for a foreign office; however, a broker/dealer is not required to maintain or produce those records at the

foreign office. Instead, those records would be maintained at the broker/dealer's main office.

### **GENERAL RECORD RETENTION REQUIREMENTS**

**Kyra:** Thanks, Bill. Now, Emily, I know that there are a number of new record retention requirements. Can you give some of the highlights?

**Emily:** Sure, Kyra. First, firms are required to retain originals of all communications received and copies of all communications sent (and any approvals thereof) by the firm, including interoffice memoranda and communications relating to its business including all communications which are subject to the rules of a self regulatory organization of which the firm is a member regarding communications with the public. Please note that the term “communication” includes sales scripts.

Also, firms have to preserve for a period of not less than 6 years after the closing of any customer’s account, any account cards or records which relate to the terms and conditions with respect to the opening and maintenance of the account.

In addition, firms must retain copies of certain organizational documents for the life of the entity such as partnership articles or articles of incorporation or charter books. Each firm is also required to maintain copies of all of its Forms BD, Forms BDW, and all amendments thereto and all licenses or other documents showing the registration of the firm with any securities regulatory authority.

**Kyra:** What are some of the other requirements?

**Emily:** Well, firms are required to keep, for three years after the date of the report, all reports which a securities regulatory authority has requested or required a firm to make and furnish to it pursuant to an order or settlement, and each securities regulatory authority examination report.

Also, firms must keep for three years after the termination of use, all compliance, supervisory, and procedure manuals describing the firm's policies and practices with respect to compliance and supervision.

In addition, firms must, for 18 months after the date the report was generated, maintain all reports created to review unusual activity in customer accounts.

For more information on these requirements, firms should look at the Adopting Release found either on the SEC web site at [www.sec.gov](http://www.sec.gov) or NASD's web site at [www.nasdr.com](http://www.nasdr.com).

### **EXAMINATIONS**

**Kyra:** Thanks, Emily for describing all of that information.

Now, as everyone knows the deadline for compliance is May 2, 2003. NASD's examination program has been tasked with the responsibility of determining and ensuring member compliance with the securities laws, including these books and records rules. To talk about this, I would like to introduce George Walz, Director of NASD Member Regulation's Examination Program Group. George, how is NASD preparing to examine for this?

**George:** As everyone is well aware by now, broker/dealers must be in compliance with these new requirements that are effective May 2<sup>nd</sup>. NASD will also have to adjust to the new rules and amendments by conducting examinations for compliance with the new requirements. We have had to adjust our examination procedures accordingly to be ready for the 2<sup>nd</sup> of May. Also, our examinations staff has been educating themselves and preparing themselves for these requirements along with member firms. So, not surprisingly, it has been a busy time for NASD's examiners, as well.

**Kyra:** How will NASD be examining for compliance with these requirements?

**George:** NASD's examiners will begin looking for compliance with the books and records rule amendments on May 2<sup>nd</sup> in various ways. Through our routine examinations, our examiners will review member firm's books and records to make sure that the member firm has complied with the amendments. Also through our routine examinations, NASD's examiners will review customer complaints, as we normally do during the course of a routine examination, and the attendant books and records to

determine not only if the firm may have sales practice problems, but also if the firm has made appropriate changes to its systems in accordance to the amendments of 17a-3 and 17a-4. Finally, our examiners will review for compliance with the amendments during cause investigations, where examiners routinely request books and records from member firms to support the ongoing investigation of a customer complaint, termination for cause, or other sales practice issue. Our examiners will not only be reviewing the substance of the alleged activity, but also the underlying books and records of the member firm.

Obviously there will be a period of time in which the books and records were prepared in accordance with the requirements of the rules prior to the amendment's effective date, but certain books and records, such as those related to complaints and compensation, will likely already be effective under the amendment's requirements.

**Kyra:** Now, let me ask you about non-compliance. What happens when firms are found to be non-compliant with these requirements?

**George:** Good question. Part of our role is to educate. Another is to fully and adequately discharge our oversight responsibilities. We will approach each situation with common sense and on a fact-specific, case-by case basis. I think we would initially approach a violation as we would in other areas—from an informal basis. If the firm does not follow-up with those documents, or its response is inadequate, however, this may warrant an escalation of disciplinary response. This approach will provide a mechanism for the District Offices to ensure that if a firm is not in compliance, there can be adequate follow-up necessary to satisfy the staff that the firm has fixed the problem

without requiring the staff to go back into the firm in every instance. NASD has taken disciplinary action for egregious books and records violations in the past, and will continue to do so, should there be acts by member firms or associated persons to impede investigations through the firm's books and records, or should there be substantial non-compliance with the rules.

**Kyra:** Thanks, George for your insight and comments.

Bill, what about with the states? How will examinations be handled—at least from the perspective of your agency? How will non-compliance be handled?

**Bill:** During the last 18 months, part of my job has been to educate state securities regulators on the new requirements of the amended rules. I believe this education process will promote uniform examinations by state securities regulators.

Just as it is imperative to educate regulators, I agree with George that the roles of the states, SRO's, and SEC are to educate the industry, not only in the rules, but each of the rules and regulations we are responsible for enforcing. As previously indicated, the SEC adopted the amended rules in October 2001, with an implementation date of May 2003, some 18 months. Therefore, I believe broker/dealers have made substantial progress and will achieve compliance with the rules by its implementation date. However, for those firms who may encounter compliance problems, I believe state regulators will work with firms to achieve full compliance. However, for those firms which demonstrate blatant disregard or substantial non-compliance with the amended rules will encounter

substantial sanctions. On a closing note, I encourage broker/dealers to attend any seminars offered in this area and not hesitate to contact its state, SRO, or SEC for clarification on any questions you have on the amended rules.

### **CONCLUSION**

**Kyra:** Thank you. Well, that will conclude our program for today. I'd like to thank Bill, Vicky, Emily, Patricia, and George very much for all of the effort that they put into today's presentation. I'd like to remind people listening in that a transcript of today's workshop will be posted on our Regulatory and Compliance Workshop web page shortly. We have created a separate "Books and Records" page on NASD's web site, at [www.nasdr.com/books.asp](http://www.nasdr.com/books.asp). We will add a Frequently Asked Questions section to NASD's Web page and a compliance checklist to this web page shortly.

Also, NASD is hosting a panel on books and records at its upcoming Spring Securities Conference from May 1-2, 2003 in Hollywood, Florida. For more information about the conference and registration, please visit our web site.

I'd also like to encourage you to send us your comments about today's workshop and suggestions for future workshops. We want to be responsive to our members and provide you with the type of information that best suits your business needs.

Thank you very much for listening and I look forward to hearing from you.