Notice to Members

JULY 2003

SUGGESTED ROUTING

Legal and Compliance

Senior Management

Operations

Trading and Market Making

KEY TOPICS

Electronic Communications

Communications with the Public

Recordkeeping

INFORMATIONAL

Instant Messaging

Clarification for Members Regarding Supervisory Obligations and Recordkeeping Requirements for Instant Messaging

Executive Summary

NASD is clarifying for members their supervisory obligations and recordkeeping requirements with respect to instant messaging.

Questions/Further Information

Questions concerning this *Notice* may be directed to Mary Sue Fisher, Special Counsel, Regulation Policy, Department of Member Regulation at 202-728-8277, or Thomas A. Pappas, Associate Vice President, Advertising Regulation at 240-386-4553.

Background

The Securities and Exchange Commission (SEC) issued key releases in 1996 and 1997 that guide the use of electronic media by broker/dealers. The first release discussed the use of electronic media to deliver information to customers (Electronic Delivery Release); the second described the application of recordkeeping requirements to electronic communications (Electronic Records Release).[1] Although electronic communications technology has evolved rapidly in the intervening years, these releases established a basic principle that underlies current regulatory policy. The SEC stated in the Electronic Delivery Release that:

> SRO rules concerning the supervisory requirements for electronic communications should be based on the content and audience of the message, and not merely the electronic form of the communication.[2]

The Electronic Records Release extended that principle to broker/dealer record-keeping requirements, prescribing that:

> [f]or record retention purposes under Rule 17a-4, the content of the electronic communication is determinative, and therefore broker/dealers must retain only those e-mail and Internet communications (including inter-office communications) which relate to the broker/dealer's "business as such."[3]

NASD has followed these precepts in adopting, amending, and interpreting NASD rules governing communications with customers and the public (2200), suitability (2310), research analysts and reports (2711), supervision (3010), and books and records (3110). These rules accord members flexibility to use a variety of approaches, including innovative technologies, if their use is subject to an effective program of supervision and complies with applicable recordkeeping requirements.

Communications with the Public

NASD recognizes that evolving technologies may offer multiple functions that do not fit neatly into traditional supervisory categories. NASD therefore published the *Internet Guide for Registered Representatives* to assist registered representatives and firms in their use and supervision of electronic communications with the public.[4] The *Internet Guide* first lays out the general compliance requirements that apply to all forms of communication with the public; it then discusses how specific types of electronic media fit within existing supervisory categories. For example, the *Internet Guide* treats group e-mail as "sales literature,"[5] individual e-mail as "correspondence," publicly available Web sites as "advertisements," and chat-room discussions as "public appearances."

NASD developed the *Internet Guide* relying on the same basic principles established in the SEC's Electronic Delivery and Electronic Records Releases: the content and audience of each type of electronic communication determine the appropriate supervisory and recordkeeping treatment. These principles also form the basis of the "facts and circumstances" test adopted by NASD in its policy statement concerning online suitability.[6]

Instant Messaging

Instant messaging is a developing technology that can pose supervisory and recordkeeping challenges for member firms. Instant messaging alerts users when other users are online and enables those users to communicate in real time. Instant messaging was originally introduced as an add-on to subscription Internet services, but has a growing presence in business communication. Consumer versions of instant messaging did not provide business users with tools to monitor or archive instant messaging communication. Many firms determined that they could not adequately supervise instant messaging communications and banned the use of instant messaging for communication with the public.

Other firms have allowed use of instant messaging, reasoning that instant messaging is less formal than e-mail and paper-based communication and need not be subject to the same requirements. However, lack of formality of instant messaging does not exempt it from the general standards applicable to all forms of communication with the public. Members should evaluate instant

messaging according to the "content and audience" of the instant messaging communications.

Members must supervise the use of instant messaging consistent with the required supervision of e-mail messaging. Depending on the circumstances, instant messaging could be either sales literature or correspondence.[7] Compliance in each of these situations depends on clear supervision and review procedures that are consistently followed.[8] If a member is unable to establish an adequate supervisory program, the member must prohibit the use of instant messaging in customer communication.[9]

Members must also ensure that their use of instant messaging complies with applicable SEC and NASD recordkeeping requirements. Messages exchanged on many popular instant messaging platforms cannot be saved or subsequently retrieved, making them inappropriate for communications that must be retained as firm records. Members that permit instant messaging must use a platform that enables the member to monitor, archive, and retrieve message traffic.

Internal Communications and Recordkeeping Requirements

NASD Rule 3010 requires

> each member to establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with [NASD] Rules....

NASD rules do not specifically require member firms to review or approve internal communications. However, members must be certain that they have procedures adequate to supervise the activities of each registered representative and associated person, including their use of electronic communications technology.

Members must also assure themselves that their use of electronic communications media enables them to make and keep records, as required by SEC Rules 17a-3, 17a-4, and NASD Rule 3110. Recent SEC and NASD enforcement actions serve as a forceful reminder that

> Rule 17a-4 is not limited to physical documents.... [I]nternal e-mail communications relating to a broker or dealer's "business as such" fall within the purview of Rule 17a-4.[10]

SEC Rule 17a-4(b)(4) and NASD Rule 3110

> require firms to preserve for a period of not less than three years, the first two years in an easily accessible place, originals of all communications received and copies of all communications sent by the firm or its employees relating to its business. Those rules apply to electronic communications....[11]

NASD urges members to evaluate their internal use of instant messaging in light of their supervisory and recordkeeping requirements. NASD recognizes that technology enhances business opportunities, increases public access to market information, and supports regulatory compliance. Nonetheless, the preference of employees to use instant messaging to communicate does not alter the obligation of the firm to keep relevant records. NASD members must ensure that their use of instant messaging is consistent with their basic supervisory and recordkeeping obligations.

Endnotes

1 SEC Release No. 34-37182 (May 1996) (Electronic Delivery Release); SEC Release No.34-38245 (Jan. 1997) (Electronic Records Release).

2 Electronic Delivery Release at 5.

3 Electronic Records Release at 16.

4 The *Guide* is available on the NASD Web Site at *http://www.nasdr.com/4040.asp*.

5 The treatment of group e-mail will be modified by amendments to Rule 2210, approved by the SEC on May 9, 2003. *See,* SEC Release No. 34-47820 (May 9,2003), 68 Fed. Reg. 27116 (May 19, 2003). The amended definition of "correspondence" in Rule 2210 includes any written letter or electronic mail message distributed by a member to one or more existing retail customers and fewer than 25 prospective retail customers within a 30-day period. The rule change takes effect on November 3, 2003. In the interim, NASD has taken a no-action position with respect to group e-mail sent to institutional accounts, provided that the e-mail is subject to the same supervisory system as individual correspondence. *See,* Letter from Alden S. Atkins, General Counsel, NASD Regulation to Yoon-Yung Lee, Wilmer, Cutler & Pickering, (Dec. 7, 1999) available at *http://www.nasdr.com/2910/2210_07.asp*.

6 *NASD Notice to Members 01-23.*

7 *See,* note 5 for a discussion of recently approved amendments to Rule 2210.

8 The essential elements of the supervisory program are discussed in *NASD Notice to Members 98-11.*

9 Id. *Notice to Members 98-11* states that supervisory policy and procedures must "prohibit registered representatives' and other employees' use of electronic correspondence to the public unless such communications are subject to supervisory and review procedures developed by the firm. For example, [NASD] would expect members to prohibit correspondence with customers from employees' home computers or through third party systems unless the firm is capable of monitoring such communications."

10 *See,* In Re Deutsche Bank Securities, Inc., Goldman, Sachs and Co., Morgan Stanley & Co. Incorporated, Salomon Smith Barney, Inc., U.S. Bancorp Piper Jaffray Inc., Letter of Acceptance, Waiver and Consent No. CAF020064 (Nov. 2002) p.5.

11 *See, In Re Robertson Stephens,* Letter of Acceptance, Waiver and Consent No. CAF030001 (Jan. 2003) p. 12.

Notice to Members

JUNE 2003

SUGGESTED ROUTING

Legal and Compliance

Operations

Registration

Senior Management

KEY TOPICS

Anti-Money Laundering Compliance Programs

INFORMATIONAL

Anti-Money Laundering Customer Identification Programs for Broker/Dealers

Treasury and SEC Issue Final Rule Regarding Customer Identification Programs for Broker/Dealers; **Effective Date: October 1, 2003**

Executive Summary

On April 30, 2003, the Department of Treasury (Treasury) and the Securities and Exchange Commission (SEC or Commission) jointly issued a final rule to implement Section 326 of the USA PATRIOT Act (PATRIOT Act).[1] Section 326 provides that Treasury and SEC issue a rule that, at a minimum, requires broker/dealers to implement reasonable procedures to: (1) verify the identity of any person seeking to open an account, to the extent reasonable and practicable; (2) maintain records of the information used to verify the person's identity; and (3) determine whether the person appears on any lists of known or suspected terrorists or terrorist organizations provided to brokers or dealers by any government agency. The final rule requires each broker/dealer to establish a written Customer Identification Program (CIP) to verify the identity of each customer who opens an account. The written CIP must also include recordkeeping procedures and procedures for providing customers with notice that the broker/dealer is requesting information to verify their identity. Broker/dealers must fully implement their CIPs by October 1, 2003.

