[Release No. 34–36982; File Nos. SR–MCC–96–03]

Self-Regulatory Organizations; Midwest Clearing Corporation; Notice of Filing of a Proposed Rule Change Relating to the Pass-Through of Certain Fees and Charges and the Elimination of All Other Charges

March 18, 1996.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] notice is hereby given that on March 1, 1996, the Midwest Clearing Corporation (''MCC'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change (File No. SR–MCC–96–03) as described in Items I, II, and III below, which items have been prepared primarily by MCC. MCC amended the filing on March 7, 1996.[2] The Commission is publishing this notice to solicit comments from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

MCC proposes to add a provision to its Services and Schedule of Charges that will permit MCC to pass-through at cost to Sponsored Participants (''SPs'') and Temporary Sponsored Participants (''TSPs'')[3] fees and other charges assessed MCC by the National Securities Clearing Corporation (''NSCC''). MCC also proposes to eliminate the remainder of its existing fee schedule.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, MCC included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. MCC has prepared summaries, set forth in section (A), (B), and (C) below, of the most significant aspects of such statements.[4]

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

The purpose of the proposed rule change is to permit MCC to charge SPs and TSPs at cost the fees and charges assessed on MCC by NSCC in connection with SPs' and TSPs' use of NSCC's services. The proposed rule change also eliminates all other existing MCC fees.

MCC proposes to eliminate its existing fee schedule in its entirety and replace it with the following schedule.

Sponsored Participants and Temporary Sponsored Participants

Fees and charges assessed on MCC by the National Securities Clearing Corporation

Charge: Rebilled at Cost

MCC believes the proposed rule change is consistent with Section 17A of the Act and the rules and regulations thereunder because it provides for the equitable allocation of reasonable fees and other charges among participants using its facilities.

(B) Self-Regulatory Organization's Statement on Burden on Competition

MCC does not believe the proposed rule change will impose a burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

(C) Self-Regulatory Organization's Statement on Comments on the Purposed Rule Change Received From Members, Participants or Others

Written comments on the proposals have not been solicited or received.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within thirty-five days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to ninety days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which MCC consents, the Commission will:

(A) By order approve such proposed rule change or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submission should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington D.C. 20549. Copies of the submissions, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communication relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. § 552 will be available for inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such filing also will be available for inspection and copying at the principal office of MCC. All submissions should refer to the file number SR–MCC–96–03 and should be submitted by April 12, 1996.

For the Commission by the Division of Market Regulation, pursuant to delegated authority.[5]

Margaret H. McFarland,

Deputy Secretary.

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[1] 15 U.S.C. § 78s(b)(1) (1988).

[2] MCC originally filed the proposed rule change under Section 19(b)(3)(A) of the Act. On March 7, 1996, MCC requested that the proposal be considered filed under Section 19(b)(2) of the Act. Telephone conversation between David T. Rusoff, Foley and Lardner [counsel to MCC], and Jerry W. Carpenter, Assistant Director, Peter R. Geraghty, Senior Counsel, and Cheryl O. Tumlin, Attorney, Division of Market Regulation, Commission (March 7, 1996).

[3] For a detailed discussion of the clearing arrangements for SPs and TSPs, refer to Securities Exchange Act Release No. 36740 (January 19, 1996) 61 FR 2553 [File No. SR–MCC–95–05] (notice of filing and order granting accelerated approval of a proposed rule change relating to a contingency plan for participants in connection with MCC's decision to withdraw from the securities clearing business). Release No. 36740 (January 19, 1996) 61 FR 2553 [File No. SR–MCC–95–05] (notice of filing and order granting accelerated approval of a proposed rule change relating to a contingency plan for participants in connection with MCC's decision to withdraw from the securities clearing business).

[4] The Commission has modified the text of the summaries prepared by MCC.

[5] 17 CFR 200.30–3(a)(12) (1995).

[Release No. 34–36980; File No. SR-NASD–95–63]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Regulating the Conduct of Broker/Dealers Operating on the Premises of a Financial Institution

March 15, 1996.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''1934 Act''),[1] notice is hereby given that on December 28, 1995, the National Association of Securities Dealers, Inc. (''NASD'' or ''Association'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission'') the proposed rule change as described in Items I, II, and III below, which Items

[1] 15 U.S.C. 78s(b)(1).

have been prepared by the NASD. The filing was subsequently amended on January 24, January 29 and March 7, 1996.[2] The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The NASD is proposing to add a new section specifying requirements for broker/dealer conduct on the premises of a financial institution. Below is the text of the proposed rule change.

RULES OF FAIR PRACTICE

Broker/Dealer Conduct on the Premises of Financial Institutions

Sec. _____.

(a) Applicability

This section shall apply exclusively to those broker/dealer services conducted by members on the premises of a financial institution where retail deposits are taken. This section does not alter or abrogate members' obligations to comply with other applicable NASD rules, regulations, and requirements, nor those of other regulatory authorities that may govern members operating on the premises of financial institutions.

(b) Definitions

(1) For purposes of this section, the term ''financial institution'' shall mean federal and state-chartered banks, savings and loan associations, savings banks, credit unions, and the service corporations required by law of such institutions.

(2) ''Networking arrangement'' and ''brokerage affiliate arrangement'' shall mean a contractual arrangement between a member and a financial institution pursuant to which the member conducts broker/dealer services for customers of the financial institution and the general public on the premises of such financial institution where retail deposits are taken.

(3) ''Affiliate'' shall mean a company which controls, is controlled by or is under common control with a member as defined in Schedule E of the By-Laws.

(4) ''Broker/dealer services'' shall mean the investment banking or securities business as defined in Paragraph (l) of Article I of the By-Laws.

(5) ''Confidential financial information'' shall not include:

(A) customers' names, addresses, and telephone numbers, unless a customer specifies otherwise; or

(B) information that can be obtained from unaffiliated credit bureaus or similar companies in the ordinary course of business.

(c) Standards for Member Conduct

No member shall conduct broker/dealer services on the premises of a financial institution unless the member complies initially and continuously with the following requirements:

Setting

(1) Wherever possible, the member's broker/dealer services shall be conducted in a physical location distinct from the area where the financial institution's retail deposits are taken. In all situations, members shall identify the member's broker/dealer services in a manner that is clearly distinguished from the financial institution's retail deposit-taking activities. The member's name shall be clearly displayed in the area in which the member conducts its broker/dealer services.

Networking and Brokerage Affiliate Agreements

(2) Networking and brokerage affiliate arrangements between a member and a financial institution must be governed by a written agreement that sets forth the responsibilities of the parties and the compensation arrangements. The member must ensure the agreement stipulates that:

(A) supervisory personnel of the member and representatives of the Securities and Exchange Commission and the Association will be permitted access to the financial institution's premises where the member conducts broker/dealer services in order to inspect the books and records and other relevant information maintained by the member with respect to its broker/dealer services;

(B) unregistered employees of the financial institution will not receive any compensation, cash or non-cash, that is conditioned on whether a referral of a customer of the financial institution to the member results in a transaction; and

(C) the member will notify the financial institution if any associated person of the member who is employed by the financial institution is terminated for cause by the member.

Compensation of Registered/Unregistered Persons

(3) The member shall not provide cash or non-cash compensation to employees of the financial institution who are not registered with an NASD member in connection with, but not limited to, locating, introducing, or referring customers of the financial institution to the member.

Customer Disclosure and Written Acknowledgment

(4) (A) When a customer account is opened by a broker/dealer on the premises of a financial institution where retail deposits are taken, the member shall disclose, orally and in writing, that the securities products purchased or sold in a transaction with the member:

(i) are not insured by the Federal Deposit Insurance Corporation (''FDIC'') or other applicable deposit insurance;

(ii) are not deposits or other obligations of the financial institution and are not guaranteed by the financial institution; and

(iii) are subject to investment risks, including possible loss of the principal invested.

(B) For all accounts opened by a broker/dealer on the premises of a financial institution where retail deposits are taken, the member shall make reasonable efforts to obtain from each customer during the account opening process a written acknowledgement of the disclosures required by Subsections (c)(4)(A) (i) through (iii).

Use of Confidential Financial Information

(5) The member shall not use confidential financial information provided by the financial institution regarding its customer unless prior written approval has been granted by the customer to release the information.

