

Notice to Members

NOVEMBER 2002

SUGGESTED ROUTING

Legal & Compliance
Operations, Trading and Training
Registered Representatives
Senior Management

KEY TOPICS

Security Futures

INFORMATIONAL

Business Conduct and Responsibility Rules

SEC Approves New Rules and Rule Amendments Concerning Security Futures; **Effective Date: October 15, 2002**

Executive Summary

On October 15, 2002, the Securities and Exchange Commission (SEC) approved rule changes by NASD that both create and amend certain rules and interpretive materials to address the requirements for NASD members engaging in a security futures business. These rule changes:

- ◆ amend registration rules to expand several registration categories to include engaging in and supervising security futures transactions;
- ◆ amend Rule 1060 (Persons Exempt from Registration) to exempt from NASD registration persons associated with a member who are already registered with a registered futures association and whose functions are related exclusively to security futures transactions;
- ◆ create Rule 2865 (Security Futures Rule) to regulate security futures sales practices and amend Interpretive Material 2310-2 (Fair Dealing with Customers) to refer to new Rule 2865 regarding security futures sales practices;
- ◆ amend Interpretive Material 2110-3 (Front Running Policy) to add block trading in single stock futures to the prohibition against front running;
- ◆ amend NASD's advertising rule – Rule 2210 (Communications with the Public) and create new Interpretive Material 2210-7 (Guidelines for Communications with the Public Regarding Security Futures) to regulate communications with the public regarding security futures;

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- ▶ amend Rule 3010(b)(2) (the Taping Rule) to recognize the ability of futures regulators to expel a member from the futures industry for futures-related sales practice violations;
- ▶ amend Rule 3010(e) (Qualification of Job Applicants) to require firms to check the backgrounds of job applicants who have previously worked in the futures industry;
- ▶ amend Rule 3050 (Transactions for or by Associated Persons) to require associated persons to notify their member firm when they open certain futures accounts or engage in certain security futures transactions; and
- ▶ amend Rule 3370 (Prompt Receipt and Delivery of Securities) to exempt security futures from the affirmative determination requirement.

These changes are included with this *Notice* (see Attachment A). They become effective October 15, 2002.

This *Notice* also explains that adding a security futures business may constitute a material change of business and describes the factors a member should consider in determining whether engaging in a security futures business constitutes a material change that would require the member to file a continuing membership application with NASD and obtain prior approval before engaging in a security futures business. The *Notice* also clarifies that best execution obligations apply to transactions in security futures. In addition, the *Notice* explains that members engaged in a security futures business must comply with their obligations in the analyst rule, Rule 2711 ("Research Analysts and Research Reports").

Questions/Further Information

Questions concerning this *Notice* may be directed to the Office of General Counsel, NASD Regulatory Policy and Oversight: Gary L. Goldsholle, Associate General Counsel, (202) 728-8104; Alan Lawhead, Associate General Counsel, (202) 728-8853; or Patricia Albrecht, Assistant General Counsel, (202) 728-8026.

Background

The Commodity Futures Modernization Act of 2000 (CFMA) lifted the ban on the trading of security futures, i.e., single stock and narrow-based stock index futures ("security futures").¹ The CFMA defines security futures both as securities under the federal securities laws,² and as futures contracts for purposes of the Commodity Exchange Act (CEA).³ Accordingly, the SEC and the Commodity Futures Trading Commission (CFTC) have joint jurisdiction over the intermediaries and markets that trade security futures products.

Because they are subject to regulation both as securities and as futures contracts, security futures must be traded on trading facilities⁴ and through intermediaries that are registered with both the SEC and the CFTC. Broker/dealers that wish to conduct a business in security futures are required to notice register with the CFTC as Futures Commission Merchants (FCMs) or Introducing Brokers (IBs).⁵ Similarly, FCMs and IBs are required to notice register as broker/dealers if they wish to conduct a business in security futures.⁶ Firms that are fully registered as both FCMs or IBs and broker/dealers may engage in security futures transactions without any notice registration.

NASD has amended certain rules and interpretive materials and created new rules and interpretive materials to address security futures.⁷ This *Notice* explains and describes: (1) changes to the qualifications and testing requirements; (2) the provisions of new Rule 2865 and other rule changes; (3) that best execution obligations apply to transactions in security futures; (4) that adding a security futures business constitutes a material change of business under NASD rules and the implications of adding this new business; and (5) that members engaged in a security futures business must comply with their obligations in Rule 2711.

I. Qualification and Training

A. *Changes to Registration; Continuing Education for Existing Registrants*

Under the CFMA, self-regulatory organizations (SROs) are responsible for ensuring that individuals engaging in a security futures business are properly qualified.⁸ To accommodate the introduction of security futures, several registration categories have been modified to include the activities of engaging in and supervising securities futures. In general, where a registration category permits an individual to engage in an options business, that category has been modified to permit activity in security futures. Specifically, the modified categories are the Series 4 (Registered Options and Security Futures Principal (replaces Registered Options Principal)), Series 9/10 (Limited Principal – General Securities Sales Supervisor),⁹ Series 7 (General Securities Representative), and Series 42 (Limited Representative – Options and Security Futures (replaces Limited Representative – Options)).¹⁰

Until December 31, 2006, persons who are currently registered in the above-mentioned categories or who become registered in one of these categories prior to the implementation of the revised examinations addressing security futures and who want to engage in a security futures business must complete a firm-element continuing education requirement addressing security futures before engaging in any security futures business. As discussed below, the continuing education requirement has been instituted as an alternative to retesting and is discussed below.

The opportunity for eligible registrants to qualify to engage in a security futures business by completing a firm-element continuing education requirement ends on December 31, 2006. After that date, if an eligible registrant has not taken the firm element continuing education program and wants to begin participating in a security futures business, that registrant must take a revised qualification examination before engaging in a security futures business.

We recognize that this is the first time NASD has mandated a particular firm-element continuing education program.¹¹ Traditionally, member firms have determined the nature and content of their firm-element continuing education programs. The introduction of security futures in the United States, however, is an extraordinary situation. Following a nearly 20-year ban, securities professionals will be able to trade products that are both securities and futures. Accordingly, securities professionals may not be sufficiently familiar with the different risks, trading characteristics, and terms and nomenclature of these products, including the fact that the products are subject to the joint jurisdiction of the

SEC and CFTC. Consequently, we have determined that firm element continuing education is the most effective method of ensuring that existing registrants are properly informed about security futures.¹²

To facilitate firms' compliance with the continuing education requirement, we have developed with the National Futures Association (NFA) and the Institute for Financial Markets an internet-based training program that firms may use to satisfy the firm element requirement. Attached to this *Notice* is an outline of the content of the continuing education program. (See Attachment B). Registered personnel may access the training through NASD's Web Site at <http://www.nasd.com>. Use of the NASD/NFA program, however, is not mandatory. Firms may develop their own firm element training programs following the NASD syllabus. Firms also may engage other continuing education providers to deliver the training, provided that the training covers all of the subjects in the NASD syllabus. NASD and NFA are offering a web-based training program because we recognize that many firms may not have the resources or expertise to develop such programs "in-house" or in a timely manner. NASD is offering the training program free of charge. More information about the NASD/NFA continuing education program can be found at the NASD Web Site.

B. Development of New Qualification Examinations

We are currently working with industry representatives and other SROs to develop revised qualification examination questions on security futures. These new questions on security futures will be added to the Series 4, Series 9/10, and Series 42.¹³

We also intend to offer a new Series 43 examination for general securities representatives seeking to engage in a security futures business. Once the Series 43 is developed, new applicants seeking to act as a general securities representative may choose to take only the Series 7, or, if they intend to engage in a security futures business, the Series 7 and Series 43 examinations. After the Series 43 examination is developed, persons taking only the Series 7 will not be permitted to engage in a security futures business, nor will they be able to qualify to engage in a security futures business by completing a firm-element continuing education program.¹⁴ Firm-element continuing education programs will be an option available only for persons who are registered as a general securities representative before the Series 43 examination becomes available.

We are not amending the Series 24 – General Securities Principal examination. The Series 24 does not permit a principal to supervise options activity, and consequently, we do not intend to amend the examination to allow such persons to supervise security futures activity.

NASD anticipates that the new and revised qualification examinations will be available six months after trading in security futures commences.

In addition, NASD is allowing individuals who have passed the Series 30 (NFA's Branch Manager Examination) to supervise security futures activities. This is principally an accommodation to members that are registered as a broker/dealer and an FCM or IB, which are likely to have Series 30 personnel in their futures business. Rule 1022(f) requires each Registered Options and Security Futures Principal to pass "the

appropriate Qualification Examination for Registered Options and Security Futures Principal, or an equivalent examination acceptable to NASD." NASD has deemed the Series 30 examination to be an "equivalent examination acceptable to NASD" for purposes of supervising security futures activities. Persons who have passed the Series 30 and, if appropriate, the necessary firm-element continuing education, may supervise a member's security futures activities. Such persons, however, may not supervise options activities.

C. Limited Exemption from Registration for Certain Associated Persons Engaged Exclusively in Security Futures Transactions

We are also amending Rule 1060 (Persons Exempt from Registration) to exempt from NASD registration requirements associated persons whose securities activities are related solely and exclusively to transactions in security futures, provided that such persons are registered with a registered futures association. The NFA currently is the only registered futures association. This rule change recognizes that certain persons in a firm that is a broker/dealer and either an FCM or IB, who currently engage solely in a commodities business, may seek to expand their activities into security futures. The rule change has been made to avoid having such persons be required to register as representatives. While those persons are not required to register as representatives, they must follow NFA rules concerning, among other things, continuing education.

II. Security Futures Rule and Other Changes to Rules and Interpretive Materials

NASD has developed rules regulating members' activities in security futures. One of the underpinnings of the CFMA is that the regulation of security futures should be comparable to the regulation of options.¹⁵ As noted below, that principle has guided the rule and interpretive material changes addressing the introduction of security futures.

Rule 2865 – Security Futures Rule

The principal CFMA-related rule change is Rule 2865 (Security Futures Rule), which is based on the options rule, Rule 2860 (Options Rule).¹⁶ Highlighted below are the new rule's major requirements.