Questions/Further Information

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

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Background

On October 26, 2001, President Bush signed into law the PATRIOT Act. Title III of the PATRIOT Act imposed obligations on broker/dealers under new anti-money laundering (AML) provisions and amendments to the Bank Secrecy Act (BSA) in an effort to make it easier to prevent, detect, and prosecute money laundering and the financing of terrorism. Among these obligations, broker/dealers were required to have an AML compliance program in place as of April 24, 2002. Consistent with this requirement under the PATRIOT Act, NASD Rule 3011 requires each member, to develop and implement a written AML program reasonably designed to achieve and monitor the member's compliance with the requirements of the BSA and the implementing regulations.

On July 23, 2002, Treasury and the SEC jointly proposed a rule to implement Section 326 of the PATRIOT Act with respect to broker/dealers. The SEC received 20 comment letters in response to the proposal. Members of the industry questioned, among other things, the proposed rule's definition of "customer," which included persons with trading authority over an account. Others expressed concern about the verification and recordkeeping requirements. The final rule addresses many of the comments.

Description of Final Rule

Relevant Definitions

The final rule provides several definitions, which, among other things, assist members in determining who are the relevant persons whose identities need to be verified.

1. Account. The final rule defines an "account" as a formal relationship with a broker/dealer established to effect transactions in securities, including, but not limited to, the purchase or sale of securities, securities loaned and borrowed activity, and the holding of securities or other assets for safekeeping or as collateral.[2]

Importantly, the final rule contains two exclusions from the definition of "account." The definition excludes: (a) an account that the broker/dealer acquires through any acquisition, merger, purchase of assets, or assumption of liabilities;[3] and (b) an account opened for the purpose of participating in an employee benefit plan established under the Employee Retirement Income Security Act of 1974 ("ERISA").[4]

The Adopting Release explains that in acquisitions, mergers, purchases of assets, or assumptions of liabilities, customers do not initiate these transfers and, therefore, the accounts do not fall within the scope of Section 326 of the PATRIOT Act.[5]

In addition, transfers of accounts that result from an introducing broker/ dealer changing its clearing firm would fall within this exclusion.[6]

As initially proposed, the definition of "account" contained several examples of types of accounts that would be covered including cash accounts, margin accounts, prime brokerage accounts, and accounts established to engage in securities repurchase transactions. The Adopting Release notes that these types of accounts remain "accounts" for purposes of the final rule, but the final rule does not specifically include them as examples to clarify that the list is not exhaustive.

2. Broker/dealer. "Broker/dealer" is defined as a person registered or required to be registered as a broker or dealer with the Commission under the Securities Exchange Act of 1934 (Exchange Act) except persons who are required to be registered solely because they effect transactions in security futures products.[7]

3. Customer. The final rule defines "customer" as: (a) a person that opens a new account; and (b) an individual who opens a new account for an individual who lacks legal capacity or for an entity that is not a legal person.[8]

Under this definition, "customer" does not refer to persons who fill out account opening paperwork or who provide information necessary to set up an account, if such persons are not the accountholder as well.

In addition, the Adopting Release addresses concerns about identity verification in situations involving trust and omnibus accounts. The release explains that a broker/dealer is not required to look through a trust or similar account to its beneficiaries, and is required only to verify the identity of the named accountholder.[9] Similarly, with respect to an omnibus account established by an intermediary, a broker/dealer is not required to look through the intermediary to the underlying beneficial owners, if the intermediary is identified as the accountholder.[10]

As noted above, the proposed rule required that the broker/dealer verify the identity of those with trading authority over an account. The final rule, however, does not include persons with trading authority over accounts in the definition of "customer." Accordingly, the broker/ dealer does not have to verify those

individuals' identities. However, the final rule recognizes that situations may arise where a broker/dealer will have to take extra steps to verify the identity of those with trading authority. In these instances, a CIP is required to address situations where the broker/dealer will take additional steps to verify the identity of a customer that is not an individual by seeking information about individuals with authority or control over the account in order to verify the customer's identity.[11]

The final rule's definition also contains additional exclusions. The following entities are excluded from the definition of "customer":

- A person that has an existing account with the broker/dealer, provided the broker/dealer has a reasonable belief that it knows the true identity of the person;
- A financial institution regulated by a Federal functional regulator (the definitions of which are discussed below in numbers 4 and 5 of this section);
- Banks regulated by a state bank regulator;
- A department or agency of the United States, of any State, or of any political subdivision of any State;
- Any entity established under the laws of the United States, of any state, or of any political subdivision of any state, or under an interstate compact between two or more states, that exercises governmental authority on behalf of the United States or any such state or political subdivision; or
- Any entity, other than a bank, whose common stock or analogous equity interests are listed on the New York Stock Exchange or the American Stock Exchange or whose common stock or analogous equity interests have been designated as a NASDAQ National Market Security listed on The NASDAQ Stock Market (except stock or interests listed under the separate "NASDAQ Small-Cap Issues" heading), provided that, for purposes of this provision, a person that is a financial institution, other than a bank, is an exempt person only to the extent of its domestic operations.

4. Federal functional regulator. "Federal functional regulator" is defined as: the SEC; the Commodity Futures Trading Commission; the Board of Governors of the Federal Reserve System; the Office of the Comptroller of the Currency; the Board of Directors of the Federal Deposit Insurance Corporation; the Office of Thrift Supervision; or the National Credit Union Administration.[12]

5. Financial Institution. "Financial Institution" is defined to include: an insured bank (as defined in section 3(h) of the Federal Deposit Insurance Act (12 U.S.C. 1813(h))); a commercial bank or trust company; a private banker; an agency or branch of a foreign bank in the United States; an insured institution (as defined in section 401(a) of the National Housing Act, 12 U.S.C. 1724(a)); a thrift institution; a broker or dealer registered with the SEC under the Exchange Act; a broker or dealer in securities or commodities; an investment banker or investment company; a currency exchange; an issuer, redeemer, or cashier of travelers' checks, checks, money orders, or similar instruments; an operator of a credit card system; an

insurance company; a dealer in precious metals, stones, or jewels; a pawnbroker; a loan or finance company; a travel agency; a licensed sender of money; a telegraph company; a business engaged in vehicle sales, including automobile, airplane, and boat sales; persons involved in real estate closings and settlements; the United States Postal Service; an agency of the United States Government or of a state or local government carrying out a duty or power of a business described in this paragraph; a casino, gambling casino, or gaming establishment with an annual gaming revenue of more than $1,000,000 which is licensed as a casino, gambling casino, or gaming establishment under the laws of any State or any political subdivision of any State; or is an Indian gaming operation conducted under or pursuant to the Indian Gaming Regulatory Act other than an operation which is limited to class I gaming (as defined in section 4(6) of such Act); any business or agency which engages in any activity which the Secretary of the Treasury determines, by regulation, to be an activity which is similar to, related to, or a substitute for any activity in which any business described in this paragraph is authorized to engage; or any other business designated by the Secretary whose cash transactions have a high degree of usefulness in criminal, tax, or regulatory matters.[13]

6. Taxpayer identification number. "Taxpayer identification number" has the same meaning as determined under the provisions of Section 6109 of the Internal Revenue Code and the regulations of the Internal Revenue Service thereunder (*e.g.*, social security number or employer identification number).[14]

7. U.S. person. "U.S. person" means a United States citizen or a person other than an individual (such as a corporation, partnership or trust) that is established or organized under the laws of a State or the United States.[15]

8. Non-U.S. person. "Non-U.S. person" means a person that is not a U.S. person.[16]

Customer Identification Program

Minimum Requirements

The final rule requires that broker/dealers establish, document, and maintain a written CIP. This program must be appropriate for the firm's size and business, be part of the firm's anti-money laundering compliance program, and, at a minimum, must contain procedures for the following: identity verification, recordkeeping, comparison with government lists, and providing customer notice.[17]

Required Customer Information

A broker/dealer's CIP must contain procedures for opening an account that specifies the identifying information that will be obtained from each customer. The minimum identifying information that must be obtained from each customer prior to opening an account is:

- A name;
- A date of birth, for an individual;
- An address, which will be:
  - For an individual, a residential or business street address;

- For an individual who does not have a residential or business street address, an Army Post Office (APO) or Fleet Post Office (FPO) box number, or the residential or business street address of a next of kin or another contact individual; or
- For a person other than an individual (such as a corporation, partnership, or trust), a principal place of business, local office, or other physical location; and

- An identification number, which will be:
  - For a U.S. person, a taxpayer identification number; or
  - For a non-U.S. person, one or more of the following:
    - a taxpayer identification number;
    - a passport number and country of issuance;
    - an alien identification card number; or
    - the number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.[18]

Treasury and the SEC adopted the required customer information provisions substantially as proposed with changes to accommodate individuals who may not have physical addresses. The Adopting Release notes that the minimum required information is collected by most broker/dealers already, is necessary for the verification process, and serves an important law enforcement function.