Communications With the Public

(6) (A) All member communications regarding customers' securities transactions and long and short positions, including confirmations and account statements, must indicate clearly that the broker/dealer services are provided by the member. Communications that include information regarding non-deposit-insured transactions and positions with the member and deposit-insured transactions and positions or accounts with the financial institution should distinguish clearly between the two. Securities transactions conducted by the member should be introduced with the member's identity and, at a minimum, the member must disclose that

[2] *See* Letters from Elliott R. Curzon, Associate General Counsel, NASD, to Mark P. Barracca, Branch Chief, Division of Market Regulation, SEC (January 24, 1996 and March 7, 1996) and Letter from Suzanne E. Rothwell, Associate General Counsel, NASD, to Mark P. Barracca, Branch Chief, Division of Market Regulation, SEC (January 29, 1996). This notice reflects those amendments. The text of the amendments may be examined in the Commission's Public Reference Room.

securities products: are not insured by the FDIC or other applicable deposit insurance; are not deposits or other obligations of the financial institution and are not guaranteed by the financial institution; are subject to investment risks, including possible loss of the principal invested.

(B) Advertisements, sales literature, and other similar materials issued by the member that relate exclusively to its broker/dealer services will be deemed to be the materials of the member and must indicate prominently the identity of the member providing the broker/dealer services. The financial institution may be referenced in a nonprominent manner in advertising or promotional materials for the purpose of identifying the location where broker/dealer services are available and, where appropriate, to disclose a material relationship between the member and the financial institution, for example, where the member is affiliated with a financial institution that serves as investment adviser to an open-end investment company (''mutual fund'').

(C) Advertisements, sales literature, and other similar materials jointly issued by the member and a financial institution that discuss services or products offered by both entities must distinguish clearly the products and services offered by the financial institution from those offered by the member. The name of the member must be displayed prominently in the section of the materials that describes the broker/dealer services offered by the member, which section will be deemed materials of the member.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

(1) Background

In recent years, banks, savings and loan associations, credit unions and similar financial institutions not registered as a broker/dealer under the 1934 Act (''financial institutions'') have expanded their business into retail securities sales. These institutions generally conduct such activities through affiliated broker/dealers or non-affiliated broker/dealers operating under a brokerage affiliate or networking arrangement. In addition, however, banks are exempt from the definitions of the terms ''broker'' and ''dealer'' in Sections 3(a)(4) and 3(a)(5), respectively, of the 1934 Act, and thus are not required to register as broker/dealers when selling securities.

As these securities activities have expanded and financial institutions have placed securities sales facilities in their retail deposit taking areas, customers of the financial institutions have become increasingly confused about the distinction between the insured deposit products of the financial institution and the uninsured securities products of the broker/dealer operating in the same location.

In order to address this customer confusion problem, the NASD has published several notices reminding members of their obligations under the federal securities laws and the NASD's rules when selling securities products to customers who may have little or no experience with uninsured, non-depository products. In Notice to Members 91–74 (November 1991) and Notice to Members 93–87 (December 1993), the NASD reminded members of their obligations to customers who were reinvesting maturing certificates of deposit. In addition, in Notice to Members 94–16 (March 1994) the NASD reminded members of their sales practice obligations in connection with mutual fund sales and noted that the growth of bank-affiliated and networking broker/dealers had focused attention on the issue. Finally, in Notice to Members 95–80 (September 26, 1995) the NASD addressed additional concerns regarding member obligations and responsibilities regarding mutual fund sales practices.

In Notice to Members 94–47 (June 1994) the NASD published the SEC's November 24, 1993 no-action letter to the Chubb Securities Corporation (the ''Chubb Letter'') concerning broker/dealer activity on the premises of a financial institution. The Chubb Letter set forth the requirements for networking broker/dealers as they related to customer disclosure, compensation of employees of the financial institution, promotional materials of the broker/dealer, location of the securities activities of the broker/dealer, and inspection of books and records with respect to financial institutions that are subject to broker/dealer registration under Section 15(a) of the 1934 Act.

In addition, on February 15, 1994, the various financial institution regulators[3] issued a joint statement titled the ''Interagency Statement on Retail Sales of Nondeposit Investment Products'' (the ''Interagency Statement''). The Interagency Statement established guidelines for financial institutions that sell securities products to their customers, either directly or through networking or affiliated broker/dealers. It is the NASD's understanding that, to the extent securities are being sold by broker/dealers operating on financial institution premises, NASD members are observing the requirements of the Interagency Statement even though such broker/dealers are not directly subject to the jurisdiction of the financial institution regulators.

The NASD has been concerned that the activities of member firms operating on the premises of financial institutions and related customer protection issues are not adequately addressed by existing NASD rules and, because the Interagency Statement has no jurisdictional reach to broker/dealers, there is no basis for NASD disciplinary action against member firms that do not comply with the terms of the Interagency Statement. Accordingly, the NASD is proposing to add a new section to the Rules of Fair Practice to govern the conduct of broker/dealers on the premises of financial institutions.

(2) Description of Proposed Rule

Applicability. Subsection (a) of the proposed rule provides that the new section applies exclusively to broker/dealer services being conducted by NASD members on the premises of a financial institution where retail deposits are taken.

Subsection (a) specifies that the proposed rule covers financial institutions that have an area ''where retail deposits are taken.'' The NASD intends that the phrase ''where retail deposits are taken'' will have its ordinary meaning; i.e., a financial institution with an area where, with minimal limitations, the public (or members, in the case of a credit union) can access the services of the institution. It would not include financial institutions that do not generally provide access to the public without an appointment, e.g., financial

[3] The Board of Governors of the Federal Reserve System (''FRB''), the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency (''OCC''), and the Office of Thrift Supervision (''OTS'') (''financial institution regulators'').

institutions which solely provide trust services or private banking services.

Subsection (a) also provides that the section only applies to situations where broker/dealer services are conducted ''*on the premises* of a financial institution where retail deposits are taken'' (emphasis added). The proposed rule will apply to broker/dealer services provided (including all accounts opened) in person by broker/dealer personnel on the premises of the financial institution, as well as broker/dealer services provided by telephone or other means of communication (including computer terminals) by broker/dealer personnel on the premises of the financial institution. The proposed rule change will also apply to broker/dealer services provided by a broker/dealer via the telephone or other means of communication to customers who are on the premises of a financial institution even if the broker/dealer personnel themselves may not be on the premises of the financial institution.

If the broker/dealer is conducting business in a physically separate location from the retail facility of the financial institution and is not otherwise present on the premises of the financial institution via computer terminal or other electronic communication, the rule does not apply. For example, a broker/dealer operating in separate office space on another floor or in another part of the same building, even if the building is owned or primarily occupied by the financial institution, and where the entrance to the broker/dealer's office space is through the building lobby or an exterior entrance and not through the financial institution's retail facility, the broker/dealer will be considered to be conducting its services in a physically separate location.

Subsection (a) also expressly states that the proposed rule does not alter or abrogate the member's obligation to comply with other NASD rules or the rules of other financial institution regulatory authorities with respect to the member's operations on the premises of a financial institution.

(3) Definitions

Subsection (b) of the proposed rule defines several terms used in the proposed rule, such as, ''financial institution,'' ''networking arrangement'' and ''brokerage affiliate arrangement,'' ''affiliate,'' ''broker/dealer services,'' and ''confidential financial information.'' Each of the definitions are discussed below in connection with the provisions of the proposed rule where they are used. The definition of ''financial institution'' applies only to the proposed rule change; not to other provisions of the NASD's rules.

(4) Standards for Member Conduct

Subsection (c) of the proposed rule sets forth the specific requirements for members doing business on the premises of a financial institution as they relate to:

1. Setting;
2. Networking and brokerage affiliate agreements;
3. Compensation of registered and unregistered persons;
4. Customer disclosure and written acknowledgement;
5. Use of confidential financial information; and
6. Communications with the public.

The introduction to subsection (c) provides that no member shall conduct broker/dealer services on the premises of a financial institution[4] unless the member complies initially and continuously with the requirements of the proposed rule.

Setting. Subsection (c)(1) states that, wherever possible, broker/dealer services[5] shall be conducted in an area physically distinct from the retail deposit taking area of the financial institution. In all situations, the broker/dealer services must be identified in a manner that clearly distinguishes them from the activities of the financial institution. Finally, a member must clearly display its name in the area where broker/dealer services are provided.

The NASD recognizes that physical limitations in the space occupied by some financial institutions may prevent ideal physical distinctions of broker/dealer activities from the retail deposit-taking area of the financial institution from being maintained. Accordingly, the NASD has qualified the physical distinction requirement in this provision by the phrase ''wherever possible.''

In addition, the provision requires members to identify and clearly distinguish their activities from those of the financial institution, and to clearly display the member's name in the area where broker/dealer services are provided. The NASD expects that the three requirements in this provision, working in combination, will achieve the desired result, that is, the elimination of confusion among customers of the financial institution over which entity they are doing business with. The NASD expects that members unable to achieve ideal physical distinction of their broker/dealer activities from the financial institution's retail deposit taking area will pay particular attention to the other provisions of subsection (c)(1) in order to eliminate customer confusion and misidentification.