A. Opening of Accounts

Rule 2865(b)(16) provides that a member may not open a security futures account unless the member follows specific procedures. These procedures generally include:

- ◆ providing the customer with the security futures risk disclosure statement;
- ◆ gathering specific, detailed information regarding the customer's financial situation and investment objectives;
- ◆ obtaining written approval for security futures trading in the account by a principal qualified to supervise security futures activities based upon the information gathered; and
- ◆ obtaining, within 15 days after the customer's account has been

approved to trade security futures, the customer's verification of the background and financial information upon which the account was approved and a written agreement that the customer has received a copy of the security futures risk disclosure statement, agrees to be bound by NASD's security futures trading rules, and agrees not to violate applicable security futures position limits.

B. Delivery of Security Futures Risk Disclosure Statement¹⁷

In general, the requirements for delivery of the security futures risk disclosure statement are comparable to the requirements for the delivery of the options disclosure document. Under Rule 2865(b)(11), every member must deliver the security futures risk disclosure statement to each customer at or prior to the time such customer's account is approved for trading security futures. The SEC approved the security futures risk disclosure statement on October 10, 2002. Additionally, as noted above, under Rule 2865(b)(16)(D), a member must within 15 days after a customer's account has been approved for trading in security futures receive a written agreement from each customer that, among other things, states that the customer has received a copy of the security futures risk disclosure statement.

Copies of the security futures risk disclosure statement may be obtained from NASD Media Source at (301) 590-6500, or from the NFA. Electronic copies may be downloaded from NASD's Security Futures Web Page at www.nasdr.com/futures.asp, or NFA's Web Site.

C. Suitability

When recommending security futures to a customer, a member must employ a heightened suitability standard similar to the suitability standard for options.¹⁸ This heightened standard recognizes that security futures carry a higher degree of risk to a customer than many other securities products. Specifically, if an associated person recommends a security futures transaction, Rule 2865(b)(19) imposes the additional requirement that the associated person have a reasonable basis for believing "that the customer has such knowledge and experience in financial matters that the customer may reasonably be expected to be capable of evaluating the risks of the recommended transaction and is financially able to bear the risks of the recommended position in the security future." To provide consistency with the suitability standard for security futures adopted by the NFA,¹⁹ our security futures standard also explicitly includes recommendations of "trading strategies."

In addition, the suitability obligations applicable to recommendations to institutional customers, as specified in Interpretive Material 2310-3, apply to transactions in security futures and options.

D. Discretionary Accounts

Discretionary account procedures for security futures are comparable to those for discretionary accounts for options. Notably, as with options, Rule 2865(b)(18) provides that the customer must specifically authorize in writing security futures trading conducted on a discretionary basis in the account. Even those accounts that are permitted to trade options cannot trade security

futures unless a new written discretionary account authorization specifically authorizing trading of security futures is on file.

E. Statements of Account

Under Rule 2865(b)(15), members must send customers an account statement at least each month where there has been an entry in the account during the prior month with respect to a security futures contract. Also, members must send quarterly account statements to all customers that have an open security futures position or money balance in the account.

A customer account statement for a margin account must provide the market price, mark-to-market value and nominal value of each security futures position and the mark-to-market price and market value of other security positions in the margin account, the total market value of all positions in the account, the outstanding debit or credit balance in the account, and the account equity. In addition, an account statement must inform the customer that further information on commissions and other charges related to the security futures transactions covered in the statement have been included in the previously furnished transaction confirmations and that such information will be made available to the customer promptly upon request. Also, the statement must bear a legend requiring that the customer promptly report any material change in the customer's investment objectives or financial situation.

F. Confirmations

The SEC has adopted an amendment to Exchange Act Rule 10b-10 providing confirmation requirements for security

futures transactions conducted in futures accounts.²⁰ In view of the SEC's amendment, NASD currently is not amending its confirmation requirements to address transactions in security futures. However, irrespective of whether security futures are transacted in a futures account or a securities account, NASD members should ensure that the confirmations they provide to their customers for security futures transactions meet the appropriate requirements provided in Exchange Act Rule 10b-10.

G. Maintenance of Records

As part of their recordkeeping obligations, members are required under Rule 2865(b)(17) to maintain at their principal place of business or another designated principal office a separate record of all security futures-related complaints, through which these complaints can easily be identified and retrieved. In addition, Rule 2865(b)(17) requires members to maintain the background and financial information of any customer who has been approved for security futures trading at both the branch office servicing the customer's account and at the principal supervisory office having jurisdiction over that branch office. This recordkeeping provision is almost identical to the recordkeeping provision in the Options Rule.²¹

H. Restrictions in Security Futures Transactions

Rule 2865(b)(8) provides that NASD has the authority to impose on members any restrictions on security futures transactions if NASD deems the restrictions are necessary to maintain a fair and orderly market in security futures or in the underlying securities covered by those security futures or are otherwise

necessary in the public interest or for the protection of investors. This provision is substantively similar to the provision on restrictions of option transactions in the Options Rule.²²

I. Security Futures Transactions and Reports by Market Makers in Listed Securities

Under Rule 2865(b)(24), every member that is an off-board market maker in a security listed on a national securities exchange must report transactions involving 50 or more security futures contracts on such listed securities that are for the direct or indirect benefit of: (1) the member; or (2) any associated person or other employee of the member who is directly involved in the purchase or sale of the underlying security for the firm's proprietary account, is responsible for supervising such sales, or has information on the member's proprietary account in which the underlying security is traded. This provision applies to all security futures transactions, including transactions executed on an exchange in which the member belongs.

J. Trading Ahead of Customer Orders

Under Rule 2865(b)(25), every member must exercise due care to avoid trading ahead of customer security futures orders in a proprietary account or other account in which the member or an associated person has a direct or indirect interest. The prohibition is required only when a member has gained knowledge of or reasonably should have gained knowledge of the customer's order prior to the transmission of the member's order for a proprietary account or for any account in which it or any associated person has an interest.

The provision against trading ahead of customer orders is based on the NFA's

Interpretive Notice regarding obligations to customers and other market participants.²³ The NFA's Interpretive Notice gives two examples of when a firm would reasonably not be aware of a customer's order: (1) when a customer's order originates in a different branch office than the firm's proprietary order; and (2) when the firm's trading department does not have access to information about customer orders. We believe that these two situations are also examples of when a member would not violate the provisions in Rule 2865(b)(25). Moreover, generally there may be additional situations in which a member reasonably would not be aware of a customer's order for purposes of applying the rule. In those situations, the member would not violate the rule if it transmits a proprietary order to a securities exchange before a customer's order.

Interpretive Material 2110-3 (IM-2110-3) – Front Running Policy

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

We have amended this policy to apply to security futures in the same manner that it applies to options. For example, when a member has material, non-public market information concerning an

imminent block transaction in a stock, the member may not to trade the single-stock future overlying that stock in its proprietary account, other accounts in which it has an interest or discretionary authority, or in a customer's account if the member has shared the material, non-public information with the customer. The purpose of this amendment is to prohibit broker/dealers from trading security futures at a profit when they have material, non-public market information concerning a stock or from trading a stock at a profit when they have material, non-public market information concerning a security future. Once the material, non-public market information has been made publicly available, however, the front running policy restrictions no longer apply.

Rule 2210 – Communications with the Public and Interpretive Material 2210-7 (IM 2210-7) – Guidelines for Communications with the Public Regarding Security Futures

Rule 2210 (the Advertising Rule) has been amended to apply many of that rule's standards to security futures communications. In addition, new IM-2210-7 has been added to address additional advertising requirements for security futures. We have adopted this approach rather than create a stand-alone security futures advertising rule because we believe it will be easier for members to follow a modification of the general advertising rule.²⁴

A. Rule 2210 – Communications with the Public

Under the Advertising Rule, only a principal qualified to supervise security futures activities can approve advertisements and sales literature concerning

security futures.²⁵ As with the pre-use filing requirements for options communications, a member must file its security futures advertisements with NASD's Advertising Regulation Department (Department) or another self-regulatory organization of which it is a member that has comparable standards applicable to security futures at least 10 days prior to use. NASD has determined that NFA's advertising rules are comparable. Thus, NASD members that are also NFA members may file their advertising materials with either the Department or NFA. The Department will review the advertisement and either approve it, disapprove it, or specify changes that the member must make to use the communication.

As noted above, many of the Advertising Rule's standards apply to these communications. In particular, communications must be based on principles of fair dealing and good faith and should provide a sound basis for evaluating the facts regarding any security futures.²⁶ Exaggerated, unwarranted, or misleading statements about security futures are not allowed.²⁷ Moreover, no member may distribute any communication that the member knows or has reason to know contains misleading material.²⁸ Nor may a member omit a material fact or qualification if the omission, in light of the context of the material presented, would cause the communication to be misleading.²⁹ Communications with the public cannot contain promises of specific results, exaggerated or unwarranted claims or unwarranted superlatives, opinions for which there is no reasonable basis, or forecasts of future events that are unwarranted.³⁰ In addition, members making recommendations about security futures must generally inform the public if they make a market in the underlying

securities or if they own security futures of any recommended underlying securities.³¹ Finally, as explained further below, security futures communications must include specific disclosures about the risks of security futures and the ability to obtain, upon written request, documents that will support any claims made in the communications.

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

IM-2210-7 provides additional advertising guidelines for security futures communications, including generally requiring that all communications concerning security futures be accompanied or preceded by the security futures risk disclosure statement.³² IM-2210-7 also restricts the content of security futures communications, which include advertisements, sales literature, and correspondence, that are not accompanied or preceded by the security futures risk disclosure statement. Those communications must be limited to general descriptions of the security futures being offered. In addition, they may not contain statements of historical performance or projections and must contain contact information for obtaining a copy of the security futures risk disclosure statement.

Only sales literature and correspondence that is accompanied or preceded by the security futures risk disclosure statement can contain projections or historical performance information. Additionally, IM-2210-7 provides stringent standards members must follow when making projections or using historical performance data in security futures sales literature and correspondence. For example, sales literature containing projections:

- ▶ cannot suggest the certainty of future performance;
- ▶ must clearly establish the performance parameters; and
- ▶ must reflect all relevant costs, including commissions in the projections, and disclose the risks involved in the proposed transactions.

Sales literature containing historical performance information must, among other things:

- ▶ confine historical performances to a specific “universe” that can be fully isolated and that covers at least the most recent 12-month period;
- ▶ include the date and price of each recommendation or transaction at the end of the period or when liquidation was suggested or effected;
- ▶ disclose all relevant costs, including commissions; and
- ▶ have a principal qualified to supervise security futures activities ratify that the records or statistics fairly represent the status of the recommendations or transactions reported upon.

