

NASD NOTICE TO MEMBERS 98-11

SEC Approves Rules Regarding Supervision, Review, And Record Retention Of Correspondence; Effective February 15, 1998

Suggested Routing

- ☒ Senior Management
- ☒ Advertising
- ☐ Continuing Education
- ☐ Corporate Finance
- ☐ Executive Representatives
- ☐ Government Securities
- ☐ Institutional
- ☐ Insurance
- ☐ Internal Audit
- ☒ Legal & Compliance
- ☐ Municipal
- ☒ Mutual Fund
- ☐ Operations
- ☐ Options
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- ☐ Registration
- ☐ Research
- ☐ Syndicate
- ☐ Systems
- ☐ Trading
- ☒ Training
- ☐ Variable Contracts

Executive Summary

On December 31, 1997, the Securities and Exchange Commission (SEC) approved amendments to National Association of Securities Dealers, Inc. (NASD®) Rules 3010 and 3110. The amendments will allow firms to develop flexible supervisory procedures for the review of correspondence with the public. The rule amendments will be effective on February 15, 1998. The text of the amended Rules and the *Federal Register* version of the SEC Release are attached. This *Notice to Members* is being issued to provide guidance on how to implement these rules. This guidance is being issued in coordination with the New York Stock Exchange, which has issued an Information Memo providing guidance to members and member organizations on how to implement similar rules that recently were approved by the SEC.

Questions concerning this *Notice* should be directed to R. Clark Hooper, Senior Vice President, Office of Disclosure and Investor Protection, NASD Regulation, Inc., at (202) 728-8325, or Mary N. Revell, Associate General Counsel, Office of General Counsel, NASD RegulationSM, at (202) 728-8203.

Background

Technology has greatly expanded how communications between members and their customers take place. These new means of communication (e.g., e-mail, Internet) will continue to significantly affect the manner in which members and their associated persons conduct their business. While these changes allow timely and efficient communication with customers, prospective customers, and others, the significant changes in communications media and capacity raise questions regarding supervision, review, and retention of correspondence with the public.

To address these issues, NASD Regulation proposed changes to NASD Rules 3010 and 3110 to revise supervision and record retention rules to provide each firm with the flexibility to adopt and implement its own supervisory procedures relating to correspondence with the public based on the firm's structure; the nature and size of its business; and its customer base. In developing these procedures, members should continue to provide for appropriate supervision of the public correspondence of their registered representatives and other associated persons, consistent with their overall duty to supervise their employees.

Amended Rules

NASD Regulation has received SEC approval of amendments to Rule 3010 (Supervision) and Rule 3110 (Books and Records). See Securities Exchange Act Release No. 39510 (January 31, 1997), 63 FR 1131 (January 8, 1998), attached.

Rule 3010(d)(1), as amended, provides that procedures for review of correspondence with the public relating to a member's investment banking or securities business be designed to provide reasonable supervision for each registered representative, be described in an organization's written supervisory procedures, and be evidenced in an appropriate manner.

New Rule 3010(d)(2) requires each member to develop written policies and procedures for review of correspondence with the public relating to its investment banking or business, tailored to its structure and the nature and size of its business and customers. The rule requires that any member that does not conduct either an electronic or manual pre-use review will be required to:

- develop appropriate supervisory procedures;

- monitor and test to ensure these policies and procedures are being implemented and complied with;
- provide education and training to all appropriate employees concerning the member's current policies and procedures governing correspondence, and update this training as policies and procedures are changed; and
- maintain records documenting how and when employees are educated and trained.

The current requirement in Rule 3010(d) to review all correspondence of registered representatives will be retained to require review of all incoming correspondence received in non-electronic format directed to registered representatives and related to a member's investment banking or securities business. Incoming non-electronic correspondence directed to associated persons and all correspondence related to a member's investment banking or securities business received in electronic format (*e.g.*, e-mail and facsimile) will be subject to the overall supervisory and review procedures established by the member pursuant to amended Rule 3010(d)(1) and new Rule 3010(d)(2).

Given the complexity and cost of establishing appropriate systems for effectively reviewing electronic communications, some members may determine to conduct a pre-use review of all outgoing correspondence (written or electronic).

The retention requirements of new Rule 3010(d)(3) cross-reference Rule 3110 and state that the names of persons who prepared, reviewed and approved correspondence must be readily ascertainable from the retained records. Amended Rule 3110 states that these records must be retained in a format or medium that complies with Rule 17a-4 under

the Securities Exchange Act of 1934.