Finally, the NASD is aware of circumstances where financial institutions conduct business from walkup windows, kiosks or desks in public places, such as supermarkets or similar locations, many of which are operated by a single person. While the NASD cannot anticipate how the proposed rule would apply in all possible scenarios, the NASD believes it may be particularly difficult to adequately distinguish between the activities of the financial institution and the member as required by subsection (c)(1) in a setting such as a walkup window, kiosk or desk operated by a single person. Some of the difficulties with such settings could be resolved if the member exercises exceptional caution and adopts specific operational controls designed to avoid customer confusion and adequately distinguish its operations from those of the financial institution. However, the NASD expects members to be aware that there may be certain business settings of financial institutions where the member will not be able to comply with the requirements of subsection (c)(1), and may, therefore, be prevented from conducting business in such a location.

Networking and Brokerage Affiliate Agreements. Subsection (c)(2) of the proposed rules specifies that networking[6] and brokerage affiliate[7]

[4] The term ''financial institution'' is defined in proposed subsection (b)(1) as federal and state chartered banks, savings and loans, savings banks, credit unions and the service corporations required by law of such institutions.

[5] The term ''broker/dealer services'' is defined in proposed subsection (b)(4) as meaning investment banking or securities business as defined in paragraph (l) of Article I of the By-Laws. Paragraph (l) of Article I reads:

(l) ''investment banking or securities business'' means the business, carried on by a broker, dealer, or municipal securities dealer (other than a bank or department or division of a bank), or government securities broker or dealer of underwriting or distributing issues of securities, or of purchasing securities and offering the same for sale as a dealer, or of purchasing and selling securities upon the order and for the account of others.

[6] The terms ''networking arrangement'' and ''brokerage affiliate arrangement'' are defined in proposed subsection (b)(2) as a contractual arrangement between a member and a financial institution permitting the member to provide brokerage services on the premises of the financial institution.

[7] The term ''affiliate'' is defined in proposed subsection (b)(3) as a company which controls, is controlled by or is under common control with a member as defined in Schedule E of the NASD By-Laws. The formulation of this definition is consistent with definitions elsewhere in the securities laws, principally Section 20 of the 1934 Act. The NASD is also making express reference to

arrangements between a member and a financial institution must be governed by a written agreement that sets forth the responsibilities of the parties and the compensation arrangements, including: (1) Access by broker/dealer supervisory and regulatory persons to the financial institution's premises to inspect the member's books and records; (2) a prohibition on transaction-related cash or non-cash compensation to unregistered employees of the financial institution for referrals of financial institution customers to the member; and, (3) the member's obligations to notify the financial institution if any associated person of the member is terminated for cause. The proposed rule explicitly contemplates that members will not be able to conduct a securities business on the premises of a financial institution unless a written agreement that complies with subsection (c)(2) is in place.

The requirement that the agreement provide for access by the member's supervisory and NASD and SEC regulatory personnel to the financial institution's premises is intended to ensure that the existing right of such persons and entities to examine the books and records of the member, are not affected by the fact that the member is located on the premises of a financial institution.

Compensation of Registered/Unregistered Persons. Proposed subsection (c)(3) prohibits members from providing cash or non-cash compensation to employees of the financial institution who are not registered with an NASD member. Activities for which members may not compensate unregistered persons include, but are not limited to, those activities which, under the 1934 Act, may only be conducted by a registered broker/dealer or a person associated with a registered broker/dealer: the activities include, but are not limited to, locating, introducing, or referring customers of the financial institution to the member.

Customer Disclosure and Written Acknowledgment. Proposed subsection (c)(4) specifies the disclosures that a member must make to a customer when the customer opens an account with the member on the premises of a financial institution. Members must disclose, orally and in writing, that securities products sold in a transaction with the member: (1) Are not insured by the Federal Deposit Insurance Corporation (''FDIC'') or other applicable deposit insurance; (2) are not deposits or obligations of, nor are they guaranteed by, the financial institution; and (3) are subject to investment risks, including loss of principal invested. The proposed disclosures are consistent with the disclosure provisions in the Interagency Statement.

The NASD is proposing these disclosure provisions to address and eliminate customer assumptions and confusion that the securities they are purchasing from broker/dealers operating on the premises of financial institutions are either insured or guaranteed against loss of principal. Such beliefs apparently arise because customers mistakenly assume that the same insurance and guarantees that cover the deposit-type products of the financial institution also cover the securities products of the broker/dealer.

Subsection (c)(4) also requires members to make reasonable efforts to obtain a written acknowledgement of the required disclosures during the account opening process. This provision is intended to complement the oral and written disclosures members are required to give to customers opening new accounts on the premises of a financial institution. At the time the account is opened the member will provide the disclosures, both orally and in writing, and then seek to have the customer acknowledge the disclosures in writing. Because some customers may be reluctant to provide the written acknowledgement at the time the account is opened (or, indeed, at any time), the NASD is not mandating that the acknowledgement be obtained, just that the member make reasonable efforts to obtain it.[8]

Use of Confidential Financial Information. Proposed subsection (c)(5) prohibits members conducting business on the premises of a financial institution from using confidential financial information provided by the financial institution unless prior written approval has been granted by the financial institution customer to release the information. Proposed subsection (b)(5) defines ''confidential financial information''[9] in terms of what it is not: i.e., it is not lists of customer names, addresses and telephone numbers, unless the customer has specified otherwise; and it is not information that could be obtained from unaffiliated credit bureaus[10] or similar companies in the ordinary course of business. Therefore, information concerning a customer that a member obtains from a financial institution with which it has a networking or brokerage affiliate arrangement (other than the name, address, and telephone numbers of the customer, or that the member could obtain on its own from an unaffiliated credit bureau) may not be used unless the customer has granted prior written approval to the financial institution to release the information. Moreover, a member must satisfy itself that the customer has granted permission to release the information, either by obtaining copies of the written release from the financial institution, or by obtaining approval directly from the customer to release the information, before the member is permitted to use such information. In accordance with the intent of this provision, a member may not, for example, use a customer list sorted by the financial institution according to a field of information that would be confidential if released as individual customer information; e.g., lists of customers with expiring Certificates of Deposits or net worth in excess of $100,000.

Communications With the Public. Proposed subsection (c)(6) sets forth requirements for all communications with customers of members operating on the premises of a financial institution, including, account statements, confirmations, advertisements and sales literature. Paragraph (c)(6)(A) requires that all communications regarding the securities transactions of customers of members doing business on the premises of a financial institution clearly indicate that the broker/dealer services are provided by the member. Moreover, communications that include information about non-deposit-insured transactions and positions with the member and deposit-insured transactions and positions or accounts with the financial institution should be clearly distinguished from each other. The NASD also notes that if members issue account statements jointly with a financial institution, the member must

the more detailed definition of affiliate in Schedule E, Section 2(a), in order to provide additional guidance to members about what constitutes an affiliate.

[8] The approach taken by the NASD in this provision is consistent with the approach adopted by the NASD in connection with obtaining suitability information under Article III, Sections 2(b) and 21 of the Rules of Fair Practice.

[9] The NASD states that the definition of ''confidential information'' is based on the language of HR 1062 pending in the U.S. House of Representatives and the ''credit bureau'' exception is intended to except from the provision information regarding a customer that the member can obtain in the ordinary course of its business.

[10] NASD staff believes that standard information maintained by a credit bureau relates to credit history events, such as liens, loans outstanding, lines of credit, and credit cards, as opposed to net worth information that would include the value of customer assets, such as property, depository accounts, certificates of deposit, securities, and other investments.

ensure that the account statement complies with Article III, Section 45 of the Rules of Fair Practice, which requires members to periodically send account statements to their customers, as well as with the proposed new provision.

Finally, communications about securities transactions conducted by the member should be introduced to the customer in such communications with the identity of the member, and disclose to the customer that securities products are not insured by the FDIC or other applicable deposit insurance, are not deposits or obligations of the financial institution, are not guaranteed by the financial institution, and are subject to investment risks, including possible loss of principal invested. This provision is intended to provide the same disclosures in all communications with the customer as are provided when the account is opened.

Proposed paragraph (c)(6)(B) provides that advertisements, sales literature and other similar materials issued by the member which relate exclusively to its broker/dealer services will be deemed the materials of the member and must indicate prominently the identity of the member providing the services. The material may include non-prominent references to the financial institution where the broker/dealer is conducting business in order to identify the location where broker/dealer services are available. In addition, such a non-prominent reference to the financial institution may be included to disclose a material relationship between the member and financial institution, such as that of an investment adviser to an investment company.