With respect to non-U.S. persons, the final rule contains some flexibility in the identification number requirement because a firm can choose from a variety of information numbers to accept from a non-U.S. person. In this regard, the Adopting Release states that there is no uniform identification number that non-U.S. persons would be able to provide to a broker/dealer. Nevertheless, whatever identifying information the firm does accept must enable the firm to form a reasonable belief that it knows the true identity of a customer.[19]

Exception for Persons Applying for a Taxpayer Identification Number

The proposed rule allowed broker/dealers to open an account for a new business that applied for, but had not received, a taxpayer identification number. The final rule expanded the exception in the proposed rule to include natural persons who have applied for, but not received, a taxpayer identification number. Therefore, instead of obtaining a taxpayer identification number from a customer (either natural or non-natural) prior to opening an account, a CIP may include procedures for opening an account for a customer that has applied for, but has not received, a taxpayer identification number. In this case, the CIP must include procedures to confirm that the application was filed before the customer opens the account and to obtain the taxpayer identification number within a reasonable period of time after the account is opened.[20]

Identity Verification Procedures

A CIP must include risk-based procedures for verifying the identity of each customer to the extent reasonable and practicable. The procedures must enable the broker/dealer to form a reasonable

belief that it knows the true identity of each customer. The procedures must be based on the broker/dealer's assessment of the relevant risks, including those presented by the:

- types of accounts maintained by the broker/dealer;
- methods of opening accounts provided by the broker/dealer;
- types of identifying information available; and
- broker/dealer's size, location, and customer base.[21]

Customer Verification

A CIP must contain procedures for verifying the identity of each customer, using the required information described above, within a reasonable time *before or after* the customer's account is opened.[22]

The final rule and Adopting Release do not define "reasonable time." The Adopting Release states that "[t]he amount of time may depend on the type of account opened, whether the customer opens the account in-person, and the type of identifying information available."[23]

A broker/dealer's CIP is required to include procedures that describe when the broker/dealer will use documentary methods, non-documentary methods, or a combination of both methods to verify customers' identities. For example, depending on the type of customer, the method of opening an account, and the type of identifying information available, it may be more appropriate to use either documentary or non-documentary methods, and in some cases it may be appropriate to use both methods. These procedures should be based on the firm's assessment of the relevant risk factors discussed above.[24]

Verification through documents

The final rule requires that a CIP contain procedures that describe the documents the broker/dealer will use for verification.[25] Each broker/dealer must conduct its own risk-based analysis of the types of documents that it believes will enable it to verify the true identities of customers. Examples of documents that firms may use for verification include:

- For an individual, an unexpired government-issued identification evidencing nationality or residence and bearing a photograph or similar safeguard, such as a driver's license or passport; and
- For a person other than an individual (such as a corporation, partnership, or trust), documents showing the existence of the entity, such as certified articles of incorporation, a government-issued business license, a partnership agreement, or a trust instrument.[26]

These documents are merely examples of reliable documents. A firm may use other documents for verification provided that the documents allow a firm to establish a reasonable belief that it knows the true identity of the customer.

The Adopting Release encourages firms to obtain more than one type of documentary verification to ensure that they have a reasonable belief that they know their customers' true identities. This will increase the likelihood of finding inconsistencies if a person is attempting to provide false information. Also firms should use a variety of methods to verify the identity of a customer, especially when the broker/dealer does not have

the ability to examine the original documents.[27]

The final rule generally does not require a firm to ensure the validity of documents.[28] The Adopting Release explains that, once a firm obtains and verifies the identity of a customer through a document, such as a driver's license or passport, a firm is not required to take steps to determine whether the document has been validly issued. A firm may rely on a government-issued identification as verification of a customer's identity. If, however, a firm notes that the document shows some obvious form of fraud, the firm must consider that factor in determining whether it can form a reasonable belief that it knows the customer's true identity.[29]

Verification through non-documentary methods

The final rule requires a CIP to contain procedures that describe the non-documentary methods the broker/dealer will use for verification.[30] Examples of non-documentary methods of verification include:

- Contacting a customer;
- Independently verifying the customer's identity through the comparison of information provided by the customer with information obtained from a consumer reporting agency, public database,[31] or other source;
- Checking references with other financial institutions; or
- Obtaining a financial statement.[32]

Treasury and the SEC recommend that firms analyze whether there is a logical consistency between the identifying information provided, such as the customer's name, street address, zip code, telephone number (if provided), date of birth, and Social Security number (*e.g.*, zip code and city/state are consistent).

The final rule requires that a broker/dealer's CIP address the following circumstances where non-documentary procedures must be used:

- An individual is unable to present an unexpired government-issued identification document that bears a photograph or similar safeguard;
- The broker/dealer is not familiar with the documents presented;
- The account is opened without obtaining documents;
- The customer opens the account without appearing in person at the broker/dealer; and
- Where the broker/dealer is otherwise presented with circumstances that increase the risk that the broker/dealer will be unable to verify the true identity of a customer through documents.[33]

Due to the prevalence of identity theft and because identification documents may be obtained illegally and be fraudulent, firms are encouraged to use non-documentary methods even when a customer has provided identification documents.[34]

Additional Verification for Certain Customers

Treasury and the SEC added a new provision to the final rule regarding additional verification for certain customers. The Adopting Release explains that, while firms may be able to verify the majority of customers adequately

through documentary and non-documentary methods, there may be instances where those methods are inadequate.[35] The risk that a firm may not know the customer's true identity may be heightened for certain types of accounts, such as an account opened in the name of a corporation, partnership, or trust that is created or conducts substantial business in a jurisdiction that has been designated by the U.S. as a primary money laundering concern or has been designated as non-cooperative by an international body.[36] Treasury and the SEC emphasize that a firm must take further steps to identify customers that pose a heightened risk of not being properly identified. A firm's CIP must prescribe additional measures that may be used to obtain information about the identity of the individuals associated with the customer when standard documentary methods prove to be insufficient.[37]

Therefore, the final rule requires that a CIP address situations where, based on the broker/dealer's risk assessment of a new account opened by a customer that is not an individual, the broker/dealer will obtain information about individuals with authority or control over such account. This verification method applies only when the broker/dealer cannot verify the customer's true identity using documentary and non-documentary verification methods.[38]

Lack of Verification

A CIP must include procedures for responding to circumstances in which a broker/dealer cannot form a reasonable belief that it knows the true identity of a customer.[39] These procedures should describe:

- When the broker/dealer should not open an account;
- The terms under which a customer may conduct transactions while the broker/dealer attempts to verify the customer's identity;
- When the broker/dealer should close an account after attempts to verify a customer's identity fail; and
- When the broker/dealer should file a Suspicious Activity Report (Form SAR-SF) in accordance with applicable law and regulation.[40]

Recordkeeping

Required records

A CIP must include procedures for making and maintaining a record of all information obtained to verify a customer's identity.[41] At a minimum, the record must include all identifying information about a customer obtained to verify a customer's identity.

With regard to verification, a firm's records must contain a description of any document that was relied on to verify the customer's identity, noting the type of document, any identification number contained in the document, the place of issuance, and, if any, the date of issuance and expiration date. This differs from the proposed rule, which required that firms keep copies of verification documents.

With respect to non-documentary verification, the final rule requires that records contain a description of the methods and the results of any measures undertaken to verify the identity of a customer.

Finally, the final rule requires, with respect to any method of verification chosen, a description of the resolution of each substantive discrepancy discovered when verifying the identifying information obtained.[42]

Retention of records

A broker/dealer must retain records of all of the identification information obtained from the customer for five years after the account is closed.[43] In addition, records made about information that verifies a customer's identity only have to be retained for five years after the record is made. In all other respects, the records must be maintained pursuant to the provisions of SEC Rule 17a-4.[44]

Comparison with Government Lists

A CIP must include procedures for determining whether a customer appears on any list of known or suspected terrorists or terrorist organizations issued by any Federal government agency and designated as such by Treasury in consultation with the Federal functional regulators.[45] The procedures must require that the broker/dealer make such a determination within a reasonable period of time after the account is opened, or earlier if required by another Federal law or regulation or Federal directive issued in connection with the applicable list. The procedures also must require that the broker/dealer follow all Federal directives issued in connection with such lists.[46]

The Adopting Release notes that Treasury and the Federal functional regulators have not yet designated any government lists. The Adopting Release also notes that firms do not have an affirmative duty to seek out all lists of known or suspected terrorists or terrorist organizations compiled by the federal government. Instead, firms will receive notification from the federal government regarding the lists that they must consult for purposes of this provision.