These requirements are similar to provisions in the options advertising rule and also are substantially similar to the NFA’s requirement regarding communications with the public for security futures.³³

IM-2210-7 also requires three specific disclosures about security futures. First, if the communication refers to the potential advantages of security futures, the communication must balance the statement of advantages with a reference, in the same degree of

specificity, about the corresponding risks. This requirement of a closely balanced presentation of advantages and risks is a more exacting standard than is contained in NASD's general standard for communications with the public, which prohibits exaggerated, unwarranted, or misleading statements.³⁴ Second, the communication must include a warning that security futures are not suitable for all investors. Third, IM-2210-7 requires that the communications state that, upon request, the member will provide documents that support any claims, comparisons, recommendations, statistics, or other technical data used in the communication. All three of these disclosure requirements are similar to the requirements for options communications.³⁵

Rule 3010(b)(2) – The Taping Rule

NASD Rule 3010(b)(2) (the Taping Rule) is applicable to NASD members if a certain percentage of their registered persons have been employed by a disciplined firm within the last three years. The Taping Rule requires subject NASD members to tape record "all telephone conversations between the member's registered persons and both existing and potential customers"³⁶ and maintain other special written procedures for supervising the telemarketing activities of all of the member's registered persons. The Taping Rule seeks to prevent registered persons who have been employed by disciplined firms from clustering together at a different firm. For purposes of the Taping Rule, a disciplined firm is one that, in connection with sales practices involving the offer, purchase, or sale of any security, has been expelled from NASD membership, expelled from any other securities industry self-regulatory organization, or is subject to an SEC

order revoking its registration as a broker/dealer.

In the futures industry, the NFA's taping rule requires NFA members that have a certain percentage of associated persons who have been employed by disciplined firms to tape record telephone conversations between associated persons and customers. The NFA has a three-fold definition of a disciplined firm that includes the following: (1) the firm has been charged formally by either the CFTC or NFA with deceptive telemarketing practices or promotional material; (2) the charges have been resolved; and (3) the firm has been closed and permanently barred from the industry as a result of those charges.³⁷

NASD has incorporated this definition into the Taping Rule's existing definition of "disciplined firm" and has therefore broadened the scope of the Taping Rule to include FCMs and IBs that will be selling security futures within the group of intermediaries that can potentially meet the definition of a disciplined firm. We have adopted this amendment to promote consistency with the NFA in monitoring associated persons from disciplined firms that may engage in the security futures business.

Rule 3010(e) – Qualifications of Job Applicants

NASD Rule 3010(e) provides that members have a responsibility to investigate the good character, business repute, qualifications, and experience of a job applicant before the member applies to register that applicant with NASD. When the job applicant previously has been registered with NASD, the member must obtain a copy of the applicant's Uniform Termination Notice

of Securities Industry Registration ("Form U-5") that was filed by the applicant's most recent member employer.

In light of the passage of the CFMA, Rule 3010(e) has been modified to provide that an NASD member must also review a job applicant's employment experience to determine if the applicant has been recently employed by an FCM or an IB that is notice-registered with the SEC pursuant to Exchange Act Section 15(b)(11).³⁸ In such a case, the hiring firm would be required to review a copy of CFTC Form 8-T, Notice of Termination of Associated Person, NFA Associate, Branch Office Manager, Designated Supervisor or Principal. The Form 8-T asks for the same types of information as does the Form U-5. We anticipate that NASD members will be able to review the CFTC Form 8-T by requesting it from the applicant or the applicant's previous employer. Rule 3010(e) has been amended because an individual's prior experience at an FCM or an IB that conducts a security futures business may have particular bearing on his or her fitness to be sponsored by an NASD member.

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

functionality of Web CRD to review Form U-5s. Members, however, will be expected to be able to demonstrate compliance with the rule.

Rule 3050 – Transactions for or by Associated Persons

NASD Rule 3050(d) states that associated persons seeking to open accounts or place securities orders with a financial institution that is not their employer may not do so unless they notify their employer member and, upon written request by the employer member, obtain from the financial institution duplicate copies of certain documents concerning the orders or accounts. This rule allows NASD members to monitor the outside securities activities of their employees. The scope of this rule has been expanded to require the same notification standards for associated persons opening an account or placing an order with an FCM or IB that is notice-registered with the SEC to trade security futures.

Rule 3370 – Prompt Receipt and Delivery of Securities

Rule 3370 generally requires an NASD member, prior to accepting a short sale order from a customer in any security, to make an affirmative determination that the member can borrow or otherwise provide for delivery of the security by the settlement date.³⁹ Because the CFMA exempts transactions in security futures from the short sale provisions of Exchange Act Section 10(a)(1),⁴⁰ NASD has exempted security futures from the affirmative determination requirement of NASD Rule 3370.⁴¹ Members, however, would be prudent to ensure that their customers can provide delivery of the security by the settlement date.

We also have amended the definition of "bona fide fully hedged" positions in Rule 3370 to include certain long single stock futures positions in connection with short positions. These particular single stock future positions are similar to in-the-money call options, which are already included in the definition.⁴²

III. Best Execution

The duty of best execution applies to members' transactions in securities, which includes transactions in security futures. The duty of best execution, which is rooted in common law agency principles and fiduciary obligations, requires that a broker/dealer seek to obtain for its customers' orders the most favorable terms reasonably available under the circumstances.⁴³ The obligation of best execution is codified in NASD Rule 2320, which provides that in any transaction for or with a customer, a member and persons associated with a member shall use reasonable diligence to ascertain the best market for a security and buy or sell in such market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. Best execution is, however, an obligation that necessarily involves a "facts and circumstances" analysis.

In the context of security futures, when a customer's order may be executed on two or more markets that trade security future contracts that are not materially different, members have an obligation to use reasonable diligence to ascertain the market in which the customer's order will receive the most favorable terms. Members should consider the factors enumerated in Rule 2320 when making these decisions. If, however, a customer's order may be executed on only one exchange, or when a customer requests that a security futures order be directed

to a particular market, members do not have to decide where to route the order.

NASD recognizes the practical necessity of members automating the handling of retail orders and the impracticability of members making order-by-order routing decisions for typical retail orders. In the context of aggregate order handling decisions, members are required to have in place procedures to regularly and rigorously examine their execution quality as a whole.

For a fuller discussion of best execution obligations, members should review the SEC's recent interpretation regarding a broker/dealer's best execution obligation for security futures.⁴⁴

IV. Membership Application Process

In November 2000, NASD amended its rules governing the membership application process. The amended rules provide additional guidance about the requirement that a member firm must file a continuing membership application with NASD and obtain approval prior to effecting a material change in business operations.⁴⁵ Specifically, the membership rules now define a "material change in business operations" as including: (1) market making, underwriting, or acting as a dealer for the first time; (2) adding business activities that require a higher minimum net capital; and (3) removing or modifying a membership agreement restriction.⁴⁶ All other business expansions are to be evaluated on a facts and circumstances, case-by-case basis, and firms must make a decision as to whether any particular expansion is "material" for purposes of the rules and thus requires an application. In cases requiring an application, members may not proceed with the planned expansion until NASD approves the application.

In making the required evaluation, members should consider the criteria identified in the guidance accompanying the amended rules.⁴⁷ Specifically, as with any new line of business, an evaluation of all the relevant facts and circumstances should include, among other things, an assessment of the relationship between a security futures line of business and the firm's existing business; the effect that adding a security futures business will have on the firm's capital; the qualifications and experience of the firm's personnel; and the degree to which the firm's existing financial, operational, supervisory, and compliance systems can accommodate the addition of security futures.⁴⁸

For purposes of analyzing whether the addition of security futures constitutes a material change in business operations, member firms are considered to fall into two general categories: firms that currently conduct an options business and those that do not.

Firms that currently conduct an options business should evaluate, based on the facts and circumstances, whether undertaking a security futures business constitutes a material change in business operations. These firms should apply the criteria identified previously for assessing the materiality of the proposed expansion.

For firms that currently do not engage in an options business, it is likely that engaging in a security futures business will constitute a material change in business operations. As to these firms, if they have assessed the potential impact on their firm of adding a security futures business and would like District Office input on the issue of whether an application is required to approve this expansion, they can consult with the District Offices by submitting notice of

their intent to engage in a security futures business to their District Office. The District Office will conduct an informal, expedited review of the firm's query that will include asking the firm questions about its existing operations and its potential security futures business. The District Office will then advise the firm regarding whether adding a security futures line of business constitutes a material change in business operations. If the District Office concludes that the firm should submit a continuing membership application, the District Office, in calculating the allotted review time, will give the firm credit for the amount of time elapsed since it provided the initial notice to the District Office.

This approach provides certain firms the opportunity to have a quick, informal assessment of whether they need to submit a continuing membership application, reduces the regulatory burden on some firms, and increases the efficiency of the continuing membership application process.