Proposed paragraph (c)(6)(C) provides that advertisements, sales literature and other similar materials jointly issued by the member and a financial institution that discuss services or products offered by both entities must clearly distinguish the products and services offered by the broker/dealer from those offered by the financial institution. The member's name must appear prominently in the portion of the materials that describes the broker/dealer services and products offered by the member. That section of the materials will be deemed to be the materials of the member. In addition, the NASD intends to review the entire contents of all joint advertisements, sales literature and similar material to determine if the context within which the member's material appears complies with the NASD's advertising rules. For example, if a member's joint advertising material with a financial institution, when read in the context of the joint advertisement, fails to comply with the NASD's rules, the NASD may ask the member to seek modification of any part of the joint advertisement or require that the member not participate in the joint advertisement. In the event the member is unable to or chooses not to modify the joint advertisement, the member may, nevertheless, publish its portion of the advertisement separately (provided the advertisement complies with the NASD's rules).

The intent of subsection (c)(6) in general, and of paragraphs (c)(6)(B) and (c)(6)(C) in particular, is to prevent investor confusion between the products and services offered by the broker/dealer and the products and services offered by the financial institution, as well as to establish that advertising and sales literature promoting the products and services of the member conducting business on the premises of a financial institution are subject to the regulatory oversight of the NASD. With respect to such materials, the member must comply with all provisions of the NASD's rules including, but not limited to, the NASD's advertising rules, Article III, Section 35 of the Rules of Fair Practice.

Effective Date

The NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be no more than 60 days following the publication of the Notice to Members announcing Commission approval.

The NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act [11] in that regulating the conduct of broker/dealers on the premises of financial institutions will alleviate customer confusion in dealing with such entities and provide a regulatory framework for regulating such broker/dealer activities with the result that investors will be able to make more informed investment decisions with a better understanding of the distinctions between the securities industry and other segments of the financial services industry, in furtherance of the requirement that the Association's rules promote just and equitable principles of trade, prevent fraudulent and manipulative acts and practices, and protect investors and the public interest.

(B) Self-Regulatory Organization's Statement on Burden on Competition

In response to NASD Notice to Members 94–94, a number of commentators [12] noted that the proposed rule language in that Notice required members to disclose to customers that securities products purchased or sold by the member are not insured by the Securities Investor Protection Corporation (''SIPC'').[13] The commentators noted that because such disclosures would apply only to broker/dealers operating on the premises of a financial institution, it would unnecessarily discriminate among broker/dealers when customers of all broker/dealers are subject to the same potential confusion about the nature of SIPC insurance.[14] The commentators argued that if there was going to be such a requirement at all, the disclosures should apply to all member firms whether they operate on the premises of a financial institution or not. Moreover, the commentators argued that limiting SIPC disclosure to financial institution broker/dealers is not only anti-competitive but misleading because customers who are already susceptible to confusion about the nature of SIPC insurance would have their attention drawn to SIPC without a requirement that SIPC insurance be explained to eliminate customer misperceptions.

In response to the commentators, the NASD has determined to eliminate the SIPC disclosure requirement from the proposed rule change, and rely instead on the disclosures that remain in the proposed rule change which are consistent with provisions contained in the Interagency Statement issued by the four bank regulators. The provisions that remain in the proposed rule change require members to disclose to customers that securities products sold by the member (1) Are not deposit insured, (2) are not deposits of or other obligations of the financial institution and are not guaranteed by the financial institution, and (3) are subject to investment risks, including possible loss of principal invested.

Some commentators have argued that the other disclosure requirements that were contained in the proposed rules that were published in Notice to Members 94–94 (that remain in the proposed rule change) are

[11] 15 U.S.C. 78*o*–3.

[12] Copies of comment letters received by the NASD on this previous proposal are available for inspection and copying at the NASD and in the Commission's Public Reference Room.

[13] *See*, Notice to Members 94–94 (December 1994), proposed subsection (c)(9)(D).

[14] *See*, comment letters 1, 3, 4, 7, 8, 17, 18, 22, 23, 25, 27, 37, 40, 47, 48, 50, 52, 54, 56, 63, 64, 77, 81, 84, 88, 92, 94, 99, 100, 104, 107, 109, 110, 115, 119, 121, 122, 123, 129, 130, 140, 142, 147, 153, 155, 167, 168, 169, 174, 177, 184, 186, 189, 190, 193, 197, 204, 207, 208, 212, 216, 225, 226, 227, 230, 236, 239, 240, 242, 256, 258, 266, 269, 270, 271 and 279.

discriminatory and burdensome on the class of broker/dealers that conduct broker/dealer activities on the premises of a financial institution. The NASD believes that the provisions of the proposed rule change as revised are necessary to address a specific problem (customer confusion) that the NASD has identified in connection with the activities of members conducted on the premises of a financial institution and has, in general, narrowly tailored the proposed rule change to address the problem.

Therefore, the NASD does not believe that these provisions or any other provisions of the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received From Members, Participants, or Others

The proposed rule change was published for comment in Notice to Members 94–94 (December 1994) (hereinafter referred to as ''original proposed rule change'' or ''original proposed rules''). 284 comments were received in response thereto. Of the 284 comment letters received, 54 were in favor of the proposed rule change, 51 of which requested modifications, 209 were opposed, and 21 were neither in favor nor opposed.

I. General Comments

A. Jurisdiction of the NASD in the Proposed Rules. Several commentators, including the American Bankers Association (''ABA''), the Bank Securities Association (''BSA''), and the Consumer Bankers Association (''CBA''), expressed their belief that certain provisions of the original proposed rules would subject the activities of banks to NASD regulation.[15] The commentators stated that by subjecting banks to regulation as broker/dealers, the proposed rules fail to recognize the exemption from broker/dealer registration that is afforded to banks under Section 3(a)(6) of the 1934 Act. The commentators maintained that the proposed rules also ignore the well-settled authority of banks to provide securities brokerage services directly to their customers under the Glass-Steagall Act, and cited *American Bankers Association* v. *Securities and Exchange Commission,* 804 F.2d 739 (D.C. Cir. 1986) in support.

In considering the NASD's jurisdictional reach, the ABA, BSA, CBA, and several other commentators also argued that the NASD has incorrectly interpreted the Securities and Exchange Commission's no-action letter to Chubb Securities Corporation (the ''Chubb Letter''). Because the Chubb Letter was intended to govern thrift institutions that are not exempt from broker/dealer registration under the 1934 Act, the commentators stated that it is inappropriate to extend the requirements of the Chubb Letter to banks which are otherwise exempt from broker/dealer registration by means of the device of the proposed rule change.[16] Because the Chubb Letter is neither legislation nor regulation, the commentators stated that it does not give the NASD the authority to disregard the bank exemption in the 1934 Act in order to regulate banks.

The NASD never intended to, and the proposed rule change does not, extend its jurisdictional reach to banks and other financial institutions that are not members of the Association, nor to their employees. Accordingly, the NASD has amended subsection (a) to clarify that the proposed rule change applies only to NASD members providing broker/dealer services on the premises of a financial institution.

Comments about the jurisdictional reach of specific provisions of the original proposed rules are addressed in more detail below.

B. Regulatory Duplication. Several commentators said that the proposed rule change duplicates existing regulations. One group of commentators argued that the Interagency Statement issued by the financial institution regulators on February 15, 1994, and other existing financial institution regulations adequately address the activity governed by the proposed rule change.[17] In general, these commentators maintained that the activity addressed by the original proposed rules should be governed by financial institution regulations, as opposed to rules promulgated by the SEC or the NASD. In addition, another group of commentators, which included the ABA, BSA, and CBA, argued that some of the provisions of the original proposed rules were redundant of existing NASD, SEC and financial institution regulations. With respect to NASD rules, the commentators referenced existing branch office registration requirements, supervisory requirements, and personnel registration/associated persons provisions of the NASD rules. While these commentators recognized that additional regulation of financial institution broker/dealer[18] activities are appropriate, they argued that additional regulations are already in place in the form of the Interagency Statement and financial institution regulations, the Chubb Letter and existing NASD rules. The commentators believed that these guidelines, interpretations and rules adequately address the activities that would be governed by the proposed rules.[19]

The NASD agrees that some of the provisions of the original proposed rules duplicated existing NASD rules. Accordingly, the NASD has amended the proposed rules to eliminate such duplication as described in more detail below. With respect to arguments that the proposed rules duplicate the rules of other regulatory entities (e.g., the Interagency Statement), the NASD notes that many of the rules, policies and guidelines of other agencies do not directly or indirectly apply to NASD members. The NASD believes it is imperative to adopt a set of rules that establishes clear standards of conduct governing the practices of member firms operating on the premises of financial institutions that are enforceable by the NASD.

