Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Executive Representative

Legal & Compliance

Operations

Senior Management

KEY TOPICS

Investment Banking

Research Reports

Small Firms

REQUEST FOR COMMENT ACTION REQUESTED BY AUGUST 30, 2002

Research Analysts and Research Reports

NASD Requests Comment on Application of Rule 2711 to Small Firms; **Comment Period Expires on August 30, 2002**

Executive Summary

On May 10, 2002, the Securities and Exchange Commission (SEC) approved new NASD Rule 2711, Research Analysts and Research Reports. The rule is intended to address potential conflicts of interest in the issuance of research reports by members, improve the objectivity of research, and provide investors with more useful and reliable information when making investment decisions. The SEC also approved on that day similar amendments to New York Stock Exchange (NYSE) Rule 472. The rules will be implemented in phases during the period from July 9, 2002 to November 6, 2002.

On July 1, 2002, NASD filed with the SEC a rule change that, among other things, delayed the effectiveness of two provisions of Rule 2711 for small firms. These delaying amendments establish November 6, 2002, as the effective date for Rules 2711(b) and (c) for members that have engaged in a limited number of investment banking transactions over the previous three years. Rules 2711(b) and (c) prohibit a research analyst from being subject to the supervision or control of the member's investment banking department and require compliance personnel to intermediate certain communications between research, investment banking, and the company that is the subject of the research report.

This *Notice* requests comment on whether smaller NASD members should be exempt from certain provisions of Rule 2711. The *Notice* seeks comment on which provisions of Rule 2711 present the greatest challenges for small firms. To the extent NASD determines that it should provide exemptions for small firms, NASD invites comment on which firms should be eligible for these exemptions.

Questions or comments concerning NASD Rule 2711 or this *Notice* may be directed to the NASD Corporate Financing Department at (240) 386-4623.

02-44

Request for Comment

NASD requests comment on whether certain small members should be eligible for exemptions from certain provisions of NASD Rule 2711. Comments must be received by August 30, 2002. Members and interested persons can submit their comments using the following methods:

- mailing in Attachment A—Request for Comment Form—along with written comments
- mailing in written comments
- e-mailing written comments to *pubcom@nasd.com*
- submitting written comments online on our Web Site (*www.nasd.com*)

Written comments submitted via hard copy should be mailed to:

Barbara Z. Sweeney
NASD
Office of the Corporate Secretary
1735 K Street, NW
Washington, DC 20006-1500

Important Note: The only comments that will be considered are those submitted in writing by mail, our Web Site, or by e-mail.

Before becoming effective, any rule change developed as a result of responses received to this *Notice* must by approved by the NASD Board of Governors and the SEC.

Background and Discussion

Delaying Amendments for Small Firms

In response to requests from some of our smaller members, on July 1, 2002, NASD filed with the SEC a rule change that, among other things, established November 6, 2002, as the effective date for Rules 2711(b) and (c) for smaller members. These delaying amendments applied to members that over the previous three years, on average each year, have: participated in 10 or fewer investment banking transactions as manager or co-manager; and generated no more than $5 million in gross investment banking revenues from those transactions.

Regulatory Relief for Small Firms

NASD is soliciting comment during the delay on whether small firms should be eligible for exemptions from certain provisions of Rule 2711 on a permanent basis. Accordingly, NASD requests comment on several questions.

First, NASD requests comment on the potential conflicts of interest faced by smaller firms when they issue research reports. Are the research reports issued by smaller firms any more or less objective than those issued by larger firms? What factors account for any differences in objectivity? To what extent do the conflicts of interest faced by smaller firms differ from those faced by larger firms?

Second, NASD requests comment on whether smaller firms have adopted procedures, other than those required by Rule 2711, to address these conflicts. How effective have any such procedures been?

Third, NASD requests comment on whether any provision of Rule 2711 imposes a burden that is unique to smaller firms. Does any unique burden outweigh any potential benefit to the investing public, and thus justify an exemption for smaller firms?

Fourth, if NASD determined to provide an exemption from certain provisions of the rule to smaller firms, what would be the best method to differentiate between firms that should be eligible for the exemption and those that should not be eligible? Is the transactions and revenues test that was adopted for the delaying amendment appropriate? Are there factors other than the number of investment banking transactions or the amount of investment banking revenues that NASD should consider in determining which members are "small firms"?

ATTACHMENT A

Request for Comment Form

We have provided below a form that members and other interested parties may use in addition to written comments. This form is intended to offer a convenient way to participate in the comment process, but does not cover all aspects of the proposal described in the *Notice*. We therefore encourage members and other interested parties to review the entire *Notice* and provide written comments, as necessary.

Instructions

Comments must be received by August 30, 2002. Members and interested parties can submit their comments using the following methods:

- mailing in this form with attached comments
- e-mailing written comments to *pubcom@nasd.com*
- mailing in written comments
- submitting comments online at our Web Site (*www.nasd.com*)

This form and/or written comments should be mailed to:

Barbara Z. Sweeney
NASD
Office of the Corporate Secretary
1735 K Street, NW
Washington, DC 20006-1500

Research Analysts and Research Reposts

The staff requests input from members and other interested parties on whether NASD should grant regulatory relief from NASD Rule 2711 for small firms. In particular, the staff seeks comment on the following questions:

1. Are research reports issued by smaller firms more objective than those issued by larger firms?

   ◯ Yes ◯ No ◯ See my attached written comments

2. Do the conflicts of interest faced by smaller NASD firms when they issue research reports differ from those faced by other members?

   ◯ Yes ◯ No ◯ See my attached written comments

3. Have smaller firms adopted procedures, other than those required by Rule 2711, to address conflicts of interest that arise when they issue research reports?

   ◯ Yes ◯ No ◯ See my attached written comments

4. Does any provision of NASD Rule 2711 impose a burden that is unique to smaller firms?

   ◯ Yes ◯ No ◯ See my attached written comments

5. Does any unique burden imposed on smaller firms by a provision of Rule 2711 outweigh the potential benefits to the investing public from the provision, and thus justify an exemption for small firms?

   ◯ Yes ◯ No ◯ See my attached written comments

6. Is the appropriate test for determining which firms qualify for regulatory relief from Rule 2711 a test that includes members that, on average over the past three years, have participated in 10 or fewer investment banking transactions as manager or co-manager and generated $5 million or less in gross investment banking revenues from those transactions?

   ◯ Yes ◯ No ◯ See my attached written comments

7. Are there factors other than the number of investment banking transactions and amount of investment banking revenues that NASD should consider in determining which firms qualify for regulatory relief?

   ◯ Yes ◯ No ◯ See my attached written comments

Contact Information

Name: _____

Firm: _____

Address: _____

City/State/Zip: _____

Phone: _____

E-Mail: _____

Are you:

- ◯ An NASD Member
- ◯ An Investor
- ◯ A Registered Representative
- ◯ Other: _____

Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Senior Management

Legal and Compliance

Operations

Trading

Market Making

KEY TOPICS

Alternative Display Facility

Alternative Display Facility (ADF) Nine-Month Pilot Approved for Trading in Nasdaq Securities

Executive Summary

On July 24, 2002, the Securities and Exchange Commission (SEC) approved amendments to NASD rules that establish, implement, and operate NASD's Alternative Display Facility (ADF) on a pilot basis for nine months.[1] As described in more detail herein, members that choose to participate in the ADF during the pilot may quote and trade Nasdaq-listed securities on or through the ADF, commencing on July 29, 2002. NASD has proposed the permanent establishment and operation of the ADF in a separate rule filing, which would provide market participants the ability to quote and trade Nasdaq and exchange-listed securities.[2] However, several regulatory issues relating to the trading of exchange-listed securities on the ADF have not been resolved. Because these open issues do not relate to trading Nasdaq securities, NASD has received approval to operate the ADF on a pilot basis with respect to Nasdaq securities only.

The SEC Approval Order, which includes the text of the amendments, is available at *http://www.sec.gov/rules/sro/34-46249.html.* This *Notice* is intended to provide an overview of how the ADF will operate and member requirements in this regard. For additional information regarding ADF, members should review the SEC Approval Order and other ADF documentation available at *http://www.nasd.com/ mkt_sys/adf_info.asp.*

Questions concerning this *Notice* related to the rules should be directed to either the Division of Regulatory Policy and Oversight, Office of General Counsel, at (202) 728-8071, or Market Regulation Department, at (240) 386-5126. Questions related to the operation of the ADF or becoming an ADF participant should be directed to the Division of Regulatory Services and Operations, Market Operations and Information Services, at (866) 776-0800 or (212) 858-5178.

02-45

Background

The ADF is a quotation collection, trade comparison, and trade reporting facility developed by NASD in accordance with the SEC's SuperMontage Approval Order[3] and in conjunction with The Nasdaq Stock Market, Inc.'s (Nasdaq) anticipated registration as a national securities exchange.[4] Initially, the ADF will be operated on a pilot basis for nine months. During the pilot, ADF market participants (market makers and ECNs) will be able to post quotations in Nasdaq securities and all members that participate in the ADF will be able to view quotations and report transactions in Nasdaq securities. The facility also will provide for trade reporting and comparison through the Trade Reporting and Comparison Service ("TRACS"), which is described in detail below.

Because the ADF pilot will be operating prior to the approval of Nasdaq's registration as an exchange, NASD will operate both Nasdaq and the ADF during the pilot period. Accordingly, the new rules applicable to quotation and trading requirements for activities through the ADF are separate from the quotation and trading rules relating to Nasdaq. Certain rules applicable to trading on Nasdaq have been amended, but only to reflect that members that choose to participate in both Nasdaq and the ADF may elect to trade report to either facility, except as specifically described herein. Otherwise, rules applicable to trading on Nasdaq have not changed.

The ADF trade reporting rules are consistent with current requirements applicable to Nasdaq market participants and are not intended to require new or different trade reporting responsibilities for parties to transactions. As described in more detail herein, the new Rule 5400 Series details which party to a transaction has the trade reporting responsibility and where (ADF or Nasdaq) the party with the trade reporting responsibility is required, or has the choice, to trade report.