V. Analysts and Research Reports

Rule 2711 ("Research Analysts and Research Reports") generally restricts the relationship between a member's research and investment banking departments; requires disclosure of financial interests in covered companies by the member's analyst and the member; requires members to disclose existing and potential investment banking relationships with subject companies; imposes quiet periods for the issuance of research reports; restricts personal trading by analysts; and requires disclosure of information that helps investors track the correlation between an analyst's rating and the stock's price movements.⁴⁹ The provisions of Rule 2711 are generally applicable to security

futures. For example, the restrictions on personal trading by analysts extend to trading in security futures on companies covered by the analyst. Similarly, provisions addressing disclosure of members' or research analysts' ownership interests in a security include security futures interests held by that person. And, the Rule 2711 definition of "Research Report" includes certain written or electronic communications on security futures because security futures are defined as "equity securities" under the Exchange Act.⁵⁰

Endnotes

- 1 Appendix E of Pub. L. No. 106-554, 114 Stat. 2763. Under Section 3(a)(55)(A) of the Securities Exchange Act of 1934 ("Exchange Act"), the term "security future" is defined as a contract of sale for future delivery of a single security or of a narrow-based security index. 15 U.S.C. 78c(a)(55)(A). Under Exchange Act Section 3(a)(56), the term "security futures product" is defined as a security future or an option on a security future. 15 U.S.C. 78c(a)(56).
- 2 See, e.g., Exchange Act Section 3(a)(10) (15 U.S.C. 78c(a)(10)).
- 3 The term "security future" is defined in CEA Section 1a(31) (7 U.S.C. 1a(31)) as a contract of sale for future delivery of a single security or a narrow-based security index. Under CEA Section 1a(33) (7 U.S.C. 1a(33)), the term "security futures product" is defined as a security future or an option on a security future.
- 4 See Exchange Act Section 6(g) (15 U.S.C. 78f(g)); CEA Section 5f (7 U.S.C. 7b-1).
- 5 CEA Section 4f(a)(2) (7 U.S.C. 6f(a)(2)); 66 FR 43080 (August 17, 2001).
- 6 Exchange Act Section 15(b)(11)(a)(i) (15 U.S.C. 78o(b)(11)(a)(i)); 66 FR 45138 (August 27, 2001).
- 7 NASD rules apply only to NASD members. Because FCMs and IBs that are notice-registered with the SEC are not required to become NASD members, any NASD rule changes, including the ones explained here, may not apply to them.
- 8 See generally Exchange Act Section 19(b)(7)(A) (15 U.S.C. 78s(b)(7)(A)) (mandating that national securities exchanges or national securities associations registered with the SEC develop rules effectuating the obligation of these SROs to enforce the securities laws and to propose rule changes developing, among other things, sales practices for persons who effect transactions in security futures products); see also Exchange Act Section 15A(k)(2)(D) (15 U.S.C. 78o-3(k)(2)(D)) (requiring registered futures associations that apply for registration as a limited purpose national securities association to have rules that ensure that members meet such standards of training, experience, and competence necessary to effect transactions in security futures products and are tested for their knowledge of securities and security futures products).
- 9 Rule 1022(f)(5) and (g)(3), respectively; see also changes to Interpretive Materials 1022-1 and 1022-2. IM-1022-1 replaces references to the old category, Registered Options Principals, with the new category of Registered Options and Security Futures Principals and reflects that a Registered Options and Security Futures Principal may supervise security futures trading activities. Likewise, IM-1022-2 now reflects that a Limited Principal – General Securities Sales Supervisor may also supervise security futures sales activities.
- 10 Rule 1032(a)(2)(E) and (d)(4), respectively.
- 11 See NASD Rule 1120(b)(4) (provision permits NASD to require a member to provide specific training in areas NASD deems appropriate).
- 12 Similarly, the National Futures Association (NFA) is requiring continuing education for its existing registrants.
- 13 Some of these qualification exams are NYSE examinations. NASD, NYSE, and other SROs are working collectively to revise qualification examinations to address security futures.
- 14 In contrast, persons registered in all of the other effected categories who intend to engage in a security futures business shall be able to elect to take firm-element continuing education programs until December 31, 2006, even if new qualifying examinations have been created prior to that date.

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- 15 For example, the CFMA establishes that margin requirements for security futures be consistent with comparable option contracts and that listing standards for security futures be no less restrictive than comparable listing standards for options traded on a national securities exchange or a national securities association. See Exchange Act Sections 7(c)(2) & 6(h)(3)(C); 15 U.S.C. 78g(c)(2) & 78f(h)(3)(C).
- 16 On September 27, 2001, the SEC published a group of new NFA rules and amendments to NFA rules governing security futures. See 66 FR 49439 (September 27, 2001). The NFA's rules also were modeled after NASD's options rule. In developing NASD's security futures rule, we have sought to adopt requirements that are consistent with those of the NFA to avoid regulatory disparity between firms subject to the jurisdiction of the NFA and NASD.
- 17 The security futures risk disclosure statement has been developed collectively by NASD, NFA, the New York Stock Exchange, the American Stock Exchange, One Chicago, the Chicago Board Options Exchange, NQLX, and the Options Clearing Corporation.
- 18 See NASD Rule 2860(b)(19). We also are amending Interpretive Material 2310-2 (Fair Dealing with Customers) to require members to comply with the security futures sales practices and procedures contained in new Rule 2865.
- 19 See NFA Rule 2-30(j)(4).
- 20 See Exchange Act Release No. 46471 (Sept. 6, 2002), 67 FR 58302 (Sept. 13, 2002).
- 21 See Rule 2860(b)(17).
- 22 See Rule 2860(b)(8).
- 23 National Futures Association Manual, ¶ 9041 (Vol. 7, No. 2 2001).
- 24 Members also are advised that Rule 2240 ("Disclosure of Control Relationship with an Issuer") does not apply to security futures. Rule 2240 requires members that are controlled by, controlling, or under common control with, the issuer of any security to disclose to customers the existence of such control prior to entering into any contract with or for a customer for the purchase or sale of such security.
- 25 See Rule 2210(b)(1) & (c)(2). Although many of the advertising requirements for security futures are similar to the options advertising requirements, the definitions of "options advertisement," "educational material," and "sales literature" differ from the definitions that will apply to security futures. Because the security futures advertising requirements follow the requirements of the NASD's general advertising rule, the definition of "advertisement" is essentially material that is disseminated via mass media channels. See Rule 2210(a)(1). "Sales literature" is defined to include circulars, research reports, market letters, performance reports or summaries, form letters, telemarketing scripts, seminar texts, and reprints or excerpts of any other advertisement, sales literature, or published article that is distributed or made generally available to customers or the public. See Rule 2210(a)(2).
- 26 Rule 2210(d)(1)(A).
- 27 Rule 2210(d)(1)(B).
- 28 Rule 2210(d)(1)(B).
- 29 Rule 2210(d)(1)(A).
- 30 Rule 2210(d)(2)(C).
- 31 Rule 2210(d)(2)(B)(i)a & b.
- 32 These guidelines are similar in many respects to the requirements of Rule 2220, which governs the advertising of options.
- 33 See NFA Rule 2-29(j)(12); see also 66 FR 49439 (September 27, 2001).
- 34 See Rule 2210(d)(1)(B).
- 35 See Rule 2220(d)(2)(A)(i) & (ii), 2220(d)(2)(D)(i).
- 36 Rule 3010(b)(2)(iii).
- 37 NFA Rule 2-9: Enhanced Supervisory Requirements – Interpretive Notice.
- 38 66 FR 45137 (August 27, 2001).
- 39 For NASDAQ National Market securities, NASD rules include an additional short sale restriction: the bid test. See Rule 3350(a). We believe that the bid test has no application to security futures, and we are not proposing any amendments to Rule 3350.

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- 40 See Exchange Act Section 10(a)(2) (15 U.S.C. 78j(a)(2)) (exempting transactions in security futures from short sale provisions in Exchange Act Section 10(a)(1)).
- 41 Currently, the affirmative determination requirement of Rule 3370 does not apply to options transactions.
- 42 See Rule 3370(b)(5)(iv).
- 43 See *Notice to Members 01-22* (April 2001).
- 44 See SEC Interpretation: Commission Guidance on the Application of Certain Provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and Rules thereunder to Trading in Security Futures Products, Release Nos. 33-8107 & 34-46101 (June 27, 2002) (questions 21-23).
- 45 A member is required to file an application pursuant to NASD Rule 1017 for, among other things, a material change in business operations. NASD Rule 1017(e).
- 46 NASD Rule 1011(i).
- 47 See *Notice to Members 00-73* (Oct. 2000).
- 48 *Id.*
- 48 See *Notice to Members 02-39* (July 2002).
- 50 Exchange Act Section 3(a)(11) (15 U.S.C. 78c(a)(11)).
- © 2002. NASD. All rights reserved. *Notices to Members* attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.

ATTACHMENT A

1000. Membership, Registration and Qualification Requirements

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1020. Registration of Principals

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1022. Categories of Principal Registration

(a) through (e) No change

(f) **Registered Options and Security Futures Principals**

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

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

in the duties or accepting the responsibilities of a Registered Options and Security Futures Principal.

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

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

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

~~(5)~~[(6)] Any person who is registered with NASD as a Registered Options and Security Futures Principal , or who becomes registered as a Registered Options and Security Futures Principal before a revised examination that includes security futures products is offered, must complete a firm-element continuing education program that addresses security futures and a principal's responsibilities for security futures before such person can supervise security futures activities. After a revised examination that includes security futures products is offered, a person associated with a member who passes such a revised Qualification Examination for Registered Options and Security Futures Principal (or any other examination covering security futures that is acceptable to NASD) is not required to complete a firm-element continuing education program that addresses security futures and a principal's responsibilities for security futures to supervise activities in such products, except as otherwise required by Rule 1120 generally or by the member firm. Any Registered Options and Securities Futures Principal who intends to qualify to supervise security futures activities by completing a firm-element continuing education program must complete such a program by December 31, 2006. Any Registered Options and Securities Futures Principal who has not completed a firm-element continuing education program by that date will be required to pass an appropriate qualification examination covering security futures to supervise security futures activities.

(g) Limited Principal—General Securities Sales Supervisor

(1) through (2) No change

(3) Any person who is registered with NASD as a Limited Principal—General Securities Sales Supervisor, or who becomes registered as a Limited Principal – General Securities Sales Supervisor before a revised examination that includes security futures products is offered, must complete a firm-element continuing education program that addresses security futures and a principal’s responsibilities for security futures before such person can supervise security futures activities. After a revised examination that includes security futures products is offered, a person associated with a member who passes such a revised Qualification Examination for Limited Principal—General Securities Sales Supervisor (or any other examination covering security futures that is acceptable to NASD) is not required to complete a firm-element continuing education program that addresses security futures and a principal’s responsibilities for security futures to supervise such products, except as otherwise required by Rule 1120 generally or by the member firm. Any Limited Principal—General Securities Sales Supervisor who intends to qualify to supervise security futures activities by completing a firm-element continuing education program must complete such a program by December 31, 2006. Any Limited Principal—General Security Sales Supervisor who has not completed a firm-element continuing education program by that date will be required to pass an appropriate qualification examination covering security futures to supervise security futures activities.