The Adopting Release also cautions that this does not mean that firms do not have obligations under other laws to screen their customer against government lists. It mentions, as an example, compliance with the OFAC rules prohibiting transactions with certain foreign countries and nationals. Firms must check the OFAC List to ensure that potential customers and existing customers, on an ongoing basis, are not prohibited persons or entities and are not from embargoed countries or regions before transacting any business with them.[47]

Customer Notice

A CIP must include procedures "for providing customers with adequate notice that the broker/dealer is requesting information to verify their identities."[48] Notice must occur before the account is opened. Notice is adequate if the broker/dealer generally describes the identification requirements of the final rule and provides such notice in a manner reasonably designed to ensure that a customer is able to view the notice, or otherwise given notice, before opening an account.[49] For example, depending upon the manner in which the account is opened, a broker/dealer may post a notice in the lobby or on its Web site, include the notice on its account applications, or use any other form of oral or written notice.

Sample Notice

The final rule provides the following sample language for notice to be provided to a firm's customers, if appropriate:[50]

> Important Information About Procedures for Opening a New Account
>
> To help the government fight the funding of terrorism and money laundering activities, Federal law requires all financial institutions to obtain, verify, and record information that identifies each person who opens an account.
>
> What this means for you: When you open an account, we will ask for your name, address, date of birth and other information that will allow us to identify you. We may also ask to see your driver's license or other identifying documents.

Reliance on Another Financial Institution

The final rule acknowledges that there may be circumstances in which a firm may be able to rely on the performance by another financial institution of some or all of the elements of a firm's CIP.[51] Therefore, the final rule provides that a CIP *may* include procedures specifying when the broker/dealer will rely on the performance by another financial institution (including an affiliate) of any procedures of the broker/dealer's CIP, with respect to any customer of the broker/dealer that is opening an account or has established an account or similar business relationship with the other financial institution to provide or engage in services, dealings, or other financial transactions.

In order for a broker/dealer to rely on another financial institution, the following requirements must be met:

- Reliance must be reasonable under the circumstances;
- The other financial institution must be subject to a rule implementing the anti-money laundering compliance program requirements of the PATRIOT Act and be regulated by a Federal functional regulator; and
- The other financial institution must enter into a contract requiring it to certify annually to the broker/dealer that it has implemented its anti-money laundering program, and that it will perform (or its agent will perform) specified requirements of the broker/dealer's CIP.

The Adopting Release notes that the contract and certification will provide a standard means for a firm to demonstrate the extent to which it is relying on another financial institution to perform its CIP, and that the other institution has agreed to perform those functions.[52] If it is not clear from these documents, a broker/dealer must be able to otherwise demonstrate when it is relying on another financial institution to perform its CIP with respect to a particular customer. A broker/dealer will not be held responsible for the failure of the other financial institution to fulfill adequately the broker/dealer's CIP responsibilities, provided that the broker/dealer can establish that its reliance was reasonable and that it has obtained the requisite contracts and certifications.[53] Treasury and the SEC emphasize that the broker/dealer and the other financial institution upon which it relies must satisfy *all of the conditions* set forth in this final rule. If they do not, then the broker/dealer remains solely responsible for applying its own CIP to each customer in accordance with the rule.[54]

Endnotes

1 68 Fed. Reg. 25,113 (May 9, 2003) ("Adopting Release").

2 31 C.F.R. § 103.122(a)(1).

3 Broker/dealers are advised to consider situations when it may be appropriate to verify the identity of customers associated with transferred accounts in developing and implementing the required anti-money laundering compliance program. 68 Fed. Reg. 25,113, 25,115.

4 The Adopting Release discusses why these accounts are excluded from the definition of "account." Such accounts are less susceptible to be used for the financing of terrorism and money laundering because, among other things, they are funded through payroll deductions in connection with employment plans that must comply with federal regulations. These regulations impose, among other requirements, low contribution limits and strict distribution requirements. 68 Fed. Reg. 25,113, 25,115.

5 68 Fed. Reg. 25,113, 25,115.

6 However, the introducing firm and the clearing firm would need to meet the requirements for reliance on another financial institution (as discussed *supra* on page 355) such as entering into a contract and providing certifications to the extent that they intend to rely on each other to undertake CIP requirements with respect to customers that open accounts after the transfer. 68 Fed. Reg. 25,113, 25,115, fn. 20.

7 31 C.F.R. § 103.122(a)(2).

8 31 C.F.R. § 103.122(a)(4).

9 68 Fed. Reg. 25,113, 25,116. However, a broker/dealer, based on its risk-assessment of a new account, may need to take additional steps to verify the identity of a customer that is not an individual, such as obtaining information about persons with control over the account. In addition, the due diligence procedures required under other provisions of the BSA or securities laws may require broker/dealers to look through to owners of certain types of accounts. Id. at 25,115, fn. 30.

10 The final rule does not affect any requirements under SEC Rule 17a-3(a)(9) to make records with respect to the beneficial owners of certain accounts. 68 Fed. Reg. 25,113, 25,116, fn. 31.

11 68 Fed. Reg. 25,113, 25,116. *See* discussion *supra* at page 353.

12 31 C.F.R. § 103.122(a)(5).

13 31 C.F.R. § 103.122(a)(6).

14 31 C.F.R. § 103.122(a)(7).

15 31 C.F.R. § 103.122(a)(8).

16 31 C.F.R. § 103.122(a)(9).

17 31 C.F.R. § 103.122(b)(1). The Adopting Release notes that the provision permitting broker/dealers to rely on the performance of another financial institution for some or all of the elements of a firm's CIP (as discussed *supra* on page 355) is not specified as a minimum CIP requirement because any such reliance is optional. 68 Fed. Reg. 25,113, 25,117, fn. 48.

18 31 C.F.R. § 103.122(b)(2)(i)(A). The Treasury and the SEC recognize that a foreign business or enterprise may not have an identification number. The Adopting Release states that when a firm is opening an account for a foreign business or enterprise that does not have an identification number, the broker/dealer must request alternative government-issued documentation certifying the existence of the business or enterprise. 68 Fed. Reg. 25,113, 25,118, fn. 65.

19 68 Fed. Reg. 25,113, 25,118, fn. 65. The Adopting Release emphasizes that the rule neither endorses nor prohibits a broker/dealer from accepting information from particular types of identification documents issued by foreign governments. The broker/dealer must determine, based upon appropriate risk factors, including those discussed on page 351 (under "Identity Verification Procedures"), whether the information presented by a customer is reliable.

20 31 C.F.R. § 103.122(b)(2)(i)(B).

21 31 C.F.R. § 103.122(b)(2).

22 31 C.F.R. § 103.122(b)(2)(ii). The Adopting Release notes that it is possible, however, that a firm would violate other laws by permitting a customer to transact business prior to verifying the customer identity. *See, e.g.,* 31 C.F.R. Part 500 (regulations of Treasury's Office of Foreign Asset Control (OFAC)). Firms are prohibited from doing business with those persons and organizations listed on the OFAC Web Site as well as with the listed embargoed countries and regions. 68 Fed. Reg, 25,113, 25,119, (fn. 79).

23 68 Fed. Reg. 25,113, 25,119.

24 68 Fed. Reg. 25,113, 25,119.

25 31 C.F.R. § 103.122(b)(2)(ii)(A).

26 *Id.*

27 68 Fed. Reg. 25,113, 25,119.

28 *Id.*

29 *Id.* at 25,119-25,220.

30 31 C.F.R. § 103.122(b)(2)(ii)(B).

31 The Adopting Release does not list the specific types of databases that would be suitable for verification. It will depend on the circumstances and the firm's assessment of relevant risk factors. 68 Fed. Reg. 25,113, 25,120, fn. 95.

32 31 C.F.R. § 103.122(b)(2)(ii)(B)(1).

33 31 C.F.R. § 103.122(b)(2)(ii)(B)(2). The Adopting Release notes that there may be circumstances other than those described when a firm should use non-documentary verification procedures. 68 Fed. Reg. 25,113, 25,120, fn. 98.

34 68 Fed. Reg. 25,113, 25,120.

35 31 C.F.R. § 103.122(b)(2)(ii)(C).

36 *See, e.g.,* the list of non-cooperative countries and territories published by the Financial Action Task Force on Money Laundering (FATF) at http://www1.oecd.org/fatf/NCCT_en.htm. The FATF is an intergovernmental body whose purpose is the development and promotion of policies to combat money laundering.

37 68 Fed. Reg. 25,113, 25,121.

38 *Id.*

39 31 C.F.R. § 103.122(b)(2)(iii).

40 68 Fed. Reg. 25,113, 25,121. For more information regarding the filing of Form SAR-SFs, see NASD Notice to Members 02-47, Treasury Issues Final Suspicious Activity Reporting Rule for Broker/Dealers; Effective Date: Transactions After December 30, 2002, *http://www.nasdr.com/pdf-text/0247ntm.pdf.*

41 31 C.F.R. § 103.122(b)(3).

42 The Adopting Release notes that the requirement was limited to substantive discrepancies to make clear that records would not have to be made in the case of minor discrepancies, such as those caused by typographical error. 68 Fed. Reg. 25,113, 25,121, fn. 111.

43 31 C.F.R. § 103.122(b)(3)(ii).