C. Discriminatory Impact and Anti-Competitive Effects. The ABA, BSA, CBA and many other commentators believe that it is inappropriate to establish separate regulations to govern

[15] *See,* comment letters 1, 5, 7, 8, 17, 19, 21, 22, 23, 27, 28, 30, 37, 40, 48, 51, 54, 56, 62, 63, 65, 67, 77, 80, 84, 90, 92, 99, 102, 107, 108, 111, 115, 118, 122, 123, 126, 127, 129, 131, 138, 141, 147, 148, 156, 158, 173, 179, 186, 188, 189, 190, 192, 195, 204, 207, 208, 209, 212, 214, 216, 225, 226, 227, 229, 233, 234, 236, 242, 266, 269, 270 and 271.

[16] *See,* comment letters 1, 8, 17, 19, 27, 80, 84, 89, 103, 115, 122, 123, 134, 138, 180, 209, 210 and 242.

[17] *See,* comment letters 1, 5, 8, 18, 21, 22, 31, 37, 38, 40, 47, 53, 54, 56, 58, 62, 65, 70, 75, 78, 91, 94, 99, 100, 101, 107, 108, 111, 126, 127, 130, 133, 138, 141, 145, 147, 151, 158, 169, 170, 179, 184, 186, 188, 190, 196, 211, 216, 218, 220, 225, 226, 227, 229, 230, 232, 236, 238, 241, 242, 245, 255, 266, 268, 269, 270, 271, 275 and 282.

[18] As used in this rule filing, the term ''financial institution broker/dealer'' refers to broker/dealers affiliated with financial institutions (as defined in the proposed rule the term ''financial institution'' means ''federal and state-chartered banks, savings and loan associations, savings banks, credit unions, and the service corporations required by law of such institutions'') or conducting business with financial institutions under networking arrangements. The term ''non-financial institution broker/dealer'' refers to broker/dealers not affiliated with, or conducting business under a networking arrangement with, financial institutions.

[19] *See,* comment letters 2, 7, 9, 10, 11, 17, 19, 23, 24, 25, 27, 28, 29, 30, 32, 33, 34, 35, 36, 37, 41, 42, 43, 44, 45, 48, 49, 52, 53, 55, 59, 60, 61, 63, 64, 66, 67, 68, 69, 71, 74, 76, 77, 82, 84, 87, 90, 92, 97, 102, 105, 114, 115, 116, 117, 118, 119, 120, 121, 122, 124, 128, 129, 131, 132, 148, 149, 153, 156, 157, 160, 161, 162, 163, 165, 166, 168, 169, 172, 173, 174, 175, 177, 178, 184, 189, 194, 195, 197, 201, 204, 207, 208, 209, 224, 225, 228, 231, 235, 242, 243, 246, 247, 248, 249, 250, 257, 258, 259, 261, 262, 263, 273, 279, 280, 281 and 283.

broker/dealers operating on financial institution premises than those in existence for other NASD members.[20] In general, these commentators believe that the proposed rules unfairly discriminate against a class of broker/dealers in violation of Section 15A(b)(6) of the 1934 Act. The commentators argued that the 1934 Act provides no basis for a classification of broker/dealers based on location.

The NASD has identified circumstances associated with conducting broker/dealer services on the premises of a financial institution that are unique to that location and that require rules which specifically address the conduct of members engaging in such business. The principal circumstance noted is the enhanced likelihood that customers of the financial institution may not be aware of the differences between the insured depository products of the financial institution and the uninsured securities products of the broker/dealer operating in the same location. Accordingly, the NASD has determined that it is in the public interest to propose rules to address these unique circumstances. The NASD believes, therefore, that it is acting in furtherance of the 1934 Act in proposing rules to regulate the activities of broker/dealers on the premises of financial institutions in order to address on-going problems of customer confusion and the adequacy of the disclosures made.

These commentators also asserted their view that the NASD has not provided statistical data to support its contention that financial institution broker/dealers should be subject to a ''higher standard of regulation.'' These commentators believe that the proposed rules are anti-competitive because, in their view, they create an uneven regulatory scheme favoring non-financial institution broker/dealers over financial institution broker/dealers. The NASD does not believe that the proposed rule change is anti-competitive in that the revised rule filed herein is, in general, narrowly structured to address its concern of customer confusion and investor protection.

In addition, two commentators speculated that the proposed rules are a reflection of the NASD's on-going battle with the financial institution regulators.[21] One commentator expressed its belief that the proposed rules are a reflection of competitive pressures from NASD members who fear financial institution incursions into the securities industry.[22] Finally, one commentator expressed the opinion that the rules are punitive of members who are seeking to do business with financial institutions.[23]

The NASD regrets that any commentators believe that there is a non-regulatory motivation to the proposed rules, but there is no basis for such comments. The NASD has responded to commentators by modifying the rules to clarify their jurisdictional reach, provide for greater flexibility of compliance in certain cases, and narrow the provisions to those most clearly applicable to addressing the potential for customer confusion in connection with the conduct of broker/dealer services on the premises of a financial institution.

D. Conflicting Banking and NASD Regulations. The ICI, the OCC, the FRB, the ABA, BSA, CBA, and other commentators expressed concern about requiring financial institution broker/dealers to comply with potentially conflicting requirements of the NASD and financial institution regulators.[24] The ICI stated that in the absence of functional regulation of securities activities of various entities, the financial institution broker/dealer regulations of the various regulators must be coordinated and harmonized in order to reduce burdens on industry participants. These commentators cited inconsistencies between the proposed rule change and the Interagency Statement as an example. To the extent that the proposed rule change differs from the Interagency Statement, these commentators asserted that member firm compliance will be both challenging and expensive. In addition, a few commentators requested that the proposed rule change be amended to provide a regulatory conflict resolution process.[25]

To resolve these concerns, the NASD has amended the original proposed rules to eliminate, to the degree possible, inconsistencies and conflicts between the proposed rules and existing rules and guidelines of financial institution regulators, as discussed in more detail below. Unless regulatory conflicts arise, which the NASD is not currently aware of, it is unnecessary to institute a conflict resolution process. The NASD agrees that the regulations of various regulators must be consistent and intends to continue communications with the financial institution regulators in order to coordinate interpretations and application of common provisions to avoid such problems before they develop.

E. Rationale for the New Rules. Some commentators questioned the rationale for the proposed rule change: The need to address issues of investor confusion and to provide clear guidance through rules or regulations addressing the activities of financial institution-affiliated and networking broker/dealers operating on the premises of financial institutions.[26]

As discussed above, the NASD has business practice and investor protection concerns that it believes justify the adoption of the proposed rules. The NASD believes the proposed rule change is a measured response to the concerns that have been identified and the unique circumstances present with respect to broker/dealers operating on the premises of a financial institution.

F. Disparate Treatment of Investors. Some commentators argued that financial institution customers should not be treated as a separate class of investors for purposes of customer protection.[27] These commentators said that such disparate treatment suggests that financial institution customers are less sophisticated than those who deal with separate, full service, broker/dealers.

The NASD disagrees that the proposed rule change suggests that financial institution customers are less sophisticated than customers of full service broker/dealers. As discussed above, the NASD has identified circumstances associated with conducting broker/dealer services on the premises of a financial institution that appear to be unique to that location. The principal circumstance noted is the enhanced likelihood that customers of

[20] *See*, comment letters 1, 2, 5, 7, 8, 9, 11, 17, 19, 21, 23, 24, 25, 27, 29, 30, 31, 32, 33, 34, 35, 36, 43, 48, 49, 52, 54, 55, 56, 59, 61, 63, 64, 66, 67, 68, 69, 71, 74, 76, 77, 82, 84, 86, 87, 88, 89, 91, 92, 97, 98, 102, 104, 105, 107, 108, 115, 116, 118, 119, 121, 122, 123, 124, 125, 126, 127, 128, 129, 131, 132, 139, 141, 142, 147, 149, 157, 159, 162, 163, 164, 165, 168, 173, 175, 178, 179, 184, 189, 194, 195, 197, 204, 208, 209, 213, 219, 218, 220, 225, 226, 227, 228, 229, 230, 236, 235, 240, 243, 242, 244, 249, 250, 257, 258, 259, 261, 262, 263, 264, 265, 273, 276, 279, 280, 281 and 283.