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

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

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

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

IM-1022-2. Limited Principal—General Securities Sales Supervisor

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

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

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1032. Categories of Representative Registration

(a) General Securities Representative

- (1) No change
- (2) Except as provided in Rule 1031(c):
 - (A) through (D) No change

(E) A person who is registered with the Association as a General Securities Representative, or who becomes registered as a General Securities Representative before a new examination that includes security futures is offered, must complete a firm-element continuing education program that addresses security futures products. After a new examination that includes security futures products is offered, a person associated with a member who passes such a new Qualification Examination for General Securities Representative (or any other examination covering security futures that is acceptable to NASD) is not required to complete a firm-element continuing education program that addresses security futures to act as a General Securities Representative with regard to such products, except as otherwise required by Rule 1120 generally or by the member firm. Once the new examination that includes security futures becomes available, persons seeking to become a General Securities Representative will be required to pass such new examination (or any other examination covering security futures that is acceptable to NASD) to act as a General Securities Representative with regard to security futures products. Only persons registered as a General Securities Representative prior to the time that the new examination is available ("eligible General Securities Representatives") will be eligible to use a firm-element continuing education program in lieu of passing the new examination or module to engage in a security futures business. Any eligible General Securities Representative who intends to qualify as a General Securities Representative with regard to security futures products by completing a firm-element continuing education program must complete such a program by December 31, 2006. Any eligible General Securities Representative who has not completed a firm-element continuing education program by that date will be required to pass an appropriate qualification examination to engage in security futures activities.

(E) through (H) Renumbered as (F) through (I)

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

(b) through (c) No change

(d) Limited Representative—Options and Security Futures

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

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

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

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

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

(4) Any person who is registered with the Association as a Limited Representative—Options and Security Futures, or who becomes registered as a Limited Representative—Options and Security Futures before a revised examination that includes security futures is offered, must complete a firm-element continuing education program that addresses security futures. After a revised examination that includes security futures products is offered, a person associated with a member who passes such a revised Qualification Examination for Limited Representative—Options and Security Futures (or any other examination covering security futures that is acceptable to NASD) is not required to complete a firm-element continuing education program that addresses security futures to act as a limited representative with regard to such products, except as otherwise required by Rule 1120 generally or by the member firm. Any Limited Representative—Options and Security Futures who intends to qualify as a Limited Representative with regard to security futures products by completing a firm-element

continuing education program must complete such a program by December 31, 2006. Any Limited Representative—Options and Security Futures who has not completed a firm-element continuing education program by that date will be required to pass an appropriate qualification examination covering security futures to engage in security futures activities.

(e) through (h) No change

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1060. Persons Exempt from Registration

(a) The following persons associated with a member are not required to be registered with the Association:

(1) through (3) No Change

(4) persons associated with a member whose functions are related solely and exclusively to:

(A) No Change

(B) transactions in municipal securities; [or]

(C) transactions in commodities; or

(D) transactions in security futures, provided that any such person is registered with a registered futures association.

(b) No Change

* * * * *

IM-2110-3. Front Running Policy

It shall be considered conduct inconsistent with just and equitable principles of trade for a member or person associated with a member, for an account in which such member or person associated with a member has an interest, for an account with respect to which such member or person associated with a member exercises investment discretion, or for certain customer accounts, to cause to be executed:

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

customer has been provided such material, non-public market information by the member or any person associated with a member; or

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

The violative practice noted above may include transactions which are executed based upon knowledge of less than all of the terms of the block transaction, so long as there is knowledge that all of the material terms of the transaction have been or will be agreed upon imminently.

The general prohibitions stated above shall not apply to transactions executed by member participants in automatic execution systems in those instances where participants must accept automatic executions.

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

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

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

* * * * *

2210. Communications with the Public

(a) No change

(b) Approval and Recordkeeping

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

(2) No Change

(c) Filing Requirements and Review Procedures

(1) No change

(2) Advertisements concerning collateralized mortgage obligations, advertisements concerning security futures, and advertisements and sales literature concerning registered investment companies (including mutual funds, variable contracts and unit investment trusts) that include or incorporate rankings or comparisons of the investment company with other investment companies where the ranking or comparison category is not generally published or is the creation, either directly or indirectly, of the investment company, its underwriter or an affiliate, shall be filed with the Department for review at least 10 days

prior to use (or such shorter period as the Department may allow in particular circumstances) for approval and, if changed by the Association, shall be withheld from publication or circulation until any changes specified by the Association have been made or, if expressly disapproved, until the advertisement has been refiled for, and has received, Association approval. The member must provide with each filing the actual or anticipated date of first use. Any member filing any investment company advertisement or sales literature pursuant to this paragraph shall include a copy of the data, ranking or comparison on which the ranking or comparison is based.

(3) through (9) No Change

(d) Standards Applicable to Communications with the Public

(1) No Change

(2) Specific Standards

In addition to the foregoing general standards, the following specific standards apply:

(A) No Change

(B) Recommendations

(i) In making a recommendation in advertisements and sales literature, whether or not labeled as such, a member must have a reasonable basis for the recommendation and must disclose any of the following situations which are applicable:

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

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

c. No Change

(ii) through (iv) No Change

(e) through (f) No Change

* * * * *

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

(a) Association Approval Requirements and Review Procedures

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

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

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

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

(b) Disclosure Statement

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

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

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

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

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

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

future is priced;

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

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

(c) Recordkeeping

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

(d) Specific Standards

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

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

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

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

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

(e) Projections

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

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

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

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

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

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

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

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

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

(f) Historical Performance

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

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

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

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

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

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

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

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

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

(g) Security Futures Programs

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

(h) Standard Forms of Worksheets

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

(i) Recordkeeping

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

* * * * *

IM-2310-2. Fair Dealing with Customers

(a) through (d) No change

(e) Fair Dealing with Customers with Regard to Derivative Products or New Financial Products

The Board emphasizes members' obligations for fair dealing with customers when making recommendations or accepting orders for new financial products. As new products are introduced from time to time, it is important that members make every effort to familiarize themselves with each customer's financial situation, trading experience, and ability to meet the risks involved with such products and to make every effort to make customers aware of the pertinent information regarding the products. Members must follow specific guidelines, set forth below, for qualifying the accounts to trade the products and for supervising the accounts thereafter.

(1) Security Futures

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

(2) Index Warrants

Members are obliged to comply with the Rules, regulations and procedures applicable to index warrants and foreign currency warrants contained in the Rule 2840 Series.

[(2)] (3) Hybrid Securities and Selected Equity-Linked Debt Securities ("SEEDS") Designated as Nasdaq National Market Securities Pursuant to the Rule 4400 Series

Members are obligated to comply with any Rules, regulations, or procedures applicable to such securities pursuant to the Rule 4420 Series, as well as any other applicable Rule, regulation, or procedure of the Association.

* * * * *

2865. Security Futures

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

(b) Requirements

(1) General

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

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

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

(2) Definitions

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

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

(3) through (7) Reserved

(8) Restrictions on Security Futures Transactions

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

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

(9) through (10) Reserved

(11) Delivery of Security Futures Risk Disclosure Statement

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

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

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

(12) Reserved

(13) Reserved

(14) Reserved

(15) Statements of Account

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

(16) Opening of Accounts

(A) Approval Required

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

(B) Diligence in Opening Accounts

In approving a customer's account for security futures trading, a member or any person associated with a member shall exercise due diligence to ascertain the essential

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

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

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

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

c. Estimated annual income from all sources;

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

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

f. Marital status and number of dependents;

g. Age; and,

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

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

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

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

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

d. Name of registered representative;

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

f. Dates of verification of currency of account information.

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

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

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

(C) Verification of Customer Background and Financial Information

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

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

(D) Account Agreement

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

(17) Maintenance of Records

(A) In addition to the requirements of Rule 3110, every member shall maintain and keep current a separate central log, index, or other file for all security futures-related complaints, through which these complaints can easily be identified and retrieved. The central file shall be located at the principal place of business of the member or such other principal office as shall be designated by the member. At a minimum, the central file shall include: (i) identification of complainant; (ii) date complaint was received; (iii) identification of registered representative servicing the account; (iv) a general description of the matter complained of; and (v) a record of what action, if any, has been taken by the member with respect to the complaint. For purposes of this subparagraph, the term "security futures-related complaint" shall mean any written statement by a customer or person acting on behalf of a customer alleging a grievance arising out of or in connection with security futures. Each security futures-related complaint received by a branch office of a member shall be forwarded to the office in which the separate, central file is located not later than 30 days after receipt by the branch office that is the subject of the complaint. A copy of every security futures-related complaint shall also be maintained at the branch office that is the subject of the complaint.

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

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

(18) Discretionary Accounts

(A) Authorization and Approval

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

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

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

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

(B) Record of Transactions

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

(C) Security Futures Programs

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

(19) Suitability

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

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

(20) Reserved

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

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

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

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

(22) Reserved

(23) Reserved

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

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

(25) Trading Ahead of Customer Orders

Every member shall exercise due care to avoid trading ahead of a customer's security futures order. A member must exercise the due care required by this subsection when the member has gained knowledge of or reasonably should have gained knowledge of the customer's order prior to the transmission to a securities exchange of the member's order for a proprietary account, or for any account in which it or any person associated with it is directly or indirectly interested.

* * * * *

3010. Supervision

(a) No change

(b) Written Procedures

(1) No Change

(2) Tape recording of conversations

(i) through (viii) No change

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

(xi) No change

(c) through (d) No change

(e) Qualifications Investigated

Each member shall have the responsibility and duty to ascertain by investigation the good character, business repute, qualifications, and experience of any person prior to making such a certification in the application of such person for registration with this Association. Where an applicant for registration has previously been registered with the Association, the member shall review [obtain from the Central Registration Depository or from the applicant] a copy of the Uniform Termination Notice of Securities Industry Registration (Form U-5) filed with the

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

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

(f) through (g) No change

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3050. Transactions for or by Associated Persons

(a) through (c) No change

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

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

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

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

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

* * * * *

3370. Prompt Receipt and Delivery of Securities

(a) No change

(b) Sales

(1) No change

(2) "Short Sales"

(A) Customer short sales

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

(B) Proprietary short sales

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

quotation in an independent quotation medium, or to transactions [which] that result in fully hedged or arbitrated positions.

(3) through (4) No change

(5) “Bona Fide Fully Hedged” and “Bona Fide Fully Arbitrated”

In determining the availability of the exemption provided in paragraph (b)(2)(B) above and in Rule 11830 from short sale requirements for “bona fide fully hedged” and “bona fide fully arbitrated” transactions, the following guidelines shall apply. These guidelines are for illustrative purposes and are not intended to limit the Association’s ability to determine the proper scope of the terms “bona fide fully hedged” or “bona fide fully arbitrated” pursuant to this provision, on a case-by-case basis.

(A) Bona Fide Fully Hedged

The following transactions shall be considered bona fide fully hedged:

(i) through (iii) No change

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

Example: Long 1 single stock future of MNOP.