44 *Id.*

45 31 C.F.R. § 103.122(b)(4).

46 *Id.*

47 *See, infra* endnote 22; 68 Fed. Reg. 25,113, 25,122, fn. 120.

48 31 C.F.R. § 103.122(b)(5)(i).

49 31 C.F.R. § 103.122(b)(5)(ii).

50 31 C.F.R. § 103.122(b)(5)(iii).

51 31 C.F.R. § 103.122(b)(6).

52 68 Fed. Reg. 25,113, 25,123.

53 *Id.*

54 *Id.*

Special **Notice to Members**

JUNE 23, 2003

SUGGESTED ROUTING

Legal & Compliance

Senior Management

KEY TOPICS

Cease and Desist Proceedings and Orders

INFORMATIONAL

Temporary Cease and Desist Orders

SEC Approves NASD Rule Change Giving NASD Authority to Issue and Enforce Temporary Cease and Desist Orders

Executive Summary

On May 23, 2003, the Securities and Exchange Commission (SEC) approved an NASD proposed rule change that gives NASD the authority to impose and enforce temporary cease and desist orders for alleged violations of specified securities laws and NASD rules.[1] The rule change also makes explicit NASD's authority to impose and enforce permanent cease and desist orders as a remedy in disciplinary cases. The SEC approved the rule change on a trial basis for a two-year period.[2] The new rule text is contained in Attachment A and is effective as of the date of this *Notice to Members* (*Notice*).

Questions/Further Information

Questions regarding this *Notice* may be directed to James S. Wrona, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8270.

Background

In the past, NASD rules did not provide NASD staff with the means to respond rapidly to curtail certain types of serious misconduct by NASD members and associated persons. NASD's only means of addressing such situations was to prosecute a normal disciplinary action, a process that could take months to complete. In some instances, members or associated persons continued to engage in misconduct during the interim. In others, the members' or associated persons' financial condition significantly deteriorated.

In either case, there was a significant risk that the investing public could be further harmed while the disciplinary action was adjudicated.

The rule change described in this *Notice* will allow NASD to address such situations quickly and effectively. It establishes procedures that enable NASD to issue temporary cease and desist orders and makes explicit NASD's ability to impose permanent cease and desist orders as a remedy in disciplinary cases. The rule change also gives NASD authority to initiate non-summary proceedings when respondents violate temporary or permanent cease and desist orders. The rule change will expire in two years from the date of this *Notice* unless it is renewed by NASD with SEC approval.

The rule change includes a number of procedural checks and safeguards to ensure that cease and desist proceedings are used prudently, sparingly, and fairly. NASD, for instance, may institute such proceedings only with the written authorization of the President of NASD Regulatory Policy and Oversight or the Executive Vice President for NASD Regulatory Policy and Programs. This provision ensures that such decisions are made at the highest NASD staff levels. In addition, NASD may initiate temporary cease and desist proceedings only for alleged violations of specified securities laws and NASD rules.[3]

After the President or Executive Vice President authorizes the initiation of a temporary cease and desist proceeding, NASD's prosecuting staff must file a notice with NASD's Office of Hearing Officers (OHO) and serve it on the respondent. The notice must set forth the rule or law that NASD staff alleges the respondent has violated (or is violating), contain a declaration of facts that specifies the acts or omissions that constitute the alleged violation, and include a proposed order that contains the required elements of a temporary cease and desist order. In addition, if NASD staff has not already issued a complaint under NASD Rule 9211 against the respondent relating to the subject matter of the temporary cease and desist proceeding, NASD staff must serve the complaint with the notice initiating the temporary cease and desist proceeding.

Respondents also are entitled to a hearing before an OHO hearing panel prior to the issuance of a cease and desist order. Moreover, before a hearing panel can issue such an order, it must find, by a preponderance of the evidence, that the respondent committed the alleged violation and that the violative conduct, or its continuation, is likely to result in significant dissipation or conversion of assets or other significant harm to investors prior to the completion of the disciplinary proceeding under the Rule 9200 and 9300 Series.

If the hearing panel issues a temporary cease and desist order, the order will generally remain in effect until the conclusion of the underlying disciplinary proceeding. Furthermore, in any disciplinary proceeding for which a temporary cease and desist order has been issued, the hearing in the companion disciplinary matter will be held and the decision issued at the earliest possible time. If a respondent believes the companion disciplinary proceeding is not being conducted on an expedited basis, the respondent may petition the hearing panel to have the order modified, set aside, limited, or suspended. In addition, the respondent

may seek to challenge a temporary cease and desist order by filing an application for review with the SEC pursuant to Section 19 of the Securities Exchange Act of 1934.[4]

The rule change also provides hearing panels the explicit authority to issue permanent cease and desist orders as a remedy in disciplinary proceedings. In addition, the rule change provides NASD with a mechanism to enforce both temporary and permanent cease and desist orders. NASD may suspend or cancel a respondent's membership or association if, after a non-summary proceeding under the Rule 9510 Series, an OHO hearing panel determines that the respondent violated the cease and desist order.[5]

In sum, this rule change provides NASD with a mechanism to take appropriate remedial action against a member or an associated person that has engaged (or is engaging) in violative conduct that could cause continuing harm to the investing public if not addressed expeditiously. At the same time, the rule change contains numerous procedural protections for respondents to ensure that the proceedings are fair.

Endnotes

1 Exchange Act Release No. 47925 (May 23, 2003) (File No. SR-NASD-98-80), 68 Federal Register 33548 (June 4, 2003). The rule change authorizes NASD to initiate cease and desist proceedings for alleged violations of Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 thereunder; Rules 15g-1 through 15g-9 under the Exchange Act; or NASD Rules 2110, 2120 or 2330. With regard to alleged violations of NASD rules, the rule change is further limited. For NASD Rule 2110, governing standards of commercial honor and just and equitable principles of trade, the alleged violations are limited to violations of Section 17(a) of the Securities Act of 1933 or circumstances involving unauthorized trading or misuse or conversion of customer assets. For NASD Rule 2330, governing members' use of customers' securities or funds, the alleged violations are limited to circumstances involving misuse or conversion of customer assets.

2 The temporary cease and desist order pilot will expire two years after the effective date indicated in this *Notice to Members* unless NASD seeks and obtains SEC approval to extend or permanently adopt the proposal.

3 *See supra* note 1.

4 A respondent's application to challenge an order, however, will not stay the effectiveness of the order, unless the SEC orders otherwise.

5 The President of NASD Regulatory Policy and Oversight or the Executive Vice President for NASD Regulatory Policy and Programs must provide written authorization before NASD prosecuting staff can institute a proceeding to suspend or cancel a respondent's association or membership for violating an order.

ATTACHMENT A

New language is underlined and deletions are in brackets.

Text of Rule Change

Sanctions

8310. Sanctions for Violation of the Rules

(a) Imposition of Sanction

After compliance with the Rule 9000 Series, the Association may impose one or more of the following sanctions on a member or person associated with a member for each violation of the federal securities laws, rules or regulations thereunder, the rules of the Municipal Securities Rulemaking Board, or Rules of the Association, or may impose one or more of the following sanctions on a member or person associated with a member for any neglect or refusal to comply with an order, direction, or decision issued under the Rules of the Association:

(1) through (4) No Change.

(5) suspend or bar a member or person associated with a member from association with all members; [or]

(6) [impose any other fitting sanction.] impose a temporary or permanent cease and desist order against a member or a person associated with a member; or

(7) impose any other fitting sanction.

(b) No Change.

* * * * *

IM-8310-2. Release of Disciplinary Information

(a) through (c) No Change.

(d) (1) The Association shall release to the public information with respect to any disciplinary decision issued pursuant to the Rule 9000 Series imposing a suspension, cancellation or expulsion of a member; or suspension or revocation of the registration of a person associated with a member; or suspension or barring of a member or person associated with a member from association with all members; or imposition of monetary sanctions of $10,000 or more upon a member or person associated with a member; or containing an allegation of a violation of a Designated Rule; and may also release such information with respect to any disciplinary decision or group of decisions that involve a significant policy or enforcement determination where the release of information is deemed by the President of NASD Regulation, Inc. to be in the public interest. The Association also may release to the public information with respect to any disciplinary decision issued pursuant to the Rule 8220 Series imposing a suspension or cancellation of the member or a suspension of the association of a person with a member, unless the National Adjudicatory Council determines otherwise. The National Adjudicatory Council may, in its discretion, determine to waive the requirement to release information with respect to a disciplinary decision under those extraordinary circumstances where the release of such information would violate fundamental notions of fairness or work an injustice. The Association also shall release to the public information with respect to any temporary cease and desist order issued pursuant to the Rule 9800 Series. The Association may release to the public information on any other final, litigated, disciplinary decision issued pursuant to the Rule 8220 Series or Rule 9000 Series, not specifically enumerated in this paragraph, regardless of sanctions imposed, so long as the names of the parties and other identifying information is redacted.

(A) through (B) No Change.

(2) No Change.