[21] *See*, comment letters 127 and 258.

[22] *See*, comment letter 235.

[23] *See*, comment letter 66.

[24] *See*, comment letters 1, 3, 4, 6, 7, 8, 9, 10, 11, 12, 16, 17, 23, 25, 27, 28, 30, 32, 47, 48, 63, 64, 65, 81, 82, 83, 84, 89, 92, 99, 100, 101, 102, 103, 104, 107, 108, 109, 110, 113, 115, 119, 120, 123, 129, 133, 135, 145, 147, 151, 153, 154, 156, 163, 166, 167, 172, 173, 180, 182, 183, 184, 188, 190, 191, 192, 196, 208, 209, 210, 211, 212, 213, 215, 216, 224, 230, 234, 237, 239, 252, 266, 236, 269, 270, 271, 272, 275, 279 and 282.

[25] See, comment letters 135, 146, 156 and 239.

[26] *See*, comment letters 53, 66, 67, 115, 127, 150, 185, 190, 214, 235 and 258.

[27] *See*, comment letters 10, 53, 78, 102, 115, 136, 204, 207 and 258.

the financial institution may not be aware of the differences between the insured depository products of the financial institution and the uninsured securities products of the broker/dealer operating in the same location. Accordingly, the NASD has determined that it is the public interest to propose rules to address these unique circumstances.

II. Specific Comments

A. Applicability. Subsection (a) of the original proposed rules provided that the section would apply exclusively to the activities of members that conduct broker/dealer services on the premises of a financial institution where retail deposits are taken.

The ICI, BSA, CBA, and a number of other commentators asked that the NASD amend subsection (a) of the proposed rules to clarify that the rules apply only to financial institution sales activities that could confuse retail customers about the uninsured nature of the securities products that are being offered.[28] The commentators noted that the Interagency Statement only applies to retail sales of non-deposit investment products. The NASD believes that the proposed rules are generally consistent with the Interagency Statement in that they apply to all non-deposit investment products sold by a member that is conducting business on the premises of a retail deposit-taking institution.

The ICI, BSA, CBA, and several other commentators also requested that the NASD clarify the phrase ''on the premises'' in subsection (a) to enable members to determine the applicability of the rules under various scenarios, such as, where a member is located within a financial institution building but on a separate floor.[29] Commentators also asked whether the proposed rules apply where a member leases space in a building owned by a financial institution, but the member is not in a networking arrangement with the financial institution nor is the member a financial institution affiliate.

Subsection (a) has been clarified to specify that the provisions apply only to ''those broker/dealer services being conducted by NASD members on the premises of a financial institution where retail deposits are taken.'' It is intended that, generally, broker/dealer services will be considered separate from the retail deposit taking area of a financial institution if the broker/dealer's facilities can be entered without going through the retail facility of the financial institution. Thus, the proposed rules would not apply where the member and the financial institution are located in physically separate and separately identified offices.

Finally, the BSA recommended that subsection (a) be amended to include within the coverage of the proposed rule non-financial institution broker/dealers that offer deposit-insured financial institution products directly. The BSA expressed the opinion that such an amendment was warranted because the investor protection concerns addressed by the proposed rule change are equally as relevant with respect to non-financial institution broker/dealers that sell financial institution products.

The NASD does not agree and has no evidence that similar investor protection concerns are present with respect to customers of non-financial institution broker/dealers that sell financial institution products. The NASD believes that if such broker/dealer customers are confused about the nature and risks of securities products they are likely to believe that none of the products they purchase are insured when, in fact, the customer may acquire an insured product. Thus, any customer confusion would appear to have benign results. The NASD will, however, continue to monitor this area.

B. Definitions. Subsection (b) of the original proposed rules included definitions of the terms ''financial institution,'' ''networking arrangement,'' ''brokerage affiliate of a financial institution,'' ''dual employees,'' and ''broker/dealer services.'' The definitions of ''financial institution'' and ''broker/dealer services'' are retained in the revised rule and discussed below. The definitions of ''networking arrangement'' (which has been amended to add ''brokerage affiliate arrangement'') and ''brokerage affiliate of a financial institution'' (which has been amended to, simply, ''affiliate'') did not generate any comments and are, therefore, discussed later in connection with the provisions where the terms appear. The term ''dual employees'' was deleted from the proposed rule change in connection with the NASD's revision of the original proposed rules, but not in response to a particular comment. Therefore, it is not discussed here. Finally, a definition of the term ''confidential financial information'' was added to subsection (b). That term is discussed below in connection with the provision where it occurs.

1. ''Financial Institution.'' The BSA, CBA, the FRB, and First Fidelity expressed the concern that the definition of the term ''financial institution'' set forth in paragraph (b)(1) of the original proposed rule change inappropriately combines financial institutions and non-financial institution entities such as savings associations and credit unions within the same defined term.[30] These commentators also expressed their view that it is inappropriate to include service corporations within the definition of financial institution because service corporations themselves may be registered as broker/dealers. The NASD notes that the language of this definition is drawn from the Chubb Letter and is necessary for the proper operation and application of the proposed rule. The NASD has, however, amended the definition to ensure that it applies only to the proposed rule and not to any other NASD rule.

The FRB also suggested that the NASD consider expanding the definition of financial institution to include foreign financial institutions given that a number of foreign financial institutions have established branches in the United States, and several of these institutions have broker/dealer affiliates. The NASD believes that it is not appropriate to include within the scope of the rule foreign financial institutions not required to register as a bank, savings and loan or credit union.

2. ''Broker/dealer Services.'' The ABA, BSA, CBA , and several commentators expressed concerns about the scope of the term ''broker/dealer services'' as defined in paragraph (b)(4) of the original proposed rule change.[31] The commentators stated that the proposed definition improperly limits the activities of unregistered financial institution employees. Accordingly, the commentators have recommended that the definition be amended to state that nothing in the proposed rules is intended to limit the ability of financial institutions and their employees to engage in securities transactions pursuant to the exemption from broker/dealer registration that is granted to banks by Section 3(a)(6) of the 1934 Act.

Further, the ABA and BSA raised the concern that it was unclear whether or not the proposed rule is intended to reach investment banking services offered by bank trust departments where services are offered by individuals who hold NASD licenses. Because the term ''investment banking and securities business'' has a settled meaning within the broker/dealer industry, the BSA

[28] *See,* comment letters 11, 27, 29, 75, 84, 94, 121, 159, 167, 172, 186, 208, 210, 211 and 274.

[29] *See,* comment letters 17, 21, 27, 29, 52, 63, 84, 106, 110, 115, 121, 129, 148, 167, 172, 177, 186, 192, 207, 208, 242, 245 and 260.

[30] *See,* comment letters 27, 84, 103 and 199.

[31] *See,* comment letters 4, 8, 17, 19, 21, 25, 27, 28, 29, 54, 62, 63, 80, 84, 106, 115, 121, 131, 129, 192, 173, 186, 207, 208, 242, 267, 260, and 281.

recommends that the NASD adopt the ''investment banking'' definition in paragraph (h) of Article I of the NASD By-Laws to address the problems raised with regard to the proposed broker/dealer services definition.

In this regard, it was never the intent of the NASD to extend its jurisdictional reach to banks and other financial institutions. In response to these comments, the NASD sought to clarify its intent by amending the definition of ''broker/dealer services,'' to reference the definition of ''investment banking and securities business'' contained in Article I, Paragraph (l) of the NASD By-Laws. The definition in Article I of the By-Laws excludes investment banking and securities activities carried on by banks, including bank trust departments. In addition, as discussed above, the NASD has amended subsection (a) to clarify that the proposed rule change applies only to broker/dealer services conducted on the premises of a retail-deposit-taking financial institution. The NASD believes that these changes clarify that the proposed rule change does not seek to regulate the securities activities of banks that are exempt from broker/dealer registration.

C. Specific Provisions Relating to Activities of Members Operating on the Premises of a Financial Institution. 1. Physical Location. Subsection (c)(1) of the original proposed rules provided that a member's broker/dealer services shall be conducted in a physical location distinct from the area where the financial institution's retail deposits are taken. Several commentators requested clarification about the definition of ''where retail deposits are taken'' in subsection (c)(i) and to the term ''deposit-taking area'' [32] used in other provisions (i.e., is it the teller area of a financial institution?)