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

ATTACHMENT B

NASD Security Futures Information

Security Futures

The content outline provided below has been established by NASD and NFA for use by firms in developing their firm-element training programs. The outline contains five modules or segments: (1) Stock and Stock Options; (2) Futures Contracts; (3) Security Futures Products; (4) Regulatory Requirements for Security Futures; and (5) Supervision of the Offer and Sale of Security Futures.

Module 1 is intended primarily for futures professionals as an introduction to securities and securities law concepts. NASD will not require broker/dealers to administer the content of Module 1 to securities registrants. Firms should decide on their own whether their employees would benefit from the basic securities overview.

Module 2 is intended primarily for securities professionals as an introduction to the basic concepts and terminology of futures. In general, NASD will require that members administer the content of Module 2 to securities registrants, although firms employing dually-licensed persons (i.e., persons registered with a broker/dealer and an futures commission merchant or introducing broker), may not need to administer Module 2 to such persons.

Module 3 explains the characteristics and elements of security futures. Module 4 describes the regulatory framework, including sales practice and margin requirements, for these new products. All NASD member firms must administer the content of Modules 3 and 4 to their personnel before such persons may engage in a security futures business.

Lastly, Module 5 addresses issues relevant for persons who will be supervising personnel engaged in a security futures business. Firms must administer Module 5 to their appropriately qualified individuals before such persons can supervise security futures activity.

Module 1: Stocks and Stock Options

Introduction to Stocks

- Capital formation
- Shares in Corporate Ownership
- Dividends
- Common Stock
- Preferred Stock
- Restricted Stock
- ADRs
- Corporate Actions
 - Stock splits
 - Reverse stock splits
 - Mergers and takeovers
 - Spin-offs

Stock and Stock Options Markets and Clearing Organizations

- The Nasdaq Stock Market
- NYSE, AMEX and Regional Stock Exchanges
- Intermarket Trading System
- Electronic Communications Networks
- Options Exchanges
- Options Clearing Corporation
- Product fungibility

Trading Stocks

- Price quotation conventions
- Short selling
 - Uptick rule
 - Stock loan

- Affirmative determination
- Dividends

Types of orders (different than those in the futures markets)

- All-or-none orders

Immediate-or-cancel orders

Fill-or-kill orders

Trade settlement

Insider trading

Delayed openings

Trading halts

Circuit breakers

Stock Options and Stock Index Options

Basic description

Synthetics

Stock Market Analysis and Related Statistical Measures

Stocks by sector Stocks by strategy and Industry outlook

- Growth stocks
- Value stocks
- Income stocks

Stocks by market capitalization

- Large Cap
- Mid Cap
- Small Cap

Statistical measures

- Alpha
- Beta

Corporate Announcements and Other News and Information

Quarterly earnings reports
Corporate statements between reports
Insider filings
Short interest reports

Income Statement and Balance Sheet

General description
Earnings per share
Price/Earnings ratio
Dividend yield
Book value
Liquidity measures

- Current assets
- Quick assets
- Current liabilities
- Working capital
- Current ratio
- Acid-test ratio
- Cash flow

Margin for Stocks and Stock Options

Initial and maintenance margin for stock purchases
Initial and maintenance margin for short stock positions
Options margin

- Premium payments
- Margin for short positions

Securities Investor Protection Corporation

Purpose of SIPC
Coverage limits
Coverage amounts

Module 2: Futures Contracts

Introduction to Futures Contracts

General characteristics
Equal treatment of buys and sells
Standardized contract terms

Futures Markets and Clearing Organizations

Open-outcry
Electronic trading
Floor brokers
Floor traders
Non-fungibility across exchanges
Role of clearinghouse

- Matching trades
- Effecting settlement and payments
- Guaranteeing performance
- Facilitating deliveries

Trading Futures

Settlement

- Physical delivery
- Cash settlement

Daily price limits
Circuit breakers

Types of orders (different than those in the securities markets)

- Spread orders
- Switch orders
- Fill-or-kill orders

Volume

Open interest

Commitments of traders

Pricing of futures

Hedging

- Basis risk

Speculation

Position limits

Arbitrage

Spreading

- Intramarket spreads
- Intermarket spreads

Margins

Initial margin ("good faith deposit")

Maintenance margin

- Marking to market

Clearing margins

Segregated funds

Segregation requirements

Not covered by SIPC

Module 3: Security Futures

Security Futures

Definitions

- Futures on single stocks
- Futures on narrow-based stock indexes

- Index changes from narrow to broad-based

Exchanges trading security futures

Listing requirements

Restrictions on trading security futures on foreign markets

Contract Terms and Conditions for Security Futures Contracts

Buying security futures

Selling security futures

- No short sale requirement

Contract size

Hours of trading

Contract months/trading cycle

Last trading date

Expiration dates

Minimum price variation

Reporting requirements

- Large trader reporting levels

Position and position accountability limits

Physical delivery

Cash settlement

Strategies

- Arbitrage
- Dividend-capture

Other Characteristics of Security Futures

Fungibility (or lack thereof)

Trading halts

- Regulatory halts
- Circuit breakers

Treatment of corporate actions

- Integral stock splits

- Non-integral stock splits
- Mergers
- Takeovers
- Spin-offs

Tax treatment

Block trading requirements

Module 4: Regulatory Requirements for Security Futures

Registration Requirements

Registration of markets

Registration of intermediaries with the SEC and CFTC

Registration of certain collective investment vehicles or providers of investment advice

Sales Practices

Communications with the public
Customer protection rules

- SIPC
- Segregated funds

Risk disclosure statement

Margin Requirements

Initial margin

Maintenance margin

- Definition of current market value

Risk-based margins

- Strategy offsets
- Portfolio-based margining systems (not allowed)

Cross-margining

Applicability of Regulation T
Collateral

- Type, form and use of collateral
- Acceptable collateral deposits
- Use of money market mutual funds

Computation of equity

Meeting margin calls

Account liquidation

Extension of credit

Other Considerations

Suitability

Commissions

Account approval and documentation

Discretionary accounts

Best execution requirement

Reporting customer complaints

Anti-fraud and anti-manipulation requirements

- Section 4(b) of the CEA and 10(b) of the Securities Exchange Act
- Prohibition against trading on inside information
- Prohibition against trading ahead of research reports
- Prohibition against trading ahead of customer orders

Module 5: Supervision of the Offer and Sale of Security Futures

Security Futures Principals

General requirement

Qualifications for principals and representatives

- Licensing
- Examination modules
- New candidates
- Existing candidates

Hiring Employees

Review of securities and futures employment background

Annual Compliance Meetings

Account Approval

Specific approval required

Written procedures

- Criteria used

Discretionary Accounts

Approval

Review of discretionary activity

Promotional Material and Correspondence

Review of correspondence

Review and approval of promotional material

Notice to Members

NOVEMBER 2002

SUGGESTED ROUTING

Executive Representatives
Legal & Compliance
Operations
Senior Management

KEY TOPICS

Public Information Review

ACTION REQUESTED BY DECEMBER 2, 2002

Public Information Review

NASD Requests Comment on its Public Information Review Initiative

Executive Summary

NASD requests comment from members, associated persons, investors, investor groups, and other interested parties on a broad range of issues relating to information NASD makes public. NASD currently provides an unparalleled amount of information about firms, markets and regulation to the public. NASD's policy on public information, as established by various NASD rules, and guided by relevant federal law, has been the topic of frequent public attention. NASD has begun a corporate-wide initiative to review the information it collects or develops and the policies underlying its determination to make certain information public. The overall purpose of this initiative is to develop recommendations for a comprehensive Public Information Policy that will enhance investor protection without sacrificing the effectiveness of NASD regulatory programs or legitimate proprietary or privacy rights of member firms or their associated persons. The focus of this initiative is on information currently available to NASD, not increasing member firms' compliance or reporting obligations. Soliciting the views of NASD's constituents and the users of the information NASD makes public is a critical step in the conduct of this policy review.

NASD is considering changes that would expand the information it currently makes public, including changes to its Public Disclosure Program (PD Program).¹ Possible other changes include, for example, expanding the statistical information NASD makes available, increasing the broker-dealer information released and making arbitration award information more readily available to investors.

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One of the key challenges in conducting this policy review is the need to balance investor protection and an investor's ability to make informed decisions with the legitimate proprietary interests of member firms and the privacy interests of associated persons and other individuals. For example, NASD does not currently release personal information such as Social Security Number, home address or physical description of associated persons² through its PD Program, and has no plans to do so.³ NASD is, however, considering expanding the information released via its PD Program to include historical form filing information and disclosure information reported by a former employer on Form U-5⁴ as soon as the information is filed. Currently, disclosure information reported via Form U-5 is not released via the PD Program until the broker re-associates with another broker-dealer and is required to report the information via Form U-4.⁵

Action Requested

NASD seeks comment from members, associated persons, investors, investor groups, and other interested parties on issues relating to its Public Information Policy review and supporting or opposing the options discussed in this *Notice*.

Comments must be received by **December 2, 2002**. Members and interested persons can submit their comments using the following methods:

- ◆ mailing written comments to NASD
- ◆ e-mailing written comments to pubcom@nasd.com
- ◆ submitting written comments online on NASD's 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 or by e-mail.

Before becoming effective, any rule changes developed relating to this *Notice to Members* must be submitted to and approved by the Securities and Exchange Commission (SEC).

Questions/Further Information

Questions concerning this *Notice* may be directed to Jay Cummings, Vice President, NASD Registration and Disclosure Department, at (240) 386-4773 or Ann Bushey, Director, Regulatory Review and Disclosure, NASD Registration and Disclosure Department, at (240) 386-4724.

Background

NASD has begun a corporate-wide initiative to review the information it makes public. The initiative involves a comprehensive review of the information collected or developed by NASD and the applicable rules and policies governing whether such information is made available to the general public. As part of the Public Information Policy review, a number of options have been identified and are being presented for comment in this *Notice*. NASD is interested in comments on its Public Information Policy generally and whether commenters support or oppose the options discussed in this *Notice*. NASD will consider these

comments when formulating rule or policy changes to its Public Information Policy.