Market Maker and ECN Registration

Similar to the existing rules applicable to Nasdaq market makers, ADF participants must register as market makers or ECNs to make a market or display orders on the ADF. Market makers will receive approval for registration upon demonstration that they are members in good standing and comply with the net capital and other financial responsibility requirements of the Exchange Act. To ease the administrative burden on NASD members, the pilot ADF rules initially will allow registration as a market maker in the ADF upon proof that a member is a registered Nasdaq market maker.

The ADF rules track Nasdaq requirements that market makers maintain continuous two-sided firm quotations and prescribes market maker obligations when a bid or offer locks or crosses the market. ECNs, however, may post one-sided quotes in the ADF. If an ADF Market Maker that also is a Nasdaq Market Maker is seeking excused withdrawal status, it must obtain such excused withdrawal status in both facilities for the same time period.

The ADF rules also provide that registration as an ADF market maker in a security is voluntarily terminated when the market maker: (1) withdraws its quotations from the ADF and does not re-enter quotations in the security for five minutes; or (2) fails to re-enter quotations within 30 minutes after the end of a trading halt. In either

circumstance, a market maker would be prohibited from participating as an ADF market maker in that security for twenty (20) business days.

Order Access Rule

NASD will not provide an order routing capability. Instead, the pilot ADF Rule 4300A ("order access rule") requires NASD "market participants" to provide "direct electronic access" to other "market participants" and to provide to all other NASD members "direct electronic access" or allow for "indirect electronic access" to the individual market participant's quote ("order access rule"). The rule defines "market participants" as either an ADF Registered Market Maker, or an ADF Registered ECN or ATS. In other words, "market participants" are those members that post quotations in the ADF.

As stated above, the order access rule requires market participants to provide other market participants with direct electronic access to their quotes. "Direct electronic access" is defined in the rule as the ability to deliver an order for execution directly against an individual NASD market participant's best bid or offer without the need for voice communication, with equivalent speed, reliability, availability, and cost, as are made available to NASD market participants' own customers. Therefore, while the linkage must be electronic — telephone access is insufficient — the rule allows market participants flexibility to determine the type and method of linkage. For example, market participants are permitted to link directly among themselves bilaterally using their own technology or to use a provider with multilateral order routing facilities to satisfy the linkage requirements. The rule requires that a market participant be equally accessible to all other market participants via this electronic link.

The rule also requires market participants to provide all other NASD broker/dealer members (*i.e.*, those members that do not quote in ADF but want to access ADF quotes) with direct electronic access or allow for "indirect electronic access" through their customer broker/dealers. "Indirect electronic access" is defined as the ability to route an order through a market participant's customer broker/dealer for execution against the market participant's best bid and offer, without the need for voice communication, with equivalent speed, reliability, availability, and cost, as are made available to the market participant's customer broker/dealer providing access to the market participant's quotes.

A market participant may not deny indirect access to its quotes by requiring that all broker/dealers link directly to it. The requirement to allow for indirect access also does not permit market participants to refuse direct access to members that would prefer direct connectivity; rather, it creates an additional means for non-market participant broker/dealers to access market participants' quotes.

The order access rule applies only to a market participant's top of book, *i.e.*, the best bid and offer that is displayed in the ADF. Therefore, market participants retain substantial flexibility to negotiate the terms of many other services, such as full book access, placing orders, and use of reserve sizes. ECNs are permitted to charge more for "hit or take" access only – purely a liquidity taking function — than for full subscriber services, provided that the fee is reasonable, based on objective criteria, and not imposed discriminatorily.

Costs of Providing Order Access

Market participants must share equally the costs of providing to each other the direct electronic access required by the rule, unless those market participants agree upon another cost-sharing arrangement. For example, assume the ADF consisted of five market participants and a sixth broker/dealer registered as an ADF market participant. Under this scenario, each of the five existing market participants would be required to split with the new market participant the costs to establish their respective bilateral links with the new market participant, unless the parties agreed upon a different cost allocation.

Market participants also must pay the costs to enable direct electronic access to their quotes by non-market participant broker/dealers seeking access. Thus, a market participant must bear the costs to build, upgrade, or otherwise reconfigure its technology to allow other broker/dealers to connect to it, including the costs to accommodate additional volume resulting from indirect electronic access order flow through customer broker/dealers. Similarly, those non-market participant broker/dealers seeking access to a market participant's quote must bear the line or other costs necessary to connect with a market participant's network.

A customer broker/dealer may charge its customers a fee to provide indirect access to a market participant's quotes. A market participant may not influence or prescribe what a customer broker/dealer may charge its customers for indirect access to the market participant.[5] Further, a market participant may not preclude or discourage a specific customer broker/dealer from providing indirect access, either through discriminatory pricing or by degrading its quality of service to its customer broker/dealer. A market participant may, however, offer to provide direct electronic access at a competitive price as part of the services it provides to customers.

Connectivity costs should be distinguished from fees for various other services provided by market participants. NASD recognizes that market participants have a variety of existing business relationships with broker/dealers for which they charge fees for services rendered, *e.g.*, the handling of limit orders, price improvement opportunities, and liquidity enhancement. Market participants may continue to assess fees for these types of services, as permissible under current rules and regulations.

While ECNs may charge to execute against their best bid and offer, the fee must be based on reasonable and objective criteria. And while ECNs are permitted under the proposal to charge more for hit-or-take access than for full service access, they may not impose hit-or-take fees in a way that discriminates against a particular broker/dealer or class of broker/dealers. Thus, in setting its fee schedule, an ECN may not look through its order flow to identify and discriminate against the source of the order flow, *e.g.*, a competitor or a broker/dealer that is accessing the quote indirectly. Rather, an ECN may set a reasonable fee for order flow that takes liquidity – a fee that may be higher than for order flow that provides liquidity — and apply that fee to all such order flow, irrespective of its origin. Similarly, an ECN that offers a volume discount must offer the same terms to all broker/dealers accessing its quote via direct or indirect access, without regard to the identity of the broker/dealer or the source of its order flow.

Minimum Performance Standards

To ensure that ADF quotes are reliable and accessible, order access linkages must meet specified minimum performance standards. Specifically, the pilot ADF rules impose a technological requirement on market participants, mandating that their order linkage system provide them the capability to respond to an order – *i.e.* accept or decline it – from another market participant or customer broker/dealer, within two seconds of receipt. Additionally, market participants are required to have in place a system that can accomplish a "round trip" of an order from another market participant in three or fewer seconds, measured from the time an order is released by a market participant until the time notification of action taken on the order is received back by the market participant that sent the order.

Market participants will be required to certify that their systems can meet these standards at peak capacity, based on reasonable forecasts, before they are authorized to post quotes on the ADF. On an ongoing basis, market participants will be required to re-certify that they can meet these performance standards when volumes exceed those on which the initial certification was based. NASD will review test data to confirm the accuracy of such certifications.

It is important to note that these performance standards are independent of existing firm quote requirements in Exchange Act Rule 11Ac1-1, NASD Rule 3320, and new NASD Rule 4613A(b), which require prompt execution of an order up to the quotation size displayed by the market participant upon receipt of an order to buy or sell. The performance standards ensure that all market participants have adequate technology that will not degrade the overall accessibility of ADF quotes. By comparison, the firm quote rule addresses market participants' obligation to honor their quotes when they receive an order. Accordingly, the performance standards do not require market makers to fill orders in two seconds; however, due to their structure, broker/dealers whose business models rely primarily upon electronic executions systems, for example, ECNs, would be expected to fill orders in less than two seconds.

Market Participant Inaccessibility

To further ensure the reliability of linkages and the integrity of the ADF, NASD will have the authority to suspend from quoting or displaying orders for 20 business days any market participant that experiences three unexcused, confirmed system outages during any period of five business days. System outages are defined as an inability to quote or an inability to respond to orders. A review and appeal process is available, whereby the burden will rest with the market participant to establish that a confirmed system outage was attributable to another party. NASD will have discretion to excuse certain outages where the market participant voluntarily brings the matter to the attention of NASD. NASD also will receive and investigate complaints related to failure to provide direct or indirect access. Complaints of this nature can be reported to NASD, Market Operations at (866) 776-0800 or (212) 858-5178.

Reporting of Order Access Data to NASD

To allow NASD to monitor compliance with certain trading rules, such as the firm quote rule and "trade or move" rules, all market participants that display quotations or orders in the ADF must record specified items of information

pertaining to orders they receive from broker/dealers via direct or indirect electronic access and report this information to NASD on a real-time basis. This information must be provided to NASD within 10 seconds of the receipt of an order and, if applicable, when an order is acted upon or responded to.

Trade Reporting and Trade Comparison Service

As described above, TRACS is a trade reporting and comparison service that will operate as part of the ADF pilot. TRACS will collect trade reports for NASD registered market participants, as well as any NASD member that chooses to or is required to report transactions through the ADF. The service will transmit the reports automatically to the Exclusive Securities Information Processor (ESIP), if required, for dissemination to the public and the industry.

TRACS operates similarly to the trade reporting functions of Nasdaq's Automated Confirmation Transaction Service (ACT)[6] but contains one notable distinguishing feature. TRACS supports a "three party trade report" that will make it easier for ECNs to submit trade reports involving their subscribers and for market makers to submit riskless principal trade reports. A three party trade report is a single last sale trade report that will denote one reporting member – *i.e.*, the party with the trade reporting responsibility as defined in the Rule 4630A Series – and two contra parties. The ADF will split the three party trade report into two separate reports that will then be processed independently in accordance with existing trade reporting rules. Each of these reports will contain its own identifier and a reference to the original three party trade report, so that the separate reports can be mapped to the same transaction. Therefore, the ADF trade reporting system streamlines the reporting process by reducing from three or two to one the number of trade reports for most ECN and riskless principal transactions.

The TRAC's trade comparison service: (1) compares trade information entered by TRACS participants and submits "locked-in" trades to clearance and settlement; (2) transmits reports of the transactions automatically to the ESIP, if required, for dissemination to the public and the industry; and (3) provides participants with monitoring capabilities to facilitate participation in a "locked-in" trading environment. The trade comparison rules are found in the new Rule 6100A Series.