(e) through (l) No Change.

* * * * *

9120. Definitions

(a) through (w) No Change.

(x) "Party"

With respect to a particular proceeding, the term "Party" means:

in the Rule 9200 Series, [and] the Rule 9300 Series, and the Rule 9800 Series, the Department of Enforcement or the Department of Market Regulation or a Respondent;

(2) No Change.

(y) through (cc) No Change.

* * * * *

9240. Pre-Hearing Conference and Submission

9241. Pre-Hearing Conference

(a) through (b) No Change.

(c) Subjects to be Discussed

At a pre-hearing conference, the Hearing Officer shall schedule an expedited proceeding as required by Rule 9290, and may consider and take action with respect to any or all of the following:

(1) through (10) No Change.

(d) through (f) No Change.

* * * * *

9290. Expedited Disciplinary Proceedings

For any disciplinary proceeding, the subject matter of which also is subject to a temporary cease and desist proceeding initiated pursuant to Rule 9810 or a temporary cease and desist order, hearings shall be held and decisions shall be rendered at the earliest possible time. An expedited hearing schedule shall be determined at a pre-hearing conference held in accordance with Rule 9241.

* * * * *

9310. Appeal to or Review by National Adjudicatory Council

9311. Appeal by Any Party; Cross-Appeal

(a) No Change.

(b) Effect

An appeal to the National Adjudicatory Council from a decision issued pursuant to Rule 9268 or Rule 9269 shall operate as a stay of that decision until the National Adjudicatory Council issues a decision pursuant to Rule 9349 or, in cases called for discretionary review by the NASD Board, until a decision is issued pursuant to Rule 9351. Any such appeal, however, will not stay a decision, or that part of a decision, that imposes a permanent cease and desist order.

(c) through (f) No Change.

9312. Review Proceeding Initiated By National Adjudicatory Council

(a) No Change.

(b) Effect

Institution of review by a member of the National Adjudicatory Council on his or her own motion, a member of the Review Subcommittee on his or her own motion, or the General Counsel, on his or her own motion, shall operate as a stay of a final decision issued pursuant to Rule 9268 or Rule 9269 as to all Parties subject to the notice of review, until the National Adjudicatory Council issues a decision pursuant to Rule 9349, or, in cases called for discretionary review by the NASD Board, until a decision is issued pursuant to Rule 9351. Institution of any such review, however, will not stay a decision, or that part of a decision, that imposes a permanent cease and desist order.

(c) through (d) No Change.

* * * * *

9360. Effectiveness of Sanctions

Unless otherwise provided in the decision issued under Rule 9349 or Rule 9351, a sanction (other than a bar, [or] an expulsion, or a permanent cease and desist order) specified in a decision constituting final disciplinary action of the Association for purposes of SEC Rule 19d-1(c)(1) shall become effective on a date to be determined by Association staff. A bar, [or] an expulsion, or a permanent cease and desist order shall become effective upon service of the decision constituting final disciplinary action of the Association, unless otherwise specified therein. The Association shall serve the decision on a Respondent by courier, facsimile or other means reasonably likely to obtain prompt service when the sanction is a bar, [or] an expulsion, or a permanent cease and desist order.

* * * * *

9511. Purpose and Computation of Time

(a) Purpose

The Rule 9510 Series sets forth procedures for: (1) summary proceedings authorized by Section 15A(h)(3) of the Act; and (2) non-summary proceedings to impose (A) a suspension or cancellation for failure to comply with an arbitration award or a settlement agreement related to an arbitration or mediation pursuant to Article VI, Section 3 of the NASD By-Laws; (B) a suspension or cancellation of a member, or a limitation or prohibition on any member, associated person, or other person with respect to access to services offered by the Association or a member thereof, if the Association determines that such member or person does not meet the qualification requirements or other prerequisites for such access or such member or person cannot be permitted to continue to have such access with safety to investors, creditors, members, or the Association; [or] (C) an advertising pre-use filing requirement; or (D) a suspension or cancellation of the membership of a member or the registration of a person for failure to comply with a permanent cease and desist order entered pursuant to a decision issued under the Rule 9200 Series or Rule 9300 Series or a temporary cease and desist order entered pursuant to a decision issued under the Rule 9800 Series.

(b) No Change.

* * * * *

9513. Initiation of Non-Summary Proceeding

(a) Notice

Association staff may initiate a proceeding authorized under Rule 9511(a)(2)(A) or (B), by issuing a written notice to the member, associated person, or other person. Association staff may initiate a proceeding authorized under Rule 9511(a)(2)(D), after receiving written authorization from the President of NASD Regulatory Policy and Oversight or the Executive Vice President for NASD Regulatory Policy and Programs, by issuing a written notice to the member or associated person. The notice shall specify the grounds for and effective date of the cancellation, suspension, bar, limitation, or prohibition and shall state that the member, associated person, or other person may file a written request for a hearing under Rule 9514. In addition, if the proceeding is authorized under Rule 9511(a)(2)(D), the notice shall specifically identify the provision of the permanent or temporary cease and desist order that is alleged to have been violated, and shall contain a statement of facts specifying the alleged violation. The notice shall be served by facsimile or overnight commercial courier.

(b) Effective Date

For any cancellation or suspension pursuant to Rule 9511(a)(2)(A), the effective date shall be at least 15 days after service of the notice on the member or associated person. For any action pursuant to Rule 9511(a)(2)(B) or (D), the effective date shall be at least seven days after service of the notice on the member or person, except that the effective date for a notice of a limitation or prohibition on access to services offered by the Association or a member thereof with respect to services to which the member, associated person, or other person does not have access shall be upon receipt of the notice.

(c) No Change.

* * * * *

9800. TEMPORARY CEASE AND DESIST ORDERS

(The entire Rule 9800 Series, and related amendments adopted by SR-NASD-98-80 to Rule 8310, IM-8310-2(d)(1), 9120(x), 9241(c), 9290, 9311(b), 9312(b), 9360, 9511(a), 9513(a) and 9513(b) shall expire on June 23, 2005, unless extended or permanently adopted by the Association pursuant to SEC approval at or before such date.)

9810. Initiation of Proceeding

(a) Department of Enforcement or Department of Market Regulation

With the prior written authorization of the President of NASD Regulatory Policy and Oversight or the Executive Vice President for NASD Regulatory Policy and Programs, the Department of Enforcement or the Department of Market Regulation may initiate a temporary cease and desist proceeding with respect to alleged violations of Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5 thereunder; SEC Rules 15g-1 through 15g-9; NASD Rule 2110 (if the alleged violation is unauthorized trading, or misuse or conversion of customer assets, or based on violations of Section 17(a) of the Securities Act of 1933); NASD Rule 2120; or NASD Rule 2330 (if the alleged violation is misuse or conversion of customer assets). The Department of Enforcement or the Department of Market Regulation shall initiate the proceeding by serving a notice on a member or associated person (hereinafter "Respondent") and filing a copy thereof with the Office of Hearing Officers. The Department of Enforcement or the Department of Market Regulation shall serve the notice by personal service, overnight commercial courier, or facsimile. If service is made by facsimile, the Department of Enforcement or the Department of Market Regulation shall send an additional copy of the notice by overnight commercial courier. The notice shall be effective upon service.

(b) Contents of Notice

The notice shall set forth the rule or statutory provision that the Respondent is alleged to have violated and that the Department of Enforcement or the Department of Market Regulation is seeking to have the Respondent ordered to cease violating. The notice also shall state whether the Department of Enforcement or the Department of Market Regulation is requesting the Respondent to be required to take action or to refrain from taking action. The notice shall be accompanied by:

(1) a declaration of facts, signed by a person with knowledge of the facts contained therein, that specifies the acts or omissions that constitute the alleged violation; and

(2) a proposed order that contains the required elements of a temporary cease and desist order (except the date and hour of the order's issuance), which are set forth in Rule 9840(b).

(c) Filing of Underlying Complaint

If the Department of Enforcement or the Department of Market Regulation has not issued a complaint under Rule 9211 against the Respondent relating to the subject matter of the temporary cease and desist proceeding and alleging violations of the rule or statutory provision specified in the notice described in paragraph (b), the Department of Enforcement or the Department of Market Regulation shall serve and file such a complaint with the notice initiating the temporary cease and desist proceeding.

9820. Appointment of Hearing Officer and Hearing Panel

(a) As soon as practicable after the Department of Enforcement or the Department of Market Regulation files a copy of the notice initiating a temporary cease and desist proceeding with the Office of Hearing Officers, the Chief Hearing Officer shall assign a Hearing Officer to preside over the temporary cease and desist proceeding. The Chief Hearing Officer shall appoint two Panelists to serve on a Hearing Panel with the Hearing Officer. The Panelists shall be current or former Governors, Directors, or National Adjudicatory Council members, and at least one Panelist shall be an associated person.