Some of the options relate to the expansion of NASD's PD Program. NASD established the PD Program in 1988 to provide investors with important information about the professional background, business practices, and conduct of NASD members and their associated persons. Recognizing the PD Program's value to investors, Congress passed legislation in 1990 requiring NASD to establish and maintain a toll-free telephone number to receive inquiries regarding its members and their associated persons. In 1998, NASD began providing certain administrative information (e.g., approved registrations and employment history) online via NASD's Web Site (www.nasd.com). In 1999, annual inquiries through the PD Program broke the 1,000,000 mark. In 2000, the SEC approved changes to NASD IM-8310-2 that allowed NASD to (1) release information about persons formerly associated with a member for a two-year period following the termination of their registration with NASD; (2) release information about terminated persons and firms that is provided on Form U-6 (the form regulators use to report regulatory actions)⁶, if such matters would be required to be reported on the Form U-4 or Form BD⁷; and (3) deliver automated disclosure reports, which include verbatim information submitted by filers on Uniform Registration Forms. The PD Program is structured to provide information on a per firm or per broker basis on firms or individuals identified by the requester of the information. NASD currently does not release certain information that other securities regulators may provide, particularly State securities regulators operating

under applicable state public records laws. Nor has it historically released comparative information regarding NASD firms and their associated persons.

NASD believes that the PD Program is a critical investor education and protection service, as demonstrated by the over 2 million inquiries now processed annually. The PD Program includes information on over 850,000 former and current registered individuals and over 6,000 current or former NASD registered firms. Information released through NASD's PD Program is derived from the Central Registration Depository (CRD)⁸ system, a registration and licensing database used by regulators throughout the securities industry to register, license and regulate securities firms and their brokers.

Through the PD Program, summary information about securities-related arbitration awards involving NASD member firms is made available to the public. In addition, NASD's Dispute Resolution division has an arrangement with the *Securities Arbitration Commentator (SAC)* to provide copies of awards for inclusion in its Web-based publication service. As part of this arrangement, individual investors may search the SAC Web Site (accessible via the NASD Dispute Resolution Web Site), using the arbitration award number, to view or copy an award. The award number is contained in a broker or firm report obtained from NASD's PD Program.

NASD has a number of systems that collect data on matters that also must be reported through the CRD system. To ensure that the information is in fact reported on a timely basis, and therefore is available to the public through the PD Program, NASD plans to implement additional cross-checks to ensure that the matters reported to these systems are timely reported to the CRD system.

Discussion

The SEC, States and other self-regulatory organizations release a variety of information under their respective public information policies. These organizations often publish information NASD has available in its CRD system or other systems but does not release under its current information policy. NASD believes its Public Information Policy, including IM-8310-2 and any other relevant NASD Rules, should be amended as appropriate to enable investors to receive most of this information from NASD as well.

NASD seeks comment from members, associated persons, investors, investor groups, and other interested parties on issues relating to its Public Information Policy and whether commenters support or oppose the suggestions and options set forth in this *Notice* and discussed in more detail below.

1. Establish a Central Gateway for Access to Public Information

NASD makes a broad range of information available to the public, mostly through its Web Sites. There is, however, no single place from which to obtain a listing of the information that is publicly available. Public information is currently spread across multiple pages on at least three different Web Sites. Information frequently is presented without explanations that put the information in context or that define how statistical information has been derived.

To make information more useful and easily accessible, NASD is considering a single web location that would: (1) list and describe the public information NASD makes available; (2) provide a contact point for questions and/or

comments regarding NASD public information; (3) consolidate access to all public statistical information; and (4) enhance the statistical information NASD makes available to include certain demographic and industry segmentation data. The end result would be a central gateway for access to NASD's public information from which an Internet user could see, at-a-glance, the types of information NASD makes available and link to the specific or more detailed information he or she is interested in.

NASD seeks comment on other ways it can facilitate investor access to this information.

2. Enhance NASD's Public Disclosure Program

Over 2 million inquiries a year are processed through NASD's PD Program. It has become the primary source for investors and others seeking information about NASD member firms and their associated persons. To enhance investor protection, NASD believes that substantial changes should be made to its PD Program to:

- ◆ make it easier to use;
- ◆ provide disclosure information online;
- ◆ alert investors to key changes in available information about a broker or firm;
- ◆ put the information provided in context; and
- ◆ expand the types of information released through the PD Program.

Even with an expansion of the information available through the PD Program, there will be information available through other sources that is not available to NASD or that NASD is

unable to make public.⁹ For example, NASD does not have information regarding certain complaints made by investors to State regulators. The only source for this information is the State regulator. NASD believes the PD Program should provide investors and other users with additional information about other sources of information on NASD member firms and associated persons, including the SEC, States, other self-regulators, and, where possible, provide additional contact information for these sources.

Ease of Use - Redesign of Internet Application

NASD's Public Disclosure Internet application was initially deployed in 1998, with subsequent enhancements made in 1999 and 2000. Although NASD's PD Program Internet application was designed to be simple and efficient in its delivery of information, the Internet technology and standards available today offer significant opportunities to make NASD's PD Program easier to use and the information presented easier to understand.

To meet the needs of investors and other users, the PD Program must both provide a summary view of the wealth of detailed information that is available and the capability to view the detailed information. These two goals can best be achieved through an Internet-based approach using hyperlinks and other information architecture and presentation techniques.

Online Access to Disclosure Information

The information provided through the PD Program can be divided into two broad categories:

- ◆ **Administrative Information** – information about the firm or broker (registrations, employment history, types of business, etc.). Administrative information is available online and in Public Disclosure reports available by mail or e-mail.
- ◆ **Disclosure Information** – information provided in response to the disclosure questions on the Uniform Registration Forms (criminal, regulatory, disciplinary, customer sales practice complaints and related litigation or arbitration, etc.). Disclosure information is not available online and can only be obtained by requesting a Public Disclosure report by mail or e-mail.

The existing federal law mandating the PD Program, enacted in 1990, does not address providing disclosure information online. At the time the legislation was enacted, the PD Program was telephone-based. Investors and other users called the NASD Hotline (800-289-9999) to request reports and the legislation specifically reflected that medium for communication; Internet and online disclosure was not contemplated. Today, although the NASD Hotline is still available, investors and other users prefer to use the Internet and have expressed the strong desire to be able to obtain disclosure information online. Over 95 percent of the inquiries to the PD Program are now received through the Internet.

NASD believes it should continue to seek a change to the federal legislation governing the PD Program to provide for online presentation of disclosure information. Without the ability to display all data online, access to information and usability of the PD Program will continue to be hampered to the detriment of investor protection.

Public Disclosure Report Updates

NASD believes that current Internet technology provides a cost-effective means to provide investors and other users of the PD Program with e-mail notice if significant changes occur to the information available on a broker or member firm specified by an investor or other user of the PD Program.

NASD is considering adding functionality to the PD Program that would allow an investor or other user of the PD Program to request an e-mail notice when certain changes occur in the information previously provided to the investor or other user through the PD Program.

CRD Data and Form Filing Information

NASD has expanded the amount of information available through the PD Program since its inception in 1988. The most recent changes occurred in February 2000.¹⁰ Although a broad range of information available to regulators through the CRD system also is available to investors and others through the PD Program, NASD believes that more CRD information should be made publicly-available through the PD Program.

For example, NASD's PD Program does not release a broker's exam history or results¹¹ or other CRD system processing results; or the specific form filings and related information submitted during the course of a broker's career.¹² NASD also

does not release the date and reason for termination as reported on Form U-5. Further, as noted above, disclosure events reported via Form U-5 are disclosed only when (and if) a broker re-associates with another firm and is then required to report any new disclosure events via the Form U-4 filing submitted in connection with that application for registration. Similarly, the "firm information" currently disclosed through the PD Program does not include all information reported on Form BD, such as information regarding direct and indirect owners and control affiliates, answers and related details to all Form BD questions, disclosure information reported for control affiliates,¹³ or the actual initial Form BD and amendment filings submitted from time to time to keep a firm's CRD record current.

Given that state regulators and the SEC consider these form filings to be public documents,¹⁴ and with respect to Form BD, given that firms, as commercial entities, do not have the privacy interests of individual brokers, NASD seeks comment on whether or not it should expand the information released through its PD Program pursuant to IM-8310-2 to include some or all of the additional information described above – or any other information not specifically mentioned in this *Notice*. For example, should NASD expand its PD Program to include additional information reported on current Uniform Forms and provide investors access to historical form filings that may include disclosure events that are no longer reportable?

In considering any expansion of the information released through the PD Program, NASD will continue to balance the benefits of making this information available against the legitimate proprietary interests of member firms

and the privacy interests of associated persons and other individuals whose information might be subject to disclosure. For example, NASD does not currently release personal information such as Social Security Number, home address or physical description of associated persons, and has no plans to do so. Further, NASD does not intend to disclose the date of termination and/or reason for termination as reported on Form U-5 until such time as the Form U-5 is amended to allow firms to correct any filing errors made in reporting the date or reason for termination.¹⁵

NASD also seeks comment on whether it should provide a means for former brokers to file a response to information filed on Form U-5 by a firm with which they were associated or filed by a regulator on Form U-6. Further, NASD seeks comment on whether such a response should be through a Uniform Registration Form filing (either an existing form or a new form created for this purpose) and whether such response should be included in the CRD system and the PD Program or whether such response should be filed exclusively with NASD and made available only through the PD Program.

Putting the Information in Context

Although NASD cannot rate brokers or firms or specifically advise an investor whether or not to conduct business with a particular broker or firm, NASD believes that expanding the information available through the PD Program to include certain comparative information would help an investor better understand and evaluate the information on the specific broker or firm he or she may be interested in or how his or her broker or firm compares to the rest of the industry.

NASD seeks comment on whether or not to expand the information released through the PD Program to include comparative information to help put the specific broker or firm information into context. For example, NASD proposes adding comparative information such as the total number of active brokers or firms, certain industry averages, the universe of active brokers or firms that have disclosure, the average number of disclosure events by category for brokers or firms that do have disclosure, and possibly breaking down the total number of disclosure events for a broker or firm by the number of disclosure events initiated in the past 1, 3, or 5 years or that occurred more than 10 years ago.

Comment on the Public Disclosure Program

In addition to the specific issues for comment identified in this section, NASD seeks comment on the PD Program in general, including comment on: making disclosure information available online; expanding the information made available through the PD Program; the overall design and delivery of information available via the Public Disclosure Internet application (accessing the application, navigation, online delivery of the information, display and usability of the data); and a Public Disclosure report update service (including the types of events that would trigger an update).