For those trades where one party is a TRACS subscriber and the other party is an ACT subscriber, both TRACS and ACT will accept one-sided trade reports and submit those trades to the National Securities Clearing Corporation (NSCC). In such cases, NSCC will compare the trade.

Transaction Reporting

The pilot rules adopt the current Nasdaq approach to trade reporting for Nasdaq securities, regardless of whether the member is reporting through TRACS or ACT. The pilot rules adopt a new Rule 5430(b), which designates which party to a transaction has the trade reporting responsibility and where, TRACS or ACT, the party with the trade reporting responsibility is required, or has the choice, to trade report.

Specifically, Rule 5430(b) requires that the seller report trades between two market makers or two non-market makers, the market maker report trades between it and a customer, and an NASD member

report trades between it and a customer. NASD members that are market makers in both the ADF and Nasdaq and have a trade reporting obligation under the rule, have a choice to trade report to ADF or Nasdaq, except for those transactions that are executed or facilitated by a Nasdaq system. If a member is a market maker in either Nasdaq or the ADF, but not the other facility, and has a trade reporting obligation under the rule, the member must report to the facility in which it is a market maker.

For example, if a member is an ADF market maker, but not a Nasdaq market maker, in a security, the member, if it has a trade reporting obligation, must report the transaction in that security to TRACS, unless the trade is executed using ACES, the Nasdaq National Market Execution System (NNMS), the SelectNet Service, the SmallCap Small Order Execution System (SOES), or the Primex Auction System (Primex). A trade executed using ACES must be reported using ACT, and trades executed using NNMS, SelectNet, SOES, or Primex will be reported to ACT automatically. A member that is not a market maker in either facility but is a participant in both facilities and has a trade reporting obligation may trade report to either facility, unless the trade is executed using ACES, NNMS, SelectNet, SOES, or Primex.

With respect to trade reporting by ECNs, ECNs that currently display quotes in Nasdaq have developed different methods of reporting trades. ECNs may continue to report to Nasdaq and/or the ADF in this same manner.

Short Sale Rule

The short sale rule and its accompanying interpretation have been amended for the purposes of the pilot to provide that the current Nasdaq short rule applies to trading in Nasdaq-listed issues on the ADF. Specifically, members trading on the ADF must comply with the short sale rule based on the national best bid, as currently required under Rule 3350, and also includes the current exemption for registered market makers engaged in bona fide market making activity. The short sale rule will continue to apply as it does today to short sale activities on Nasdaq.

Trading Halts

Rule 4120A provides NASD with authority to halt trading through the ADF in Nasdaq securities. ADF will halt trading when another market halts trading in a security for regulatory reasons. If another market halts trading for operational reasons, market participants may continue to trade in the ADF and would be required to meet all applicable trade reporting requirements. In addition, the ADF has the authority to close ADF to quotation activity when the ADF is unable to transmit real-time quotation and trade reporting data to the ESIP. Under such circumstances where the ADF closes due to an inability to transmit quotation or trade reporting data under Rule 4120A(a)(2), members would not be prohibited from trading through, another market, such as Nasdaq, that has not halted trading, or within their own systems.

Any trading halt initiated by NASD would become effective simultaneously with notification via an administrative message sent through the ADF terminal or interface. Trading similarly would resume after an administrative notice has been issued.

Obligations When Quoting in Multiple Market Centers

Existing Rule 2320(g)(2) requires members that display quotations for non-Nasdaq securities in two or more quotation mediums to post the same priced quotations in each medium. Similar to this obligation, new Rule 4613A(e)(1) requires members that display quotations for Nasdaq securities in two or more market centers, including the ADF, to display the same priced quotations in each medium. It does not, however, prohibit displaying different size quotations in two or more mediums or market centers, provided that the price displayed is the same.

Obligation to Have Quotations From Other Market Centers in Close Proximity

New Rule 4613A(e)(2) requires a registered NASD market maker to have in close proximity to the ADF terminal or interface at which it makes a market in a Nasdaq security a quotation service that disseminates quotations in that security from other market centers. A similar rule, Rule 6330(c), currently exists with respect to Consolidated Quotation Service (CQS) market makers. As with the CQS rule, it is NASD's intention for the quotations displayed in the ADF terminals or interfaces to function as a verification mechanism whereby ADF market participants can monitor their current ADF quotations and ensure that NASD is timely updating and disseminating their quotations. NASD will not disseminate to ADF market participants any consolidated quotation or trade data in a security from securities exchanges and market centers. To ensure that ADF participants have the data necessary to make proper order routing decisions and to satisfy the Vendor Display Rule,[7] NASD requires ADF market participants to obtain from vendors dynamic quotations and last-sale information on the securities they trade through the ADF, and to display this data in close proximity to the ADF data displayed on their terminals, just as is currently required of CQS market makers in Rule 6330(c).

OATS Requirements

OATS requirements will remain substantially the same as current requirements, with one exception. All NASD members must complete an additional field on the OATS execution report indicating where the order was reported. This requirement will enable NASD to clearly identify which execution reports are associated with ADF trade reports and which are associated with Nasdaq trade reports and, thereby, keep this data separate and confidential, as necessary. This requirement will not be effective until September 27, 2002, to allow time for necessary system charges.

All NASD members must continue to record in electronic form and report to NASD on a daily basis certain information with respect to orders originated, received, transmitted, modified, canceled, or executed ("reportable events") by NASD members relating to equity securities traded on Nasdaq. When the

ADF and Nasdaq are both operating, NASD members, in many cases, will have at least two options as to where they may choose to report their transactions in Nasdaq securities. As such, NASD must "match" OATS execution reports to either TRACS data or ACT data, depending upon where the transaction was reported. By having a field in the OATS execution report indicating where the order was reported, NASD systems will be able to more efficiently compare the execution report to the appropriate trade report.

Fees and Assessments

The fees and assessments applicable to activities through the ADF are contained in the new Rule 7000A Series. The following are fees that will be charged relating to transactions on the ADF: Comparison — $0.014/side per 100 shares (minimum 400 shares; maximum 7,500 shares); Automated Give-Up — $0.029/side; Late Report - T+N — $0.30/side; Browse/query — $0.28/query; Trade Reporting — $.029/side (applicable only to reportable transaction not subject to trade comparison through TRACS); and Corrective Transaction Charge —$0.25.

Members choosing to participate in the ADF will be charged a minimum of $5,000 for installation costs associated with connecting to the ADF. Additional reimbursement from members will be required for charges incurred by NASD above $5,000 due to the installation, removal, relocation, or maintenance of terminal and related equipment. However, the ADF will provide members with a credit of up to $5,000 toward their trade reporting and comparison charges. Members also will be charged an ADF workstation fee of $275 per month for each ADF terminal software license and $550 per month for each ADF server license.

ADF market participants will be charged a quotation update fee of $.01 per quotation update in the ADF quotation montage. This quotation update fee, however, will apply only to those quotation updates by the member in the ADF that exceed three times the number of transactions reported by the member through the ADF. This quotation update fee will be determined on a monthly basis. By imposing this fee only where the quotation updates significantly exceed the number of transactions reported, this fee structure fairly imposes costs on those members whose quotation activity creates system capacity demands and, therefore, costs not covered by trade reporting fees.

Fee Waiver and Discount

ADF participants will not be charged for transaction and quotation update fees (Rules 7010A(a) and (b), respectively) for a period of up to three months during the initial six months of operation of the ADF. As a result, during this six-month period, for up to three months starting from the initial transaction by an ADF participant, a participant will not be charged transaction or quotation fees. However, the time period for which the three-month "fee waiver" is available concludes at the end of the six-month period, irrespective of whether the member has participated in the ADF for three months. For example, if the ADF has been operational for four months and a market participant begins trading at that time, it only would be eligible for the "fee waiver" for two months.

Also during the initial six months of operation of the ADF, NASD will adjust its fees imposed on trade reporting and quotation activities through the ADF to provide for volume discounts subsequent to the three month "fee waiver" period, as applicable. Specifically, discounted fees will apply to those members that have greater than 2,000 trades per month and for those members that have greater than 8,000 chargeable quotes per month. The volume discounts would apply to all transaction fees incurred under Rule 7010A(a), except the browse/query fee, and all quotation update fees incurred under Rule 7010A(b). The discounts would apply in the increments per the chart below.

For example, if a member had 5,000 trades and 16,000 quotation updates during a month, the discounted fee structure would apply as follows: no discount would apply to the first 2,000 trades; the fees imposed on trades 2,001 through 4,000 would be discounted by 10%; and the fees imposed on trades 4,001 through 5,000 would be discounted by 25%. The quotation update charge on 1,000 quotations (those quotations that exceed three times the number of trades) would not be discounted because it is less than 8,001.

For additional information regarding requirements related to quoting and/or trading through the ADF, members should review the rule text, SEC Approval Order, and other additional ADF documentation available at *http://www.nasd.com/mkt_sys/adf_info.asp.*

Trades per Month	Chargeable Quote Updates per Month	Discount
Up to 2,000	Up to 8,000	0%
2,001 to 4,000	8,001 to 15,000	10%
4,001 to 6,000	15,001 to 25,000	25%
6,001 to 8,000	25,001 to 35,000	35%
8,001 or greater	35,001 or greater	50%

Endnotes

1 *See* Securities Exchange Act Release No. 46249 (July 24, 2002), (File No. SR-NASD-2002-97) ("SEC Approval Order").

2 *See* SR-NASD-2001-90. It is possible that the SEC may take action prior the expiration of the pilot period on the proposed rule change to make permanent the ADF for trading both Nasdaq and exchange-listed securities. Fees and assessments applicable to the ADF on a permanent basis are proposed in SR-NASD-2002-28.

3 Securities Exchange Act Release No. 43863 (January 19, 2001), 66 Fed. Reg. 8020 (January 26, 2001) (File No. SR-NASD-99-53).

4 Securities Exchange Act Release No. 44396 (June 7, 2001), 66 Fed. Reg. 31952 (June 13, 2001) (File No. 10-131).

5 The fact that a market participant has an ownership interest in a customer broker/dealer or multilateral linkage provider does not, in itself, constitute influence for the purposes of this rule.