(b) If at any time a Hearing Officer or Hearing Panelist determines that he or she has a conflict of interest or bias or circumstances otherwise exist where his or her fairness might reasonably be questioned, or if a Party files a motion to disqualify a Hearing Officer or Hearing Panelist, the recusal and disqualification proceeding shall be conducted in accordance with Rules 9233 and 9234, except that:

(1) a motion seeking disqualification of a Hearing Officer or Hearing Panelist must be filed no later than 5 days after the later of the events described in paragraph (b) of Rules 9233 and 9234; and

(2) the Chief Hearing Officer shall appoint a replacement Panelist using the criteria set forth in paragraph (a) of this Rule.

9830. Hearing

(a) When Held

The hearing shall be held not later than 15 days after service of the notice and filing initiating the temporary cease and desist proceeding, unless otherwise extended by the Hearing Officer with the consent of the Parties for good cause shown. If a Hearing Officer or Hearing Panelist is recused or disqualified, the hearing shall be held not later than five days after a replacement Hearing Officer or Hearing Panelist is appointed.

(b) Service of Notice of Hearing

The Office of Hearing Officers shall serve a notice of date, time, and place of the hearing on the Department of Enforcement or the Department of Market Regulation and the Respondent not later than seven days before the hearing, unless otherwise ordered by the Hearing Officer. Service shall be made by personal service, overnight commercial courier, or facsimile. If service is made by facsimile, the Office of Hearing Officers shall send an additional copy of the notice by overnight commercial courier. The notice shall be effective upon service.

(c) Authority of Hearing Officer

The Hearing Officer shall have authority to do all things necessary and appropriate to discharge his or her duties as set forth under Rule 9235.

(d) Witnesses

A person who is subject to the jurisdiction of the Association shall testify under oath or affirmation. The oath or affirmation shall be administered by a court reporter or a notary public.

(e) Additional Information

At any time during its consideration, the Hearing Panel may direct a Party to submit additional information. Any additional information submitted shall be provided to all Parties at least one day before the Hearing Panel renders its decision.

(f) Transcript

The hearing shall be recorded by a court reporter and a written transcript thereof shall be prepared. A transcript of the hearing shall be available to the Parties for purchase from the court reporter at prescribed rates. A witness may purchase a copy of the transcript of his or her own testimony from the court reporter at prescribed rates. Proposed corrections to the

transcript may be submitted by affidavit to the Hearing Panel within a reasonable time determined by the Hearing Panel. Upon notice to all the Parties to the proceeding, the Hearing Panel may order corrections to the transcript as requested or sua sponte.

(g) Record and Evidence Not Admitted

The record shall consist of the notice initiating the proceeding, the declaration, and the proposed order described in Rule 9810(b); the transcript of the hearing; all evidence considered by the Hearing Panel; and any other document or item accepted into the record by the Hearing Officer or the Hearing Panel. The Office of Hearing Officers shall be the custodian of the record. Proffered evidence that is not accepted into the record by the Hearing Panel shall be retained by the custodian of the record until the date when the NASD's decision becomes final or, if applicable, upon the conclusion of any review by the Commission or the federal courts.

(h) Failure to Appear at Hearing

If a Respondent fails to appear at a hearing for which it has notice, the allegations in the notice and accompanying declaration may be deemed admitted, and the Hearing Panel may issue a temporary cease and desist order without further proceedings. If the Department of Enforcement or Department of Market Regulation fails to appear at a hearing for which it has notice, the Hearing Panel may order that the temporary cease and desist proceeding be dismissed.

9840. Issuance of Temporary Cease and Desist Order by Hearing Panel

(a) Basis for Issuance

The Hearing Panel shall issue a written decision stating whether a temporary cease and desist order shall be imposed. The Hearing Panel shall issue the decision not later than ten days after receipt of the hearing transcript, unless otherwise extended by the Hearing Officer with the consent of the Parties for good cause shown. A temporary cease and desist order shall be imposed if the Hearing Panel finds:

(1) by a preponderance of the evidence that the alleged violation specified in the notice has occurred; and

(2) that the violative conduct or continuation thereof is likely to result in significant dissipation or conversion of assets or other significant harm to investors prior to the completion of the underlying disciplinary proceeding under the Rule 9200 and 9300 Series.

(b) Content, Scope, and Form of Order

A temporary cease and desist order shall:

(1) be limited to ordering a Respondent to cease and desist from violating a specific rule or statutory provision, and, where applicable, to ordering a Respondent to cease and desist from dissipating or converting assets or causing other harm to investors;

(2) set forth the alleged violation and the significant dissipation or conversion of assets or other significant harm to investors that is likely to result without the issuance of an order;

(3) describe in reasonable detail the act or acts the Respondent is to take or refrain from taking; and

(4) include the date and hour of its issuance.

(c) Duration of Order

A temporary cease and desist order shall remain effective and enforceable until the issuance of a decision under Rule 9268 or Rule 9269.

(d) Service

The Office of Hearing Officers shall serve the Hearing Panel's decision and any temporary cease and desist order by personal service, overnight commercial courier, or facsimile. If service is made by facsimile, the Office of Hearing Officers shall send an additional copy of the Hearing Panel's decision and any temporary cease and desist order by overnight commercial courier. The temporary cease and desist order shall be effective upon service.

9850. Review by Hearing Panel

At any time after the Office of Hearing Officers serves the Respondent with a temporary cease and desist order, a Party may apply to the Hearing Panel to have the order modified, set aside, limited, or suspended. The application shall set forth with specificity the facts that support the request. The Hearing Panel shall respond to the request in writing within ten days after receipt of the request, unless otherwise extended by the Hearing Officer with the consent of the Parties for good cause shown. The Hearing Panel's response shall be served on the Respondent via personal service, overnight commercial courier, or facsimile. If service is made by facsimile, the Office of Hearing Officers shall send an additional copy of the temporary cease and desist order by overnight commercial courier. The filing of an application under this Rule shall not stay the effectiveness of the temporary cease and desist order.

9860. Violation of Temporary Cease and Desist Orders

A Respondent who violates a temporary cease and desist order imposed under this Rule Series may have its association or membership suspended or canceled under the Rule 9510 Series. The President of NASD Regulatory Policy and Oversight or the Executive Vice President for NASD Regulatory Policy and Programs must authorize the initiation of any such proceeding in writing.

9870. Application to Commission for Review

Temporary cease and desist orders issued pursuant to this Rule Series constitute final and immediately effective disciplinary sanctions imposed by the Association. The right to have any action under this Rule Series reviewed by the Commission is governed by Section 19 of the Exchange Act. The filing of an application for review shall not stay the effectiveness of the temporary cease and desist order, unless the Commission otherwise orders.

Notice to Members

JUNE 2003

SUGGESTED ROUTING

Corporate Finance
Legal and Compliance
Operations
Senior Management
Technology
Trading and Market Making
Training

KEY TOPICS

Debt Securities
Operations
Rule 6200 Series
Transaction Reporting

INFORMATIONAL

Corporate Debt Securities

SEC Approves Amendments to TRACE Rule 6230 to Reduce the Reporting Period to 45 Minutes

Executive Summary

On June 18, 2003, the Securities and Exchange Commission (SEC or Commission) approved amendments to Rule 6230 of the Trade Reporting and Compliance Engine (TRACE) Rules (Rule 6200 Series).[1] The amendments to TRACE Rule 6230 reduce the time to report a transaction in a TRACE-eligible security from 75 minutes to 45 minutes. Rule 6230, as amended, is set forth in Attachment A.

The amendments to Rule 6230 will become effective on October 1, 2003.

Questions/Further Information

Questions concerning this *Notice* should be directed to *tracefeedback.com*; Elliot Levine, Chief Counsel, Market Operations, Regulatory Services and Operations, at (212) 858-4174; or Sharon K. Zackula, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8985.

Background and Discussion

On July 1, 2002, when TRACE became effective, members were required to report required transaction information in TRACE-eligible corporate debt securities within 75 minutes of the time of execution. At that time, NASD indicated that it planned to reduce the reporting period after members had obtained experience reporting. Reducing the reporting period was, and continues to

be, an important regulatory goal that results in the market receiving market-based pricing information more quickly, which enhances the transparency of the debt market.

On May 2, 2003, NASD proposed to reduce the reporting period from 75 minutes to 45 minutes. Since 1999, NASD, the SEC, and industry participants have discussed reducing the reporting period after members obtained experience reporting corporate bond transactions to TRACE. Since July 1, 2002, when TRACE began, members have obtained that reporting experience. In addition, during the first year of TRACE, members have developed the technical and operational capabilities to report transactions within a much shorter period than the current 75-minute period. TRACE data shows that approximately 80% of all reported transactions (measured either by transaction count or par value) currently are being reported to TRACE within 45 minutes.