Many commentators criticized subsection (c)(i) as not providing adequate flexibility for financial institution locations with severe physical constraints.[33] These commentators asked the NASD to address the problem by adopting the Interagency Statement standard which, in relevant part states, ''in the limited situation where physical considerations prevent sales of non-deposit products from being conducted in a distinct area, the institution has a heightened responsibility to ensure appropriate measures are in place to minimize customer confusion.'' [34]

Finally, the BSA and four other commentators asked whether dual employees would be required to have two separate offices for conducting activities on behalf of the financial institution and the broker/dealer.[35] These commentators maintained that customers could be confused if a dual employee were required to lead customers back and forth between two locations within the financial institution. To address this potential for customer confusion, the BSA suggested that the proposed rule change be amended to permit the use of one desk for deposit and non-deposit activities. Indeed, the BSA expressed the view that appropriately qualified dual employees should be permitted to offer customers a ''menu'' of retail financial products, including insured deposits and uninsured investment products, from the same location.

In response to the commentators, subsection (c)(1) of the proposed rule change was revised to require the member to operate in a distinct area ''wherever possible,'' consistent with the Interagency Statement. In addition, the proposed rule change has been amended to require that the member ''distinguish'' its broker/dealer services from the services of the financial institution as opposed to ''segregating'' its services as required by the original proposed rule change.

With regard to the commentators' concerns regarding consistency in regulation, the NASD has amended the physical location and signage requirements and the proposed risk disclosures to ensure consistency with the Interagency Statement's standards for these matters. (See, new paragraphs (c)(1) and (c)(4), respectively.) These amendments are also discussed in greater detail below.

2. Signage. Subsection (c)(2) of the original proposed rule change stated, ''in no event shall signs regarding the broker/dealer services appear in the deposit-taking area.'' Many commentators, including the ABA, ICI, BSA, and CBA, asked whether the proposed rules would prohibit signage in the teller window or the lobby areas.[36] The commentators argued that this requirement could interfere with directional signage pointing toward the location of the broker/dealer, ordinary brochure stands, mounted lists of affiliated companies, and other signage relating to the general availability of products and services of the broker/dealer. Rather than create confusion, the BSA argued that directional signs can help avoid customer confusion by clarifying that a deposit-taking area, such as a teller window, is not the place to obtain securities products. These commentators asserted that broker/dealer signage with appropriate disclosures should be permitted to appear anywhere on the financial institution's premises.

Other commentators expressed concerns about the potential impact of the signage requirements in the case of small financial institutions.[37] These commentators noted that signage restrictions are particularly difficult for small financial institutions and small branch offices to deal with because practically all public areas could be regarded as deposit-taking areas. Further, the commentators noted that small branches may not reserve one desk solely for investment services thus preventing the segregation desired by the original proposed rules. The commentators also observed that signage restrictions, when combined with the physical location requirements, would prevent one-desk branch locations. Accordingly, these commentators recommended that the proposed rules be amended to permit signage that would facilitate dual usage of a service desk by broker/dealer and financial institution employees.

One commentator stated that, in its view, the proposed signage restrictions would interfere with the financial institution's commercial speech which is protected by the First Amendment of the U.S. Constitution.[38] This commentator also stated that this interference with the financial institution's rights resulted in the NASD's assertion of jurisdiction over the financial institution.

The NASD disagrees and does not believe that the proposed rule change infringes on the limited First Amendment protection on commercial speech because the U. S. Constitution acts as a restraint on governmental action and the First Amendment's free speech guarantee is a limitation on Congress' ability to enact laws abridging

[32] *See,* comment letters 6, 8, 12, 16, 17, 27, 29, 30, 52, 58, 63, 64, 77, 80, 83, 86, 110, 129, 153, 155, 167, 177, 186, 193, 207, 208, 213, 239, 244, 260 and 282.

[33] *See,* comment letters 1, 4, 8, 11, 16, 17, 19, 21, 25, 26, 27, 29, 30, 31, 47, 54, 76, 84, 88, 90, 94, 103, 107, 112, 118, 119, 121, 123, 127, 129, 130, 131, 140, 153, 154, 156, 166, 167, 176, 181, 182, 184, 189, 192, 193, 196, 204, 208, 210, 212, 215, 230, 233, 234, 237, 242, 244, 255, 267, 276, 279 and 282.

[34] *See,* comment letters 27, 40, 86, 96, 181, 208, 239, 245, 256 and 283.

[35] *See* comment letters 27, 110, 182, 193, 207 and 233.

[36] *See,* comment letters 4, 8, 9, 10, 11, 17, 21, 23, 25, 27, 28, 30, 48, 59, 81, 83, 84, 104, 115, 119, 120, 121, 123, 129, 134, 140, 154, 156, 167, 170, 192, 204, 207, 208, 213, 232, 233, 236, 242, 244, 245, 276, 279 and 281.

[37] *See,* comment letters 4, 12, 21, 29, 40, 47, 52, 54, 107, 113, 133, 156, 167, 181, 184, 196, 198, 210, 234, 242, 255, 256, 279 and 282.

[38] *See,* comment letter 30.

freedom of speech. The NASD's actions as a private, non-governmental, securities industry, self-regulatory organization (actions that include adopting rules or enforcing standards of business conduct) are not governmental actions subject to Constitutional restraint. Nevertheless, the NASD applies a standard of fundamental fairness in its dealings with its members and its rules, including the rule change proposed herein, are narrowly tailored to achieve legitimate regulatory purposes. The NASD also notes that even if the NASD's regulatory proposals were constrained by the Constitutional protection on commercial speech, those protections are limited to the extent that reasonable regulations of commercial speech are necessary to protect the public interest and the proposed rule change is a reasonable regulation of commercial speech.

Nevertheless, in response to the commentators, the NASD has amended the proposed rule change to delete the separate provision relating to signage, including the provisions prohibiting signs regarding broker/dealer services in the financial institution's deposit-taking area. The requirement in the deleted provision that a member clearly display its name in the area where brokerage services are being conducted has been consolidated with Subsection (c)(1) of the proposed rules. Thus, as long as signage meets the other requirements of the proposed rule change, as well as existing NASD rules requiring accurate information that is not misleading under the circumstances in which it is used, there are no other limitations.

3. Branch Office Registration Requirements. Subsection (c)(3) of the original proposed rules restated an already existing NASD rule requirement that the member must register as a branch office any of its offices which operates on the premises of a financial institution. Most commentators, including, among others, the ICI, ABA, BSA, and CBA, asked that the provision be amended to exempt from branch registration requirements locations where a broker/dealer meets a client in a financial institution office for purposes of customer convenience, but where the financial institution office is not permanently staffed by the NASD member, nor is the location held out as a branch of the NASD member.[39] These commentators expressed significant concerns regarding the cost of registering locations serviced by so-called ''circuit riders'' if the NASD does not amend the rule to provide an exception for meetings between a member's registered representative and financial institution customers that occur on an appointment basis at financial institutions.

In addition, the BSA expressed the opinion that, if the NASD has determined to publish an interpretation of what is a ''branch office'' under Section 27(g)(2) of the Rules of Fair Practice, it should be done in a uniform manner applicable to all NASD members and not as a formal NASD rule applicable only to financial institution broker/dealers. The ABA and the CBA also argued that there was no justification for treating financial institution branches any differently than other retail outlets for purposes of branch office registration.

Further, commentators observed that requiring registration of every location at which a representative meets with a customer could limit the ability of members to service customers where states do not permit a registered representative to work out of more than one registered location.[40]

Finally, the Independent Bankers Association of America (''IBAA'') and two other commentators argued that the branch office registration requirements would result in compliance problems with respect to the books and records maintained at the financial institution location.[41] To address this concern, the IBAA asked that the rules be amended to provide limited relief to allow financial institution broker/dealers to maintain books and records at a more central location, for example, the main office of the financial institution.

The NASD appreciates the concerns expressed by these commentators and, accordingly, has amended the proposed rules to delete the branch office registration requirements and, instead, rely on the branch office registration requirements currently in effect under existing NASD rules. Therefore, members doing business on the premises of a financial institution will be expected to comply with the branch office requirements in the NASD's rules that currently apply to all other members.

4. Networking and Brokerage Affiliate Agreements. Subsection (c)(4) of the original proposed rules provided that relationships between financial institutions and members (whether network or affiliate) be governed by an agreement that sets forth the responsibilities of the parties.

Regulatory Access—Paragraph (c)(4)(A) provided that the written agreement between the broker/dealer and the financial institution, among other things, specify that the SEC and the NASD must be granted access to the financial institution premises to inspect the books and records of the broker/dealer and other relevant information maintained by the member with respect to its broker/dealer services. With respect to this requirement, the North American Securities Administrators Association Inc. (''NASAA'') and the State of Iowa urged the NASD to amend the provision to grant such access to state regulators.[42] The NASD formulated this provision to be consistent with the Chubb Letter. It is believed that state regulators currently have appropriate authority to have access to the premises of financial institutions to inspect the books and records of broker/dealers. The BSA stated that the SEC will use this right of access provision to indirectly regulate any desired activity of a financial institution.[43] The NASD believes that the concerns of the BSA are more appropriately directed to the SEC.