6 TRACS will not perform risk management services that are provided by Nasdaq's ACT service.

7 Exchange Act Rule 11Ac1-2.

Special Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Legal & Compliance

Senior Management

KEY TOPICS

National Adjudicatory Council

INFORMATIONAL

NAC Nominations

NASD Announces Nomination Procedures for Regional Industry Member Vacancy on the National Adjudicatory Council; **Nomination Deadline: September 5, 2002**

Executive Summary

The purpose of this *Special Notice to Members* is to advise members of the nomination procedures to fill one upcoming vacancy on the National Adjudicatory Council (NAC). The three-year term of the NAC regional Industry member from the North Region expires in January 2003.

Exhibit I contains information regarding the NAC regional Industry member whose term expires in January 2003. Exhibit II contains a list of all NAC members. The procedures to fill the NAC regional Industry vacancies are outlined in Exhibit III. Also, a Candidate Profile Sheet is included in Exhibit IV.

Nomination Process

Members are encouraged to submit nominations for the upcoming NAC vacancy. To nominate a candidate, members should submit a cover letter and the Candidate Profile Sheet (Exhibit IV) to the appropriate Regional Nominating Committee Chair, the NASD District Director, or NASD Corporate Secretary (listed in Exhibit I) by **September 5, 2002**.

The completed Candidate Profile Sheets will be provided to all Regional Nominating Committee members for review. On or about **September 19, 2002**, the Regional Nominating Committee will provide NASD members with written notice of the NAC candidate that the Committee proposes for nomination to the National Nominating Committee. Pursuant to Article V, Section 5.3(a) of the NASD Regulation By-Laws, the NASD National Nominating Committee shall nominate all candidates for the NAC for subsequent appointment by the Board.

02-46

Questions/Further Information

Questions concerning this *Special Notice to Members* may be directed to the District Directors listed in Exhibit I or to Barbara Z. Sweeney, Senior Vice President and Corporate Secretary, NASD, at (202) 728-8062 or via e-mail at barbara.sweeney@nasd.com.

National Adjudicatory Council Membership and Function

Membership

The NAC consists of 14 members—seven Industry members and seven Non-Industry members. Exhibit II contains a list of all current NAC members. Two Industry members are appointed by the NASD Regulation Board of Directors as at-large members. Five Industry members each represent one of the following geographic regions:

West Region: Hawaii, California, Nevada, Arizona, Colorado, New Mexico, Utah, Wyoming, Alaska, Idaho, Montana, Oregon, and Washington.

South Region: Alabama, Arkansas, Kentucky, Louisiana, Mississippi, Oklahoma, Tennessee, Texas, Florida, Georgia, North Carolina, South Carolina, Puerto Rico, Virginia, Canal Zone, and the Virgin Islands.

Central Region: Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota, Illinois, Indiana, Michigan, Western New York state, and Wisconsin.

North Region: Delaware, Maryland, Pennsylvania, West Virginia, District of Columbia, New Jersey, Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont, and New York (except for New York City, Long Island, and Western New York state).

New York: New York City and Long Island.

We are seeking nominations for the North Region.

Function

According to the NASD By-Laws, the NAC is authorized to act for the NASD Board of Governors in matters concerning:

- appeals or reviews of disciplinary proceedings, statutory disqualification proceedings, or membership proceedings;
- the exercise of exemptive authority; and
- other proceedings or actions authorized by NASD rules.

The NAC also considers and makes recommendations to the Board on enforcement policy and rule changes relating to the business and sales practices of NASD members and associated persons.

EXHIBIT I

NAC Industry Member With A Term Expiring In January 2003

North Region (Districts 9 and 11)

NAC Incumbent: Theodore W. Urban

If you are interested in nominating yourself or a colleague to represent the North Region for a three-year term on the NAC, please submit a cover letter and a completed Candidate Profile Sheet (Exhibit IV) to any of the following individuals by September 5, 2002.

Peter Wheeler
Regional Committee Chair

One University Office Park
29 Sawyer Road
Waltham, MA 02453-3483

(781) 736-0700

John P. Nocella
District 9 Director

NASD
11 Penn Center
1835 Market Street, 19th Floor
Philadelphia, PA 19103

(215) 665-1180

Gary K. Liebowitz
District 9 Director

NASD
581 Main Street, 7th floor
Woodbridge, NJ 07095

(732) 596-2000

Fred McDonald
District 11 Director

NASD
260 Franklin Street, 16th Floor
Boston, MA 02110

(617) 261-0800

Barbara Z. Sweeney
Senior Vice President and Corporate Secretary

NASD
1735 K Street NW
Washington, DC 20006

(202) 728-8062

EXHIBIT II

2002 National Adjudicatory Council

Mary E.T. Beach	Attorney
Herbert H. Brown	Attorney
David A. DeMuro	Lehman Brothers
Alice T. Kane	Blaylock
Douglas L. Kelly	A.G. Edwards & Sons, Inc.
Philip R. Lochner	Director of Public Companies
Mark Madoff	Bernard L. Madoff
Philip V. Oppenheimer	Oppenheimer & Close, Inc.
Mark A. Sargent	Villanova University School of Law
Richard O. Scribner	Recording for the Blind & Dyslexic
William A. Svoboda	Morgan Stanley
Theodore W. Urban	Ferris, Baker Watts, Incorporated
Barbara L. Weaver	Legg Mason Wood Walker, Inc.
Elliott J. Weiss	University of Arizona College of Law

EXHIBIT III

National Adjudicatory Council Nomination Procedures

1. NASD maintains Regional Nominating Committees in the manner specified in Article VI of the By-Laws of NASD Regulation, Inc.

2. Members located in the North Region are hereby notified of the upcoming election of members to the National Adjudicatory Council and are encouraged to submit names of potential candidates to their respective Chair of the Regional Nominating Committee, District Director, or to NASD Corporate Secretary Barbara Z. Sweeney (see Exhibit I) by **September 5, 2002**.

3. Nominees will be asked to complete a Candidate Profile Sheet which will be reviewed by the Regional Nominating Committee.

4. The Regional Nominating Committee shall review the background of the candidates and the description of the NASD membership provided by NASD staff and shall propose one or more candidates for nomination to the National Nominating Committee. In proposing a candidate for nomination, the Regional Nominating Committee shall endeavor to secure appropriate and fair representation of the region.

5. On or about **September 19, 2002**, the Regional Nominating Committee shall notify in writing the Executive Representatives and branch offices of the NASD members in the region the name of the candidate it will propose to the National Nominating Committee for nomination to the National Adjudicatory Council.

6. If an officer, director, or employee of an NASD member in the region is not proposed for nomination by the Regional Nominating Committee and wants to seek the nomination, he or she shall send a written notice to the Regional Nominating Committee Chair or the Secretary of NASD within 14 calendar days after the mailing date of the Regional Nominating Committee's notice (#5 above) and proceed in accordance with the Contested Nomination Procedures found in Article VI of the NASDR By-Laws.

7. If no additional candidate comes forward within 14 calendar days, the Regional Nominating Committees shall certify their candidates to the National Nominating Committee.

Additional information pertaining to the National Adjudicatory Council Election Procedures can be found in Article VI of the By-Laws of NASD Regulation. The By-Laws can be found in the online NASD Manual at *www.nasd.com*.

Date: / /

EXHIBIT IV Candidate Profile Sheet

Current Employment

Name: CRD#:

Firm: #RRs at Firm:

Title/Primary Responsibility:

Address:

City: State: Zip:

Phone: Fax:

E-mail:

Prior Employment (List the most recent first. Feel free to include extra pages if necessary.)

Firm:

Title/Primary Responsibility:

Firm:

Title/Primary Responsibility:

General Areas of Expertise (please check all that apply)

- O Compliance/Legal
- O Corporate Finance
- O Financial/Operational
- O Institutional Sales
- O Investment Advisory
- O Retail Sales
- O Trading/Market Making
- O Other

Product Expertise (please check all that apply)

- O Corporate Bonds
- O Direct Participation Programs
- O Equity Securities
- O Municipal/Government Securities
- O Investment Company
- O Options
- O Variable Contracts Securities
- O Other

Memberships/Positions Held in Trade or Business Organizations

Past NASD Experience and Dates of Service (please check all that apply)

- O Committee Member (Identify committee:) Approx. Dates:
- O Arbitrator Approx. Dates:
- O Mediator Approx. Dates:
- O Expert Witness (arbitrations; disciplinary proceedings): Approx. Dates:
- O Other: Approx. Dates:

Educational Background

School: Degree:

School: Degree:

Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Legal and Compliance

Operations

Registration

Senior Management

KEY TOPICS

Money Laundering

Suspicious Activity Reporting

INFORMATIONAL

Anti-Money Laundering

Treasury Issues Final Suspicious Activity Reporting Rule for Broker/Dealers; **Effective Date: Transactions After December 30, 2002**

Draft Form SAR-SF; **Comments Requested by October 4, 2002**

Executive Summary

On October 26, 2001, President Bush signed into law the USA PATRIOT Act (Patriot Act).[1] Title III of the Patriot Act, entitled "International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001," added new provisions to the Bank Secrecy Act (BSA).[2]

Section 356 of Title III of the Patriot Act required the Department of the Treasury (Treasury), in consultation with the Securities and Exchange Commission (SEC) and the Board of Governors of the Federal Reserve System, to issue rules requiring broker/dealers to file suspicious activity reports (SARs) with the Financial Crimes Enforcement Network (FinCEN), a bureau of Treasury. On July 1, 2002, Treasury published in the *Federal Register* its final rules requiring broker/dealers in securities to file reports that identify and describe transactions that raise suspicions of illegal activity.[3] The requirement to file SARs applies to transactions occurring after December 30, 2002.[4]

Specifically, the final rule requires broker/dealers to report to FinCEN any transaction that, alone or in the aggregate, involves at least $5,000 in funds or other assets, if the broker/dealer knows, suspects, or has reason to suspect that it falls within one of four classes: (1) the transaction involves funds derived from illegal activity or is intended or conducted to hide or disguise funds or assets derived from illegal activity; (2) the transaction is designed, whether through structuring or other means, to evade the requirements of the BSA; (3) the transaction appears to serve no business or apparent lawful purpose or is not the sort of transaction in which the particular customer would be expected to engage and

for which the broker/dealer knows of no reasonable explanation after examining the available facts; or (4) the transaction involves the use of the broker/dealer to facilitate criminal activity.