45 Minute Reporting Requirement

The SEC approved the 45 minute reporting requirement on June 18, 2003. Thus, generally, in Rule 6230(a) and (a)(1), as amended, a member must report a transaction in a TRACE-eligible security within 45 minutes of the time of execution. In addition, NASD reduced other 75 minute reporting periods to 45 minutes in paragraphs (1) through (4) of Rule 6230(a). Specifically, under Rule 6230(a)(1) as amended, if a member executes a transaction within 45 minutes of the time the TRACE system closes, a member is *permitted* to report the transaction the next business day that the TRACE system opens, but must do so within 45 minutes after the TRACE system opens for the report to be timely.[2] Under Rule 6230(a)(2) as amended, a member is *required* to report a transaction that occurs after the TRACE system closes the next business day that the TRACE system opens, and must do so within 45 minutes after the TRACE system opens. Similarly, under paragraphs (a)(3) and (a)(4) as amended, a member is *required* to report on the next business day that the TRACE system opens, and within 45 minutes of the TRACE system open, any transaction in a TRACE-eligible security that occurs at or after 12:00 a.m. (midnight) through 7:59:59 a.m., Eastern Time, or during a weekend or a holiday

Effective Date

The amendments to Rule 6230 will become effective on October 1, 2003. Based on current reporting practices, it appears that many members are already technically and operationally capable of reporting within 45 minutes. By October 1, 2003, NASD expects that the membership as a whole will be able to report within 45 minutes, and intends to guide members in making the transition.

Endnotes

1 *See* Securities Exchange Act Release No. 48056 (June 18, 2003), 68 Fed. Reg. 37886 (June 25, 2003) (File No. SR-NASD-2003-78).

2 Generally, the TRACE System is open to receive reports Monday through Friday, from 8:00 a.m. through 6:29:59 p.m., Eastern Time.

EXHIBIT A

6200. TRADE REPORTING AND COMPLIANCE ENGINE (TRACE)

6230. Transaction Reporting

(a) When and How Transactions are Reported

A member that is required to report transaction information pursuant to paragraph (b) below must report such transaction information within [one hour and fifteen]45 minutes of the time of execution, except as otherwise provided below, or the transaction report will be "late." The member must transmit the report to TRACE during the hours the TRACE system is open ("TRACE system hours"), which are 8:00 a.m. Eastern Time through 6:29:59 p.m. Eastern Time. Specific trade reporting obligations during a 24-hour cycle are set forth below.

(1) Transactions Executed During TRACE System Hours

Transactions in TRACE-eligible securities executed on a business day at or after 8:00 a.m. Eastern Time through 6:29:59 p.m. Eastern Time must be reported within 45[one hour and fifteen] minutes of the time of execution. If a transaction is executed on a business day less than 45[one hour and fifteen] minutes before 6:30 p.m. Eastern Time, a member may report the transaction the next business day within 45[one hour and fifteen] minutes after the TRACE system opens. If reporting the next business day, the member must indicate "as/of" and provide the actual transaction date.

(2) Transactions Executed At or After 6:30 P.M. Through 11:59:59 P.M. Eastern Time

Transactions in TRACE-eligible securities executed on a business day at or after 6:30 p.m. Eastern Time through 11:59:59 p.m. Eastern Time must be reported the

next business day within 45[one hour and fifteen] minutes after the TRACE system opens. The member must indicate "as/of" and provide the actual transaction date.

(3) Transactions Executed At or After 12:00 A.M. Through 7:59:59 A.M. Eastern Time

Transactions in TRACE-eligible securities executed on a business day at or after 12:00 a.m. Eastern Time through 7:59:59 a.m. Eastern Time must be reported the same day within 45[one hour and fifteen] minutes after the TRACE system opens.

(4) Transactions Executed on a Non-Business Day

Transactions in TRACE-eligible securities executed on a Saturday, Sunday, or a federal or religious holiday on which the TRACE system is closed, at any time during that day (determined using Eastern Time), must be reported the next business day within 45[one hour and fifteen] minutes after the TRACE system opens. The transaction must be reported as follows: the date of execution must be the first business day (the same day the report must be made); the execution time must be "12:01:00 a.m. Eastern Time" (stated in military time as "00:01:00"); and the modifier, "special price," must be selected. In addition, the transaction must not be designated "as/of". When the reporting method chosen provides a "special price" memo field, the member must enter the actual date and time of the transaction in the field.

(5) through (6) No Change

(b) through (f) No Change

Notice to Members

JULY 2003

SUGGESTED ROUTING

Legal & Compliance

Operations

Principals

Registration

Registered Representatives

Senior Management

Training

KEY TOPICS

Qualification Examinations

General Securities Principal Sales Supervisor Module (Series 23)

General Securities Principal (Series 24)

General Securities Sales Supervisor (Series 9/10)

INFORMATIONAL

Registration Rules

New Series 23 Examination; **Effective Date: July 7, 2003**

Executive Summary

On June 4, 2003, NASD filed with the Securities and Exchange Commission (SEC) for immediate effectiveness a proposed rule change to establish the General Securities Principal Sales Supervisor Module (Series 23) examination program.[1] The new Series 23 examination, in combination with the General Securities Sales Supervisor (Series 9/10) examination, will be an acceptable qualification alternative to the General Securities Principal (Series 24) examination for associated persons who are required to register and qualify as a General Securities Principal with NASD. The Series 23 examination covers material from the Series 24 examination not otherwise covered under the Series 9/10 examination. The implementation date of the new Series 23 examination is July 7, 2003.

Questions/Further Information

Questions concerning this *Notice* may be directed to Afshin Atabaki, Attorney, Office of General Counsel, NASD Regulatory Policy and Oversight, at (202) 728-8902, or one of the following persons in NASD's Testing and Continuing Education Department: Carole Hartzog at (240) 386-4678; Eva Cichy at (240) 386-4680; Elaine Warren at (240) 386-4679; or Karen Bescher at (240) 386-4677.

Background/Discussion

The SEC recently approved a proposed rule change to NYSE Rule 342 that recognized NASD's Series 24 examination as an acceptable qualification alternative to the Series 9/10 examination for a General Securities Sales Supervisor whose duties do not include the supervision of options or municipal securities sales activity.[2] In an effort to establish reciprocal qualification standards, NASD will permit General Securities Sales Supervisors to register and qualify as a General Securities Principal by passing the newly developed Series 23 qualification examination.

NASD developed the Series 23 examination program to allow persons associated with NASD members who are registered as a General Securities Sales Supervisor and who are seeking to register and qualify as a General Securities Principal an alternative to completing the Series 24.

The Series 23 examination is a limited qualification examination that covers those subject matters that are covered on the Series 24 examination, but not included on the Series 9/10 examination. A committee of industry representatives that oversees the Series 24 examination program, together with NASD staff, compared the subject matters covered on the Series 9/10 and Series 24 examinations to determine the topics that would be extracted from the Series 24 examination to create the Series 23 examination program. The Series 23 examination program tests a candidate's knowledge of securities industry rules and regulations pertaining to the supervision of investment banking, securities markets, and trading as well as financial responsibility requirements. The committee, including NASD staff, developed the selection specifications, study outline, and question bank for the Series 23 examination.

Prerequisite Examination

In order to take the Series 23, an individual must be registered as a General Securities Sales Supervisor, or have been registered in this capacity within the past two years.[3]

The New Series 23 Examination

A study outline has been created to assist member firms in preparing candidates for the new Series 23 examination. The study outline may be used to structure or prepare training material, develop lecture notes and seminar programs, and serve as a training aide for the candidates themselves.

The Series 23 examination contains 100 questions, and candidates are allowed 2½ hours to complete the examination. A candidate must correctly answer 70 percent of the questions to receive a passing grade. The test is administered as a closed-book exam. The proctor will provide scratch paper and a basic electronic calculator. At the completion of the test, candidates will be provided with an informational breakdown of their performance on each of the sections, along with their overall score.

The Series 23 outline and test are divided into five topical sections, which are listed below along with the number of questions designated to each section.

Section 1: Supervision of Investment Banking Activities (25)

Section 2: Supervision of Trading and Market Making Activities (29)

Section 3: Supervision of Brokerage Office Operations (16)

Section 4: Sales Supervision, General Supervision of Employees, Regulatory Framework of NASD (19)

Section 5: Compliance with Financial Responsibility Rules (11)

The questions used in the examination will be updated to reflect changes in the federal securities laws and NASD rules. Questions on new rules will be added to the examination within a reasonable period of their effective dates. Questions on rescinded rules will be promptly deleted from the examination. Candidates will only be asked questions pertaining to rules that are effective at the time they take their exams.

Availability Of Study Outline

The study outline for the new Series 23 examination program will be available shortly from NASD's Qualifications Web Page at: *http://www.nasdr.com/5200_explan.htm*.

Endnotes

1 *See* Securities Exchange Act Release No. 48042 (June 17, 2003), 68 FR 37186 (June 23, 2003) (notice of filing and immediate effectiveness of File No. SR-NASD-2003-91).

2 *See* Securities Exchange Act Release No. 46631 (October 9, 2002), 67 FR 64187 (October 17, 2002) (order approving File No. SR-NYSE-2002-24).

3 As a prerequisite to the Series 23 examination, NASD also will recognize the Series 8, the historical equivalent to the Series 9/10, and the Series 12, a subset of the Series 9/10 omitting questions on options and municipal securities.