3. Implement Additional Safeguards to Ensure Timely Reporting of Disclosure Information.

The largest and most visible component of NASD's Public Information is the PD Program. The PD Program depends largely on the system of firm and broker

self-reporting to the CRD system through the uniform registration forms. Although there are a broad range of safeguards¹⁶ in place today that serve as a “check and balance” to the overall self-reporting process, NASD believes more can be done across NASD regulatory systems to ensure data integrity, reduce or eliminate reporting gaps, and ensure that the information is reported quickly, thereby providing investors and the general public with the most current and complete information. NASD also believes that these additional safeguards will not increase an individual or firm’s current reporting obligations or add significant burdens to firm compliance activities and requirements.

In this regard, NASD is considering the following additional safeguards to help achieve its objectives:

- ◆ Expand existing NASD staff review of sources of information other than the CRD system to ensure that information required to be reported by firms and brokers through the CRD system is filed in a timely manner.
 - ◆ Implement a new NASD agent registration status called “Inactive Disclosure Review” that would be applied whenever NASD staff discovers that an individual in an approved NASD registration status fails to meet a reporting requirement or fails to respond to a staff request for disclosure or related information within a prescribed period of time. This “Inactive Disclosure Review” status would parallel the existing “Inactive CE” and “Inactive Prints” agent registration statuses. A representative with this status would not be permitted to conduct sales or other regulated activity
- until the reporting obligation or response to the staff’s request is satisfied.
- ◆ Impose a late disclosure filing fee whenever a new disclosure event, or a required update to an existing disclosure event, is reported to NASD more than 30 days¹⁷ from the date triggering the reporting obligation (e.g., the date the action was initiated or the date the firm or individual learned of the facts or circumstances giving rise to the reporting requirement).¹⁸
 - ◆ Require all registered individuals (approximately 7.5 percent of registered representatives) who have not yet filed a Form U-4 amendment electronically through the CRD system to do so. This will ensure that regulators and the investing public have access to information reported on the current registration forms and verified by the filing broker and firm.¹⁹
 - ◆ Establish a web page on NASD’s Web Site where investors, attorneys or others can report instances where they believe a particular disclosure event that is required to be reported via Form U-4, Form U-5, or Form BD has not been reported. The underlying premise of this proposal is that an investor or other interested individual would alert NASD of the potential reporting requirement after viewing an individual or firm’s Public Disclosure information and seeing that the specific event in question (e.g., complaint or arbitration they had filed) is not included as part of the broker or firm’s public disclosure record.

NASD seeks comment on the safeguards noted above and any additional safeguards that NASD should consider.

4. Improve Ease of Access to Arbitration Awards.

NASD developed the *Securities Arbitration Commentator (SAC)* portal to provide access to arbitration awards for parties in subsequent arbitration cases. As part of the arbitrator selection process, parties are entitled to review the background of all potential arbitrators for their case, including prior decisions of those arbitrators. For each potential arbitrator, NASD provides parties with a report containing extensive background information and a list of that arbitrator's prior awards. With that list, parties can easily view or print awards at any time with no charge. This mechanism was designed to replace a system in which the parties requested copies of awards from NASD. Many requests were extensive and the more voluminous requests resulted in fees charged to parties.

SAC collects arbitration awards from NASD, from other self-regulatory organizations, and from the American Arbitration Association. SAC is in business to provide award summaries and searches of its award database for a fee. SAC's customers are typically attorneys for parties in arbitration matters. However, it may be possible for NASD to work with SAC to enhance the services available to individual investors in a public disclosure context. In addition, the PD Program could be enhanced to identify awards in a way that would allow more meaningful searches using the current SAC database.

NASD seeks comment on these approaches and other issues regarding the availability of dispute resolution information.

5. Other NASD Information

NASD collects a broad range of information to fulfill its regulatory mission. Because of the proprietary and confidential nature of much of this information, and its potential use in investigations, examinations or disciplinary actions, NASD believes that this information should remain non-public. In assessing whether this information should be made public, NASD initially has concluded to implement the safeguards described above to ensure that the regulatory information most pertinent to investors (*i.e.*, the information generally elicited by the uniform registration forms) is timely and fully reported to the CRD system (so it is available to regulators) and the PD Program so that it is available to investors and other users.

NASD seeks comment on this proposed approach and on any other information that NASD should consider making publicly available.

Summary

As previously stated, NASD currently provides an unparalleled amount of information about firms, markets and regulation to the public. NASD's policy on public information, as established by various NASD rules, and guided by relevant federal law, has been the topic of frequent public attention. NASD has undertaken a corporate-wide initiative to review (1) the information it collects or develops and (2) the policies underlying its determination to make certain information public. The overall objective of this initiative is to develop recommendations for a comprehensive Public Information Policy that will enhance investor protection without sacrificing the effectiveness of NASD

regulatory programs or legitimate proprietary or privacy rights of member firms or their associated persons, or increasing member firms' compliance obligations or burdens. Soliciting the views of NASD's constituents and the users of the information NASD makes public is a critical step in the conduct of this policy review.

As discussed in this *Notice*, NASD is considering changes that would expand the information it currently makes public, including changes to its PD Program.

One of the key challenges in conducting this policy review is the need to balance investor protection and an investor's ability to make informed decisions with the legitimate proprietary interests of member firms and the privacy interests of associated persons and other individuals.

NASD believes that a more comprehensive Public Information Policy will enhance investor protection without sacrificing the effectiveness of NASD regulatory programs. NASD looks forward to receiving comments from members, associated persons, investors, investor groups, and other interested parties on the broad range of issues related to information NASD makes public and on whether commenters support or oppose the options discussed in this *Notice*.

Endnotes

- 1 NASD Interpretive Material (IM) 8310-2(a) governs the information released via NASD's PD Program.
- 2 This information is required to be reported by associated persons registered with NASD on their Uniform Registration Form U-4.
- 3 Other regulators may make this information public, depending on applicable law. See Note 9, below.
- 4 Form U-5: The Uniform Termination Notice for Securities Industry Registration.
- 5 Form U-4: The Uniform Application for Securities Industry Registration or Transfer.
- 6 Form U-6: Uniform Disciplinary Action Reporting Form.
- 7 Form BD: Uniform Application for Broker-Dealer Registration. Form BD is an SEC form. As such, the SEC must adopt any proposed changes to Form BD.
- 8 NASD operates the CRD system in accordance with an agreement with the North American Securities Administrators Association (NASAA). CRD policy is jointly established by NASD and NASAA.
- 9 NASD's PD Program is governed by federal law, SEC regulations, and NASD rules approved by the SEC. Other sources may be governed by different substantive legal requirements. State disclosure programs are governed by state law, which may enable the State to provide additional information on firms or brokers licensed by the state.
- 10 Broker information currently released via the PD Program includes the broker's name and CRD number, approved registrations (provided the individual is NASD registered), 10 years of employment history (includes current and previous employment), "other business" (if any) as reported on Form U-4, and all disclosure events currently required to be reported on Form U-4 (including disclosure events reported by regulators via Form U-6, and disclosure events reported by previously employing NASD firms via Form U-5 once a subsequent Form U-4 is submitted and the individual is then required to report any new disclosure events via Form U-4). Information released through the PD Program on current and former NASD registered firms includes: applicant's name, CRD number, SEC number, main office address, mailing address, business telephone number, NASD district office assignment, approved registrations (provided the firm is NASD registered), all disclosure events involving the firm required to be reported on Form BD (including disclosure events reported by regulators via Form U-6), and summary information about securities (or commodities) related NASD arbitration awards.
- 11 Exam information includes: exams requested, taken or not taken, and exam results (i.e., pass/fail or specific grades). NASD proposes providing pass/fail instead of actual scores in part because the number of questions and the required passing score varies from exam to exam and can change over time. Exam scores are not designed to predict performance or future regulatory compliance.
- 12 Historical form filing information includes the specific form filings submitted to the CRD system and the information contained in the specific filing, including any disclosure events that were reported in error or that were required to be reported on a specific filing but are no longer reportable on the individual's current Form U-4 filing (based on a change to the question or a "sunset" provision within the question that requires reporting only for a specified period of time).
- 13 Control affiliate disclosure can be obtained (if reported to the CRD system) by a separate request for information on the control affiliates.
- 14 Forms U-4, U-5, U-6, BD, BDW and related amendment filings.
- 15 The Form U-5 and related instructions do not currently allow firms to amend any information reported on the form other than the associated person's residential address and disclosure information. As a result, firms that may make filing errors by entering an incorrect date or selecting an incorrect reason for termination from a drop down list have no mechanism to correct these errors via a Form U-5 amendment filing.

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- 16 Today's safeguards include, but are not limited to: Criminal History Record Information (CHRI) received from the Federal Bureau of Investigation as part of the fingerprint card processing results, which provides an independent source of criminal history information (fingerprint cards are submitted to NASD pursuant to Exchange Act Rule 17f-2); regulator reporting of disciplinary actions initiated against a broker or firm via Form U-6; and existing information sharing within NASD departments and among other regulators.
- 17 Note that 30 calendar days is used here as an example. The requisite number of days is to be determined; however, it likely would be based on calendar days, and would be at least 30 days, except in cases involving a statutory disqualification. NASD's By-Laws, Article IV, Section 1(c) and Article V, Section 2(c), state that all applications with NASD must be kept current at all times by supplementary amendments and that such amendments should be filed with NASD not later than 30 days after learning of the facts or circumstances triggering the amendment filing requirement. Further, if the amendment involves a statutory disqualification as defined in Section 3(a)(39) and Section 15(b)(4) of the Exchange Act, the By-Laws state that the amendment should be filed not later than 10 days after the disqualification occurs.
- 18 The intent of the late filing fee is not to generate revenue, but rather to deter late filing and ensure that the required amendment filings are submitted timely, thereby making the information available to the public as soon as possible. The fee would be imposed any time a reportable event was initially disclosed more than 30 days from the event date.
- 19 In substantially all cases, the information provided through the PD Program represents the verbatim record as it was reported to NASD on the uniform registration form then in effect. The disclosure and other questions on these forms have changed substantially over time. In addition, in certain limited circumstances relating to the conversion to electronic form filing, NASD combined information about a single event that was reported by different sources. Filing electronically on the current form would address both issues. No fee would be charged member firms for this filing, unless the filing reported new or updated disclosure, in which case the standard disclosure review fee would apply.
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