This *Notice to Members* provides a brief overview of the key provisions of the rule.

Treasury also published, in draft, a new form, "Suspicious Activity Report by the Securities and Futures Industry" (SAR-SF).[5] While Treasury's final SAR rule indicated that it was developing a suspicious activity reporting form for broker/dealers entitled "Suspicious Activity Report – Brokers or Dealers in Securities" (SAR-BD), Treasury has indicated that the Form could also be used by futures commission merchants (FCMs) registered with the Commodity Futures Trading Commission (CFTC). Accordingly, the draft Form has been revised from SAR-BD to SAR-SF and several fields have been provided on the Form for use by FCMs. Treasury requests comment on draft Form SAR-SF by October 4, 2002.

Questions/Further Information

Questions regarding this *Notice* may be directed to Vicky Berberi-Doumar, Department of Member Regulation, NASD Regulatory Policy and Oversight, at (202) 728-8905, or to Grace Yeh, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-6939.

Discussion

Background

The Patriot Act was enacted to, among other things, deter and punish terrorist acts in the United States and around the world, and to enhance law enforcement investigatory tools. Title III of the Patriot Act — The Money Laundering Abatement Act — imposes significant new obligations on broker/dealers through new anti-money laundering (AML) provisions and amendments to the existing provisions of the BSA.

Among these obligations, broker/dealers are required to have in place as of April 24, 2002, an AML compliance program. NASD Rule 3011, which was approved by the SEC on April 22, 2002, requires that each member develop and implement, by April 24, 2002, a written AML program reasonably designed to achieve and monitor the member's compliance with the requirements of the BSA and the implementing regulations promulgated thereunder by the Treasury, including the obligation to report suspicious activities as set forth in the final SAR Rule. In addition to this *Notice*, members may also refer to *Notice to Members 02-21* (April 2002), which provides guidance to members regarding the development of AML programs and the requirement to report suspicious transactions.

Suspicious Activities Reporting Requirements

Pursuant to the final rule,[6] a broker/dealer must report a transaction on Form SAR-SF if (a) the transaction is conducted or attempted by, at, or through a broker/dealer, (b) it involves or aggregates funds or other assets of at least $5,000, and (c) the broker/dealer knows, suspects, or has reason to suspect that the transaction (or a pattern of transactions of which the transaction is a part):

1. involves funds derived from illegal activity or is intended or conducted to hide or disguise funds or assets derived from illegal activity;
2. is designed, whether through structuring or other means, to evade the requirements of the BSA;

3. appears to serve no business or apparent lawful purpose or is not the sort of transactions in which the particular customer would be expected to engage and for which the broker/dealer knows of no reasonable explanation after examining the available facts; or

4. involves use of the broker/dealer to facilitate criminal activity.

FinCEN's rule is not limited only to individual transactions, but extends to patterns of transactions. In its release adopting the final rule, FinCEN explicitly clarifies that "if a broker/dealer determines that a series of transactions that would not independently trigger the suspicion of the broker/dealer, but that taken together, form a suspicious pattern of activity, the broker/dealer must file a suspicious transaction report."[7]

The release refers to the "red flags" section of *NASD Notice to Members (NtM) 02-21*[8] to help determine whether a transaction "appears to serve no business or apparent lawful purpose or is not the sort of transactions in which the particular customer would be expected to engage and for which the broker/dealer knows of no reasonable explanation after examining the available facts."[9] The release states that broker/dealers should determine whether activities vary substantially from normal practice as to raise suspicions of possible illegality by looking for red flags such as those enumerated in *NtM 02-21*.

Finally, as noted above, the rule requires broker/dealers to disclose transactions that "involves use of the broker/dealer to facilitate criminal activity."[10] The release notes that disclosure under this provision is intended to detect activities that appear to have a criminal purpose but apparently involve legally derived funds. Disclosure protects broker/dealers from being potential or actual victims of criminal violations, or being used to facilitate criminal transactions.

Exceptions from Reporting

The rule contains exceptions from reporting violations otherwise reported to various law enforcement authorities, such as: (1) a robbery or burglary that is reported by the broker/dealer to appropriate law enforcement authorities; (2) lost, missing, counterfeit, or stolen securities that are reported by the broker/dealer pursuant to Rule 17f-1 under the Securities Exchange Act of 1934 (Exchange Act); and (3) a violation of the federal securities laws or rules of a self-regulatory organization (SRO) by the broker/dealer, its officers, directors, employees, or registered representatives, that are reported appropriately to the SEC or an SRO, except for a violation of Exchange Act Rule 17a-8, which must be reported on Form SAR-SF.[11]

Who Must File

Each broker/dealer involved in a transaction has an independent obligation to monitor for, identify and report suspicious activities. When more than one broker/dealer is involved in a transaction, only one Form SAR-SF is required to be filed, provided the report includes all relevant information. The release uses as an example an introducing and clearing broker, and clarifies that the two broker/dealers may provide each other with copies of the Form SAR-SF that was filed, as well as the underlying documentation.

It is important to note that the release specifies that if the Form SAR-SF relates to the other broker/dealer, then the broker/dealer making the filing is prohibited

from notifying the other broker/dealer that a Form SAR-SF has been filed.

In response to several commenters requesting clarification on the application of the rule to certain types of broker/dealers, the final rule provides that the broker/dealer SAR requirements will not apply to dual registrants (persons registered both with the CFTC as an FCM and with the SEC as a broker/dealer) to the extent their activities are subject to the exclusive jurisdiction of the CFTC, or to broker/dealers registered with the SEC but located outside the United States. However, the final rule will apply to persons registered as a broker/dealer solely to sell variable annuity contracts issued by life insurance companies.

Confidentiality of SAR-SF Filings

The rule also requires that the filing of a Form SAR-SF report must remain confidential. The person involved in the transaction that is subject of the report must not be notified of the Form SAR-SF. In other words, if subpoenaed, the broker/dealer must refuse to provide the information and notify FinCEN of the request, unless the disclosure is required by FinCEN, the SEC, an SRO or other law enforcement authority. Where two or more broker/dealers are filing one Form SAR-SF, the confidentiality provisions apply equally to each broker/dealer participating in a transaction, and not only the broker/dealer that filed the Form SAR-SF.

Filing Procedures

Broker/dealers must file Form SAR-SF within 30 days of becoming aware of the suspicious transaction. If the broker/dealer is unable to identify a suspect, the rule provides an extra 30 days for filing the Form SAR-SF. The Form SAR-SF must be filed within 60 calendar days of initial detection, whether or not the broker/dealer can identify the suspect.

In addition, the rule requires broker/dealers to immediately notify by telephone an appropriate law enforcement authority in situations that require immediate attention, such as terrorist financing or ongoing money laundering schemes, and reminds brokers that they can also report suspicious transactions that may relate to terrorist activity to FinCEN's Financial Institutions Hotline (1-866-556-3974). In both cases, broker/dealers are still required to file a timely Form SAR-SF.

Record Keeping

Broker/dealers must maintain copies of filed Form SAR-SFs and the original related documentation for five years from the date of the filing. Broker/dealers must make the records available to FinCEN as well as to other appropriate law enforcement agencies, federal or state securities regulators, and SROs registered with the SEC.

The rule also requires a broker/dealer to keep records when relying on the rule's exception from reporting, in case FinCEN requests such information.

Form SAR-SF: Request for Comments

As mentioned above, Treasury published draft Form SAR-SF for comments. Treasury has specifically requested that the form not be used until a final version is made available. The draft form contains detailed instructions and guidelines on how to present the information and what to include in order to maximize the benefits of the information to the authorities. Treasury requests comments

on, among other things, whether the collection of information is necessary for the proper performance of the functions of the Treasury, and ways to enhance the quality, utility, and clarity of the information to be collected. Treasury also requests comments on the estimated burden of collecting the information, ways to minimize the burden, and estimates of start-up costs and costs of operation, maintenance, and purchase of services to provide information. Comments should be submitted to FinCEN by October 4, 2002.

Endnotes

1 Public Law 107-56.

2 31 U.S.C. 5311, et seq.

3 67 Fed. Reg. 44048 (July 1, 2002) *(http://www.treas.gov/fincen/brokersdealersarjuly2002.pdf).*

4 Broker/dealers that are affiliates or subsidiaries of banks or bank holding companies must continue to file SARs with FinCEN pursuant to existing BSA reporting and recordkeeping requirements until December 30, 2002. After December 30, 2002, these broker/dealers will have to use the new Form SAR-SF.

5 67 Fed. Reg. 50751 (Aug. 5, 2002) *(http://www.treas.gov/fincen/fedreg08052002.pdf).*

6 31 CFR 103.19(a)(2).

7 The release also clarifies that the rule is not intended to require broker/dealers to review every transaction that exceeds the reporting threshold. The rule is intended to encourage broker/dealers to evaluate customer activities and relationships and design an appropriate monitoring program; the release suggests that firms use a "risk-based approach" in monitoring for suspicious transactions.

8 *NtM 02-21, NASD Provides Guidance To Member Firms Concerning Anti-Money Laundering Compliance Programs Required By Federal Law.*

9 31 C.F.R. 103.19(a)(2)(iii).

10 31 C.F.R. 103.19(a)(2)(iv).

11 The release clarifies that if a broker/dealer does not report a securities violation to the SEC or an SRO because the SEC regulations or SRO rules do not require reporting of such violation, the broker/dealer must nevertheless file a Form SAR-BD to report the violation if otherwise required to be reported under the final SAR Rule.