Guidelines For Supervision And Review

In adopting review procedures pursuant to Rule 3010, members must:

- specify, in writing, the firm's policies and procedures for reviewing different types of correspondence;
- identify how supervisory reviews will be conducted and documented;
- identify what types of correspondence will be pre- or post-reviewed;
- identify the organizational position(s) responsible for conducting review of the different types of correspondence;
- specify the minimum frequency of the reviews for each type of correspondence;
- monitor the implementation of and compliance with the firm's procedures for reviewing public correspondence; and
- periodically re-evaluate the effectiveness of the firm's procedures for reviewing public correspondence and consider any necessary revisions.

In conducting reviews, members may use reasonable sampling techniques. As an example of appropriate evidence of review, e-mail related to the member's investment banking or securities business may be reviewed electronically and the evidence of review may be recorded electronically.

In developing supervisory procedures for the review of correspondence with the public, each member must consider its structure, the nature and size of its business, other pertinent characteristics, and the appropriateness of implementing uniform

firm-wide procedures or tailored procedures (*i.e.*, by specific function, office/location, individual, or group of persons).

In adopting review procedures pursuant to Rule 3010, members must, at a minimum:

- specify procedures for reviewing registered representatives' recommendations to customers;
- require supervisory review of some of each registered representative's public correspondence, including recommendations to customers;
- consider the complaint and overall disciplinary history, if any, of registered representatives and other employees (with particular emphasis on complaints regarding written or oral communications with clients); and
- consider the nature and extent of training provided registered representatives and other employees, as well as their experience in using communications media (although a firm's procedures may not eliminate or provide for minimal supervisory reviews based on an employee's training or level of experience in using communications media).

Although members may consider the number, size, and location of offices, as well as the volume of correspondence overall or in specific areas of the organization, members must nonetheless develop appropriate supervisory policies and procedures in light of their duty to supervise their associated persons. The factors listed above are not exclusive and members must consider all appropriate factors when developing their supervisory procedures and implementing their supervisory reviews.

Supervisory policy and procedures must also:

- provide that all customer complaints, whether received via e-mail or in written form from the customer, are reported to the NASD in compliance with Rule 3070(c);¹

- describe any firm standards for the content of different types of correspondence; and

- 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 Regulation 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.

Members must continually assess the effectiveness of these supervisory systems.

Education and training must be timely (prior to or concurrent with implementation of the policies and procedures) and must include all appropriate employees. Members may incorporate the required education and training on correspondence into their Continuing Education Firm Element Training Program (*see* Rule 1120—Continuing Education Requirements). The requirement for training regarding correspondence may also apply to employees who are not included under the Continuing Education requirements.

NASD Regulation examiners periodically will review each member's procedures and systems to ensure that they are reasonable in view of each firm's structure and the nature and size of its business and customer base.

Text Of Rule Amendments

(Note: New text is underlined; deletions are bracketed.)

Rule 3010. Supervision

(a) through (c) No change

(d) Review of Transactions and Correspondence [Written Approval]

(1) Supervision of Registered Representatives. Each member shall establish procedures for the review and endorsement by a registered principal in writing, on an internal record, of all transactions and for the review by a registered principal of [all] incoming and outgoing written and electronic correspondence of its registered representatives with the public relating to the investment banking or securities business of such member [pertaining to the solicitation or execution of any securities transactions]. Such procedures should be in writing and be designed to provide reasonable supervision of each registered representative. Evidence that these supervisory procedures have been implemented and carried out must be maintained and made available to the Association upon request.

(2) Review of correspondence. Each member shall develop written procedures that are appropriate to its business, size, structure, and customers for the review of incoming and outgoing written and electronic correspondence with the public relating to its investment banking or securities business. Where such procedures for the review of correspondence do not require pre-use review of all correspondence, they must include provision for the education and training of associated persons as to the firm's procedures governing correspondence; documentation of such education and training; and surveillance and follow-up to ensure that such procedures are implemented and adhered to.

(3) Retention of correspondence. Each member shall retain correspondence of registered representatives relating to its investment banking or securities business in accordance with Rule 3110 ("Books and Records"). The names of the persons who prepared outgoing correspondence and who reviewed the correspondence shall be ascertainable from the retained records and the retained records shall be readily available to the Association, upon request.

(e) through (g) No change

Rule 3110. Books and Records

(a) Requirements

Each member shall make [keep] and preserve books, accounts, records, memoranda, and correspondence in conformity with all applicable laws, rules, regulations, and statements of policy promulgated thereunder and with the Rules of this Association and as prescribed by Rule 17a-3. The record keeping format, medium, and retention period shall comply with Rule 17a-4 under the Securities Exchange Act of 1934.

(b) through (g) No change

Endnote

¹ Among other things, NASD Rule 3070(c) requires members to report to the NASD statistical information regarding customer complaints relating to matters specified by the NASD.

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