SUGGESTED ROUTING

Executive Representatives

Legal & Compliance

Operations

Senior Management

KEY TOPICS

Central Registration Depository

Fees

Renewal Program

INFORMATIONAL

Annual Renewal Fees

NASD Amends Section 4 of Schedule A to the NASD By-Laws to Establish a Late Fee for Failure to Pay Annual Renewal Fees on a Timely Basis; **Implementation Date: September 1, 2002**

Executive Summary

NASD has adopted an amendment to Section 4(b) of Schedule A to the NASD By-Laws, establishing a fee to be imposed on members that fail timely to pay their annual Renewal Fee as indicated on their Preliminary Renewal Statement. The rule change was filed with the Securities and Exchange Commission (SEC) on July 25, 2002. Pursuant to Section 19(b)(3)(A)(ii) of the Securities Exchange Act of 1934 and SEC Rule 19b-4(f)(2) thereunder, the rule change became effective upon filing. NASD will implement the rule change on September 1, 2002.

Included with this *Notice* is Attachment A, the text of the amendment to Section 4(b) of Schedule A to the NASD By-Laws.

Questions/Further Information

Questions concerning this *Notice* may be directed to Richard E. Pullano, Chief Counsel, Registration and Disclosure, NASD Regulatory Services and Operations, at (240) 386-4821, or Shirley H. Weiss, Associate General Counsel, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-8844.

Discussion

NASD has amended Section 4(b) of Schedule A to the NASD By-Laws to establish a fee if a member fails timely to pay the amount indicated on its Preliminary Renewal Statement. The fee is 10% of a member's final annual renewal assessment or $100, whichever is

greater, with a maximum charge of $5,000. As further detailed below, NASD will implement this rule change and thus assess the late fee beginning on September 1, 2002.

NASD administers an annual Renewal Program that simplifies the process of renewing registrations and licenses for member firms and their associated persons by allowing members to pay a single amount to NASD in December of each year. This annual Renewal Fee covers all NASD registration and licensing fees and fees imposed by states and other self-regulatory organizations (SROs). NASD also collects broker/dealer and investment adviser renewal fees on behalf of SROs and state regulators, as applicable, through this program.

Each year, during the first week of November, NASD publishes online, on Web CRD,℠ a Preliminary Renewal Statement for each member that advises the member of the total amount of Renewal Fees owed for the following year. The Renewal Fees are generally due to NASD by the end of the first week in December. Members typically pay the amount indicated on their Preliminary Renewal Statement by check or bank wire transfer, and NASD pays the fees to the various regulators by year end. NASD advises its members that their failure to return full payment to NASD by the stated deadline could cause a member to become ineligible to do business in the jurisdictions in which it is registered as of the first business day of the new year. The timely payment of Renewal Fees by NASD members and their subsequent disbursement to appropriate regulators helps to ensure that NASD members will not be precluded from conducting business in the next calendar year as a result of the non-payment of Renewal Fees.

Because of the potential risk to members' ability to conduct business if they fail timely to pay their renewal payments, NASD engages in a comprehensive communications and operational effort beginning in August of each year that informs members of their obligation to complete the renewals process by the stated deadline and the risk associated with their failure to do so. These communications include an Advance Calendar of Key Dates, a *Notice to Members,* a *Bulletin,* reminder e-mails, and daily reminder Broadcast Messages through Web CRD.

In early January, NASD makes available on-line a Final Renewal Statement that reflects the final status of agent and firm registrations and/or Notice Filings as of December 31 of the previous year. Any adjustments in fees owed as a result of registration terminations or approvals subsequent to the Preliminary Renewal Statement are made in this final reconciled statement on Web CRD. NASD issues a credit/refund to members that paid an amount greater than the final amount based on their Preliminary Renewal Statements. NASD assesses additional fees if a member has paid less than the final reconciled amount.

Notwithstanding NASD's efforts to obtain timely payments of Renewal Fees, a significant percentage of NASD members miss the payment deadline each year, prompting NASD staff to expend additional time and resources to collect these fees after the renewal deadline has passed. NASD staff expends considerable effort to contact delinquent members to prevent them from failing to renew with the jurisdictions with which they are registered. This annual effort is in addition to, and detracts from, NASD's efforts to serve its members in the normal course of business.

NASD has therefore established a late renewal fee that will be assessed against any NASD member that has not paid its Renewal Fees by the published deadline. NASD believes that such a fee serves a two fold purpose: (1) to provide members with an additional incentive to meet the renewals payment deadline; and (2) to cover the costs of NASD collection activities (*i.e.*, the time and resources expended in contacting and collecting fees from NASD members that miss the deadline). The purpose of the late fee is not to generate significant net revenue, and it should not do so. Instead, the late fee will cover NASD's collection costs and eliminate a significant number of late payments by encouraging members to pay their Renewal Fees by the stated deadline.

Implementation Date

NASD will implement this amendment beginning on September 1, 2002.

ATTACHMENT A

New language is underlined; deletions are in brackets.

Schedule A to the NASD By-Laws

Assessments and fees pursuant to the provisions of Article VI of the By-Laws of NASD shall be determined on the following basis.

Section 4 - Fees

(a) No change.

(b) NASD shall assess each member a fee of:

(1) through (6) No change.

(7) 10% of a member's final annual renewal assessment or $100, whichever is greater, with a maximum charge of $5,000, if the member fails timely to pay the amount indicated on its preliminary annual renewal statement.

(c) through (l) No change.

Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Executive Representatives

Legal & Compliance

Senior Management

KEY TOPICS

IM-8310-2

Release of Disciplinary Information to the Public

INFORMATIONAL

Release of Disciplinary Information

NASD Adopts Amendments to IM-8310-2 Concerning Release of Disciplinary Information to the Public; **Implementation Date: September 1, 2002**

Executive Summary

NASD has adopted amendments to NASD Interpretative Material 8310-2 (IM-8310-2), concerning the release of disciplinary information to the public. The amendments (1) clarify the circumstances under which NASD will release redacted information with respect to both Hearing Panel and Extended Hearing Panel decisions issued under the Rule 9200 Series (hereafter referred to as Hearing Panel decisions), and National Adjudicatory Council (NAC) disciplinary decisions issued under the Rule 9300 Series; and (2) conform the timing for the release of unredacted disciplinary information to the timing for the release of redacted disciplinary information with respect to Hearing Panel and NAC decisions.

The amendments were filed with the Securities and Exchange Commission (SEC) on July 31, 2002.[1] Pursuant to Section 19(b)(3)(A) of the Securities Exchange Act of 1934 and SEC Rule 19b-4(f)(6) thereunder, the amendments became effective upon filing. The NASD will implement the amendments to IM-8310-2 on September 1, 2002.

Included with this *Notice* is Attachment A, the text of amended IM-8310-2.

Questions/Further Information

Questions concerning this *Notice* may be directed to Manly Ray, Supervisory Paralegal, Office of Hearing Officers, at (202) 728-8202, or Shirley H. Weiss, Associate General Counsel, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-8844.

Discussion

IM-8310-2(d)(1) requires NASD to release to the public information with respect to any disciplinary decision that: imposes a suspension, cancellation or expulsion of a member; suspends or revokes an associated person's registration; suspends or bars an associated person; or imposes monetary sanctions of $10,000 or more. NASD also may release to the public information about disciplinary decisions that involve a significant policy or enforcement determination where the President of NASD Regulatory Policy and Oversight deems the release of such information to be in the public interest. Additionally, IM-8310-2 permits NASD to release in redacted form final, litigated decisions that do not meet any of the criteria for release of information to the public.[2] As defined in IM-8310-2(d)(1), a redacted decision is one in which the names of the parties and other identifying information (such as the names of employer firms and addresses) are deleted prior to its release.

(1) Permitting the Prompt Release of Decisions in Redacted Form Where the Sanctions Imposed by the Hearing Panel Do Not Meet the Criteria for Release of Disciplinary Information to the Public

Currently, IM-8310-2(d)(1) limits the release of redacted disciplinary decisions that do not meet any of the criteria for release of disciplinary information to the public to "final, litigated, disciplinary decision[s]." This rule language means that NASD cannot release information with respect to such Hearing Panel decisions until the decision is "final," *i.e.* the respondent has appealed to the NAC and the NAC has issued its decision or, in the alternative, the respondent has not appealed and the NAC has determined not to call the decision for review.[3] Additionally, if such a Hearing Panel decision were appealed to, or called for review by, the NAC, the NAC decision would become the "final, litigated, disciplinary decision," and NASD generally would not publish the underlying Hearing Panel decision.

The amendment to IM-8310-2(d)(1) changes "final, litigated, disciplinary decision" to "any disciplinary decision" with respect to the release of redacted decisions. This means that, as of September 1, 2002, NASD will promptly publish on its Web Site "any disciplinary decision" in either redacted or unredacted form, depending upon whether the decision meets any of the criteria for release of disciplinary information to the public. The rule change will allow public investors and other interested persons to get prompt notice of all disciplinary decisions, including those in which the sanctions imposed, if any, did not meet the publication criteria.

(2) Sanctions Imposed by the Hearing Panel Meet the Criteria for Release of Disciplinary Information to the Public, but the Sanctions Imposed by the NAC Do Not Meet the Publication Criteria

The rule change to IM-8310-2(d)(1)(A) will eliminate the current practice in which NASD publishes an unredacted Hearing Panel decision because it meets one or more of the criteria for release of information to the public, but publishes the subsequent NAC decision in redacted form because following an appeal or call for review, the NAC has lowered the sanctions below the minimum criteria for release of information to the public. As of September 1, 2002, NASD will release NAC decisions that do not meet the criteria for release of information to the

public in unredacted form if the underlying Hearing Panel decision meets the criteria for release of information under IM-8210-2 and has been published in unredacted form. This will enable public investors and other interested persons to follow the history of a disciplinary matter on the NASD Web Site in unredacted form even where the NAC has reduced the sanctions imposed by the Hearing Panel to a level that does not meet the publication criteria of IM-8310-2.

(3) Sanctions Imposed on One or More, But Not All, of the Respondents Meet the Criteria for Release of Disciplinary Information to the Public

On occasion, the sanctions imposed on one or more, but not all, of the respondents in Hearing Panel or NAC decisions meet the criteria for release of information to the public. Currently, NASD releases information with respect to both Hearing Panel and NAC decisions in redacted form as to all respondents if the sanctions imposed on one or more, but not all, of the respondents fail to meet any of the criteria for release of information to the public. The amendment to IM-8310-2(d)(1)(B) clarifies that, as of September 1, 2002, NASD will release information in unredacted form as to the respondents whose sanctions meet the publication criteria and in redacted form as to the respondents whose sanctions do not meet the publication criteria; however, consistent with the amendments to IM-8310-2(d)(1)(A) as discussed above, information regarding respondents in NAC decisions that do not meet the criteria for release of information to the public will be released in unredacted form if the sanctions imposed on the respondent in the underlying Hearing Panel decision meet one or more of such criteria and the Hearing Panel decision as to that respondent was published in unredacted form.

Implementation Date of Amendments

NASD will implement these amendments on September 1, 2002.

Endnotes

1 *See* Securities Exchange Act Release No. 46289 (July 31, 2002) (File No. SR-NASD-2002-103).

2 *See* Securities Exchange Act Release No. 42783 (May 15, 2000), 65 FR 32140 (May 22, 2000), effective on July 1, 2002 (amending IM-8310-2 to permit the release of certain disciplinary decisions in redacted form).

3 *See* Rule 9312.

ATTACHMENT A

New language is underlined; deletions are in brackets.

IM-8310-2. Release of Disciplinary Information

(a) through (c) No change

(d)(1) [The Association] NASD shall release to the public information with respect to any disciplinary decision issued pursuant to the Rule 9000 Series imposing a suspension, cancellation or expulsion of a member; or suspension or revocation of the registration of a person associated with a member; or suspension or barring of a member or person associated with a member from association with all members; or imposition of monetary sanctions of $10,000 or more upon a member or person associated with a member; or containing an allegation of a violation of a Designated Rule; and may also release such information with respect to any disciplinary decision or group of decisions that involve a significant policy or enforcement determination where the release of information is deemed by the President of NASD [Regulation, Inc.] Regulatory Policy and Oversight to be in the public interest. [The Association] NASD also may release to the public information with respect to any disciplinary decision issued pursuant to the Rule 8220 Series imposing a suspension or cancellation of the member or a suspension of the association of a person with a member, unless the National Adjudicatory Council determines otherwise. The National Adjudicatory Council may, in its discretion, determine to waive the requirement to release information with respect to a disciplinary decision under those extraordinary circumstances where the release of such information would violate fundamental notions of fairness or work an injustice. [The Association] NASD may release to the public information on any [other final, litigated,] disciplinary decision issued pursuant to the Rule 8220 Series or Rule 9000 Series, not specifically enumerated in this paragraph, regardless of sanctions imposed, so long as the names of the parties and other identifying information is redacted.

(A) NASD shall release to the public, in unredacted form, information with respect to any disciplinary decision issued pursuant to the Rule 9300 Series that does not meet one or more of the criteria in IM-8310-2(d)(1) for the release of information to the public, provided that the underlying decision issued pursuant to the Rule 9200 Series meets one or more of the criteria in IM-8310-2(d)(1) for the release of information to the public, and information regarding such decision has been released to the public in unredacted form.

(B) In the event there is more than one respondent in a disciplinary decision issued

pursuant to the Rule 9000 Series, and sanctions imposed on one or more, but not all, of the respondents meets one or more of the criteria in Rule IM-8310-2(d)(1) for the release of information to the public, NASD shall release to the public, in unredacted form, information with respect to the respondent(s) who meet such criteria, and may release to the public, in redacted form, information with respect to the respondent(s) who do not meet such criteria. Notwithstanding the foregoing, NASD shall release to the public, in unredacted form, information with respect to any respondent in a disciplinary decision issued pursuant to the Rule 9300 Series if the sanctions imposed on such respondent in the underlying decision issued pursuant to Rule 9200 meet one or more of the criteria for release of information to the public, and information with respect to that respondent has been released in unredacted form.

(2) No change.

(e) through (l) No change.

Notice to Members

AUGUST 2002

SUGGESTED ROUTING

Legal & Compliance

Operations

Registration

Senior Management

KEY TOPICS

Money Laundering Compliance Programs

INFORMATIONAL

Treasury and SEC Request Comment on Proposed Regulation Regarding Broker/Dealer Anti-Money Laundering Customer Identification Requirements; Comment Period Expires September 6, 2002

Executive Summary

On October 26, 2001, President Bush signed into law the USA PATRIOT Act (PATRIOT Act). Title III of the PATRIOT Act, referred to as the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (Money Laundering Abatement Act), imposed obligations on broker/dealers under new anti-money laundering (AML) provisions and amendments to the Bank Secrecy Act (BSA) in an effort to make it easier to prevent, detect, and prosecute money laundering and the financing of terrorism.

Among other things, Section 326 of the Act required the Secretary of the Department of Treasury (Treasury) and the Securities and Exchange Commission (SEC or Commission) jointly to issue a regulation setting forth minimum standards for broker/dealers and their customers regarding customer identification in the account opening process.

On July 23, 2002, the Treasury and SEC published for comment the proposed regulation to implement Section 326.[1] The proposed regulation would require broker/dealers to, at a minimum: (1) adopt and implement reasonable procedures to verify the identity of any person seeking to open an account, to the extent reasonable and practicable; (2) maintain records related to the verification of the person's identity; and (3) determine whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided by any government agency. The release was published in the *Federal Register;*[2] use this URL to view the text: *http://www.treas.gov/fincen/section326brokerdealers.pdf.*

02-50

Questions/Further Information

Questions regarding this *Notice to Members* may be directed to Kyra Armstrong, at (202) 728-6962, or Vicky Berberi-Doumar, at (202) 728-8905, both of the Department of Member Regulation; or Nancy Libin, at (202)-728-8835, or Grace Yeh, at (202) 728-6939, both of the Office of General Counsel, NASD Regulatory Policy and Oversight.

Background

Introduction

The PATRIOT Act is designed to deter and punish terrorists in the United States and abroad and to enhance law enforcement investigation tools by prescribing, among other things, new surveillance procedures, new immigration laws, and new and more stringent AML laws. The Money Laundering Abatement Act strengthens the AML provisions put into place by earlier legislation.

Among these obligations, broker/dealers are required to have in place as of April 24, 2002, an AML compliance program. NASD Rule 3011, which was approved by the SEC on April 22, 2002, requires that each member develop and implement, by April 24, 2002, a written AML program reasonably designed to achieve and monitor the member's compliance with the requirements of the BSA and the implementing regulations promulgated thereunder by the Treasury, including the obligation to establish reasonable customer identification and verification procedures. In addition to this *Notice,* members may also refer to *Notice to Members 02-21* (April 2002), which provides guidance to members regarding the development of AML programs and procedures for account holder identification and verification.

Description of Proposed Regulation

The proposed regulation provides several definitions, which are briefly reviewed below.

1. Account. The proposed regulation defines "account" to include all types of securities accounts maintained by brokers or dealers.[3] These include accounts to purchase, sell, lend, or otherwise hold securities or other assets, cash accounts, margin accounts, prime brokerage accounts that consolidate trading done at a number of firms, and accounts for repurchase and stock loan transactions.

2. Broker/dealer. "Broker/dealer" is defined to include any person registered, or required to be registered, with the Commission as a broker or dealer under the Securities Exchange Act of 1934 (Exchange Act), except persons who register, or are required to be registered, solely because they effect transactions in security futures products.[4]

3. Customer. "Customer" is defined as any person who opens a new account at a broker/dealer or is granted trading authority with respect to an account at a broker/dealer.[5] Under this definition, a person who has an account at a broker/dealer prior to the effective date of the regulation *would not be* a customer. However, such a person becomes a customer if the person opens a new or different type of account. The proposed regulation also states that a person with trading authority *prior* to the effective date of the regulation *is not* a customer;

however, any person who was granted trading authority *after* the effective date *is* a customer.

The proposed regulation does not apply to persons seeking information about an account (such as a schedule of transaction fees) if an account is not opened. Transfers of accounts from one broker/dealer to another that are not initiated by the customer are not covered by the proposed regulation.[6] Examples of an account transfer not initiated by a customer include a merger, acquisition, or purchase of assets or assumption of liabilities.

4. Person. "Person" is defined to include natural persons, corporations, partnerships, trusts or estates, joint stock companies, associations, syndicates, joint ventures, any unincorporated organizations or groups, Indian tribes, and all entities cognizable as legal entities.[7]

5. U.S. person. "U.S. person" is defined as a U.S. citizen, or for persons other than natural persons, an entity established or organized under the laws of a State or the United States.[8]

6. Non-U.S. person. A "Non-U.S. person" is defined as a person that is not a U.S. person as that term is defined in the regulation.[9]

7. Taxpayer Identification number. "Taxpayer identification number" is defined to have the same meaning as determined under the provisions of Section 6109 of the Internal Revenue Code and the regulations of the Internal Revenue Service thereunder.[10]

Customer Identification Program

A key aspect of the proposed regulation is the requirement that broker/dealers establish and operate a customer identification program (CIP).[11] A CIP must be part of a firm's overall AML compliance program as required under Section 352 of the PATRIOT Act.[12] It must be approved by the most senior level of the firm, which can be the board of directors, managing partners, board of managers, or other governing body performing similar functions, or by persons authorized to approve such a program.[13] A CIP's procedures also must enable the firm to form a reasonable belief that it knows the true identity of the customer.

Several factors must be considered in creating and developing CIPs. Firms should consider the types of identifying information available for customers and the methods available to verify that information. The release notes that while the proposed regulation sets forth certain minimum required information and suitable verification methods, firms should consider on an ongoing basis whether additional information and methods are appropriate. In addition, firms should consider the risks associated with their business operations. In considering the risks, firms should consider the following factors:

(1) the broker/dealer's size;

(2) the broker/dealer's location;[14]

(3) the method by which customers open accounts at the broker/dealer;[15]

(4) the types of accounts the broker/dealer maintains for customers;[16]

(5) the types of transactions the broker/dealer executes for customers;[17]

(6) the customer base; and

(7) the broker/dealer's reliance on another broker/dealer with which it shares an account relationship.[18]

This last risk factor refers to shared accounts subject to a carrying or clearing agreement governed by NASD Rule 3230 or NYSE Rule 382.[19] The proposed regulation notes that firms sharing accounts may share responsibilities pursuant to their clearing agreements. For example, the correspondent firm may undertake to obtain the identifying information while the clearing firm may undertake the verification. Nonetheless, the proposed regulation makes it clear that both firms are responsible for ensuring that each requirement in the regulation is met with respect to each customer. Therefore, broker/dealers must continually assess whether the other firm can be relied on to perform its responsibilities. A broker/dealer is expected to cease such reliance if it is no longer reasonable.

Required Information

A broker/dealer's CIP must have customers provide, at a minimum, certain identifying information before an account is opened for the customer or the customer is granted trading authority over an account. The firm must obtain from each customer, his or her:

- Name;
- Date of birth, for a natural person;
- Address(es):
  - Residence and mailing (if different) for a natural person; or
  - Principal place of business and mailing (if different) for a person other than a natural person; and
- Documentary Number:
  - For each customer that is a U.S. person, a taxpayer identification number (such as a Social Security number or employer identification number); or
  - For each customer that is a non-U.S. person,
    - a U.S. taxpayer identification number;
    - a passport number and country of issuance;
    - an alien identification card number; or
    - the number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.[20]

Firms should determine whether other identifying information is necessary to form a reasonable belief concerning the true identity of each customer during this process. The proposed regulation notes that there may be certain situations or customers that may cause the firm to obtain additional information. CIPs should have guidelines for such situations to assist in making such determinations.

The Treasury and the SEC have proposed a limited exception to the requirement that a taxpayer identification number be provided prior to opening an account or the granting of trading authority. For new businesses that have applied for, but not received, employer identification numbers (EINs) from the Internal Revenue Service, the CIP may allow the EIN to be provided within a reasonable time after the account is opened. However, CIPs must require the broker/dealer to obtain a copy of the EIN application prior to the account opening or to the grant of trading authority.

Verification Procedures

The procedures for verifying the accuracy of the information must be undertaken within a reasonable time before or after an account is opened or a customer is granted trading authority. There is some flexibility in determining what is a reasonable time. The amount of time may depend on the type of account opened, whether the account was opened in person, and on the type of identifying information available. Although an account is opened, a firm may choose to place limits on the account until the customer's identity is verified. Therefore, firms may use a risk-based approach to determine when the identity of a customer must be verified relative to the opening of an account or the granting of trading authority.

The proposed regulation explains that the verification requirements would apply every time a person opens a new account at a firm or is granted trading authority with respect to an account. However, if a customer whose identification has been verified previously opens a new account or is granted new authority, the firm would not need to verify the customer's identity a second time, provided the broker/dealer (1) previously verified the customer's identity in accordance with procedures consistent with the proposed regulation; and (2) continues to have a reasonable belief that it knows the true identity of the customer.

Verification may occur through two methods: through documents and through non-documentary means. The means of verification may vary based on the type of customer and the method of opening an account. A CIP must discuss both methods and provide guidance on when it is appropriate to use either one or a combination of both.

Documents

CIPs must provide guidance concerning when it is appropriate to use documents to verify a customer's identity. The proposed regulation lists some suitable documents.

They include:

- For natural persons, an unexpired government-issued identification evidencing nationality or residence and bearing a photograph or similar safeguard.
- For entities, documents showing existence such as registered articles of incorporation, a government-issued business license, a partnership agreement, or a trust instrument.

Non-Documentary Means

A CIP must describe non-documentary verification methods and when these methods will be used in addition to, or instead of relying on, documents. The regulation provides for the exclusive use of non-documentary means (if necessary) due to the number of accounts opened over the Internet, the telephone, and the mail. Suitable non-documentary methods of verification include:

- contacting a customer after the account is opened (particularly, if the account is opened online or by mail);
- obtaining a financial statement;
- comparing the identifying information provided by the customer against fraud and bad check databases to determine whether any of the information is associated with known incidents of fraudulent behavior (negative verification);

- comparing the identifying information with information available from a trusted third-party source, such as a credit report from a consumer reporting agency (positive verification);[21] and
- checking references with other financial institutions.

Other factors to consider include checking whether there is a logical consistency between the identifying information provided such as the customer's name; street address; zip code; telephone number, if provided; the customer's date of birth; and Social Security number.

Non-documentary methods should be used in certain situations, particularly when a firm cannot examine original documents. The following are examples of situations when non-documentary methods should be used:

- a person is unable to provide an unexpired government-issued identification document with a photograph or similar safeguard;
- the firm is presented with unfamiliar documents to verify an identity;
- the firm does not meet the customer face-to-face; or
- there is a risk that the documents will not enable the firm to verify the customer's identity.

Also, in light of the increase in identity fraud, firms are encouraged to use non-documentary methods, even when a customer has provided documents.

Use of Government Lists

The proposed regulation also requires reasonable procedures for determining whether a customer appears on any list of known or suspected terrorists or terrorist organizations provided by any government agency. This requirement applies only with respect to lists circulated by the federal government such as the list found on Treasury's Office of Foreign Assets Control (OFAC) Web Site *(www.treas.gov/fac)* and available on *www.nasdr.com/money.asp* under "OFAC List." Broker/dealers must have procedures for responding to circumstances when a customer is named on a list.[22]

Customer Notice

The proposed regulation states that firms must give their customers notice of their identity verification procedures.[23] The CIP must include procedures for providing customers with adequate notice that the broker/dealer is requesting information to verify their identity. This requirement may be satisfied generally by notifying customers about the procedures a firm must comply with to verify their identities. The release also cites, as an example, posting a sign in a firm's lobby or providing customers with any form of written, electronic, or oral notice. Notice must be given before an account is opened or trading authority is granted.

Lack of Verification

As stated above, a broker/dealer should maintain an account for a customer only when it can form a reasonable belief that it knows the customer's true identity. However, a CIP must have procedures for responding to circumstances when a firm cannot form a reasonable belief.[24] There

should also be guidelines for when an account will not be opened. Furthermore, a CIP should specify when an account should be closed after attempts have been made to verify a customer's identity. There should also be procedures for determining when a suspicious activity report (SAR) should be filed.[25]

Recordkeeping

The proposed regulation requires procedures for maintaining records of information used to verify a person's identity, including name, address, and other identifying information.[26] Information that must be maintained includes all identifying information provided by a customer. A firm must make a record of each customer's name, date of birth (if applicable), addresses, and tax identification number or other number. Firms also must maintain copies of any documents that were relied on, evidencing the type of document and any identification number it may contain. Firms must make and maintain records of the methods and results of measures undertaken to verify the identity of a customer. These records must be maintained for five years after the date the account is closed or the grant of authority to effect transactions with respect to the account is revoked.

Exemptions

The proposed regulation provides that the Commission, with the concurrence of the Secretary of the Treasury, may exempt any broker/dealer that registers with the Commission from this requirement. Excluded from this exemptive authority are firms that register as broker/dealers solely because they deal in security futures products. In issuing such exemptions, the Commission and the Secretary will consider whether the exemption is consistent with the purposes of the BSA and in the public interest and may consider other necessary and appropriate factors.[27]

Comments

Treasury and the SEC seek comment on all aspects of the proposed regulation, and specifically seek comment on the following issues:

1. Whether the proposed definition of "account" (which includes all types of securities accounts maintained by brokers or dealers) is appropriate and whether other examples of accounts should be added to the text of the regulation.
2. How broker/dealers can comply with the requirement to obtain both the address of a person's residence, and, if different, the person's mailing address in situations involving natural persons who lack a permanent address.
3. Whether non-U.S. persons that are not natural persons will be able to provide a broker/dealer with the identifying information required in 31 CFR 103.122(c)(4),[28] or whether other categories of identifying information should be added to this section.
4. The extent to which the verification procedures required by the proposed regulation makes use of the information that broker/dealers currently obtain in the account opening process.

5. Whether any of the exemptions from the customer identification requirements contained currently in 31 CFR 103.35(a)(3) should be continued in the proposed regulation. Commenters should address the standards set forth in paragraph (j) of the proposed regulation as well as any other appropriate factors.[29]

Written comments may be mailed to FinCEN, Section 326 Broker-Dealer Rule Comments, P.O. Box 39, Vienna, Virginia 22183, or sent to e-mail address *regcomments@fincen.treas.gov* with the caption "Attention: Section 326 Broker/Dealer Rule Comments" in the body of the text.

Written comments should be submitted in triplicate to the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. All submissions should refer to the File No. S7-25-02. Comments may also be submitted electronically at the following e-mail address: *rulecomments@sec.gov.* The file number should be included on the subject line if e-mail is used.

Written comments must be submitted to Treasury and the SEC on or before September 6, 2002.

Conclusion

NASD will update members when the proposed regulation becomes final. In the interim, NASD reminds members to comply with the provisions of the PATRIOT Act that currently apply to broker/dealers.

Endnotes

1 67 Fed. Reg. 48,306 (July 23, 2002).

2 Treasury, jointly with other federal financial regulators, also separately issued customer identification requirements for banks and trust companies, savings associations, credit unions, mutual funds, futures commission merchants, and futures introducing brokers.

3 67 Fed. Reg. 48,306 at 48,307.

4 *Id.*

5 *Id.*

6 The release notes that there may be times when a broker/dealer may need to verify the identity of customers associated with accounts it is acquiring. Procedures for the transfer of accounts are expected to be part of a firm's AML compliance program required under Section 352 of the PATRIOT Act.

7 67 Fed. Red. 48,306 at 48,307. Broker/dealers that register solely because they effect transactions in security futures products will be subject to separate customer identification regulations issued jointly by Treasury and the Commodity Futures Trading Commission.

8 *Id.*

9 *Id.*

10 *Id. See also* 26 U.S.C. 6109 (2002), which states that, generally speaking, the identifying number of an individual is his or her Social Security account number or employer identification number.

11 67 Fed. Reg. 48,306 at 48,307- 48,308.

12 31 U.S.C. 5318(h).

13 67 Fed. Reg. 48,306 at 48,311.

14 Firms located in certain known money laundering areas, for example, may pose a greater risk than firms located in other areas. *See* 67 Fed. Reg. 48,306 at 48,308.

15 This refers to whether the account was opened in person or whether it was opened online, for example. *See* 67 Fed. Reg. 48,306 at 48,308.