Periodic Reviews—Paragraph (c)(2)(C) of the original proposed rules required that the financial institution agree to permit the member to conduct periodic reviews to assure that the financial institution and its unregistered employees comply with the limits on their activities with respect to securities transactions and non-deposit broker/dealer services. One commentator stated that the provision could be interpreted to require that an unaffiliated network member be granted access to the books and records of its partner financial institution for periodic reviews.[44] This commentator also stated that, if the financial institution and the networking member compete in several lines of business, the requirement would have had the net effect of discouraging a financial institution's participation in networking arrangements in order to avoid disclosing confidential business information.

Further, with regard to a member conducting periodic reviews to assure that the financial institution and its unregistered employees comply with the limits on their activities, the ICI, BSA, CBA, and several other commentators argued that it is inappropriate for an NASD member to serve in the role of an auditor. They

[39] *See*, comment letters 3, 7, 8, 14, 15, 19, 23, 27, 28, 29, 30, 32, 37, 39, 40, 48, 54, 63, 75, 82, 84, 91, 96, 101, 104, 108, 109, 110, 115, 119, 121, 125, 127, 129, 140, 144, 145, 166, 167, 173, 177, 181, 189, 192, 204, 205, 207, 208, 213, 215, 230, 236, 239, 244, 251, 256, 264 and 267.

[40] *See*, comment letters 23, 108 and 236.

[41] *See*, comment letters 101, 122 and 154.

[42] *See*, comment letters 203 and 254.

[43] *See*, comment letter 27.

[44] *See*, comment letter 211.

argued that this responsibility is more appropriately handled by the financial institution.[45] The commentators also asserted that the financial institution should be responsible for conducting its own supervision, training, investigations, and compliance as it relates to the activities of its own employees who are not registered with a broker/dealer. The commentators stated that it is impractical for a small number of broker/dealer employees to monitor the activities of all unregistered financial institution employees.

Additionally, one commentator asked what actions a member could take against a financial institution if it believes the financial institution has not complied with the limits on its activities with respect to securities transactions and non-deposit broker/dealer services.[46] Another commentator argued that the contractual obligations of proposed Paragraph (c)(4)(C) would create broker/dealer liability for financial institution employees over whom the broker/dealer has no control.[47]

The ICI urged the NASD to revise the paragraph to require that members only obtain a commitment from the financial institution such that the financial institution agrees that it will promulgate and implement procedures reasonably designed to ensure compliance with the limits on the activities of unregistered financial institution employees rendered in connection with the member's broker/dealer services.

In response to the foregoing comments, the NASD has amended the proposed rule change to delete paragraph (c)(4)(C).

Dual Employees—Paragraph (c)(4)(D) of the original proposed rules provided that the written networking or brokerage affiliate agreement must require that any dual employee who is suspended from association with the member, or who the SEC, the NASD, or any other regulatory or self-regulatory organization bars or suspends from association with the member or any other broker/dealer, will be terminated or suspended, respectively, from all securities activities conducted directly by the financial institution. Many commentators strongly objected to the jurisdictional reach of this provision.[48] The commentators stated that financial institutions must retain the discretion to determine what situations justify an employee's termination or suspension.

One commentator stated that there may be a multitude of NASD, SEC or other regulatory reasons for which an employee may be suspended. The commentator maintained that some of these reasons may by regulation require a financial institution to suspend or terminate the employee's activities. However, the financial institution may not in the exercise of its independent judgment consider certain other reasons as justification for barring the employee from engaging in securities activities conducted by the financial institution.[49]

Further, one commentator stated that requiring the financial institution to agree to terminate or suspend employees would result in the creation of a ''black list'' of employees that could potentially expose the financial institution to lawsuits by such black-listed employees.[50] Rather than adopting the proposed contractual agreement of the financial institution to terminate or suspend employees, one commentator proposed that financial institutions be provided access to the Form U–5 for terminated employees.[51]

In response to the foregoing comments, the NASD has amended the proposed rule change to delete paragraph (c)(4)(D).

Competition—Paragraph (C)(4)(E) of the original proposed rules required that a contractual agreement with the financial institution provide that ''unregistered employees of the financial institution will not receive any compensation, cash or non-cash, that is based on the effectiveness or success of referrals * * *.'' Many commentators, including the ABA, BSA and OCC, urged the NASD to define the terms ''success'' and ''effectiveness of referrals'' arguing that a prohibition based on the effectiveness of sales rather than a transactional nexus is too ambiguous.[52] The commentators asked how the provision would apply where the financial institution provides payment for referrals that result in an appointment with a broker/dealer rather than a transaction.

The ABA also stated that a standard based on the success or effectiveness of referrals is stricter than existing NASD and financial institution standards that permit a referral payment where it is not tied to the success of a sale or opening of a broker/dealer account.[53]

Other commentators, including the ABA and the BSA, challenged the NASD's authority to regulate the compensation paid by a financial institution to its employees through contractual obligations of an NASD member.[54] These commentators stated that, as a general matter, financial institution regulations provide adequate investor protection safeguards with regard to the financial institution's payment of referral fees and, accordingly, NASD regulation of such payments was not required.

In response to the foregoing comments, the NASD has amended this provision to prohibit compensation that is conditioned on whether a referral results in a transaction, which is consistent with comparable provisions of the Interagency Statement. *See,* paragraph (c)(2)(B) of the proposed rule change.

Notification—Paragraph (c)(5) of the original proposed rules provided that the networking or brokerage affiliate agreement must require that the member notify the financial institution if any dual employee who is associated with the member is terminated for cause by the member. Three commentators asserted that the provision would lead to civil penalties because the disclosure of the reasons for a suspension and/or termination raises privacy issues which, absent permission from the associated person, may subject the broker/dealer to civil liabilities.[55] One commentator suggested that should the NASD determine to address the civil liability issues, it would be more appropriate to require the broker/dealer to notify the financial institution that it would no longer utilize the services of a financial institution employee and, thereafter, direct the financial institution to review the employee's Form U–5.[56]

The NASD has determined to retain this provision as paragraph (c)(2)(C) substantially unchanged. The NASD believes the financial institution should have this information in order for it to review and determine its own regulatory obligations with respect to the terminated individual.

5. Personnel Registration/Associated Person. Subsection (c)(6) of the original proposed rule change provided that broker/dealer services offered by the member could be provided only by

[45] *See,* comment letters 1, 4, 10, 17, 21, 23, 27, 28, 30, 37, 48, 59, 62, 63, 77, 80, 84, 104, 107, 121, 128, 134, 140, 142, 148, 153, 156, 181, 186, 207, 208, 234, 236, 242, 274, 281 and 282.

[46] *See,* comment letter 59.

[47] *See,* comment letter 30.

[48] *See,* comment letters 1, 4, 10, 17, 21, 23, 27, 28, 30, 37, 48, 59, 62, 63, 77, 80, 84, 104, 107, 121, 128, 134, 140, 142, 148, 153, 156, 181, 186, 207, 208, 234, 236, 242, 274, 281 and 282.

[49] *See,* comment letter 21.

[50] *See,* comment letter 128.

[51] *See,* comment letter 28.

[52] *See,* comment letters 7, 16, 19, 23, 27, 28, 37, 48, 59, 84, 86, 104, 107, 108, 110, 115, 129, 140, 142, 173, 181, 183, 186, 192, 236, 240, 244, 260, 274 and 282.

[53] *See,* comment letter 8.

[54] *See,* comment letters 1, 11, 17, 19, 28, 62, 63, 64, 83, 84, 104, 115, 121, 128, 131, 138, 153, 192, 202, 208, 216, 224, 233, 251, 281 and 282.

[55] *See,* comment letters 28, 40 and 177.

[56] *See,* comment letters 28.

persons associated with the member, except that unregistered dual employees of the member and financial institution could provide ''clerical and ministerial assistance.'' Several commentators requested clarification of the phrase ''clerical and ministerial assistance,''[57] and observed that limiting employees activities to ''clerical and ministerial'' duties could be viewed as ignoring the exemption from broker/dealer registration afforded banks under Section (3)(a)(6) of the 1934 Act. In addition, the commentators asked that subsection (c)(6) be clarified to focus on the participation of unregistered financial institution employees in a member's sales activities, rather than participation of unregistered financial institution employees in a financial institution's direct sales efforts.

In response to the comments, the NASD has determined that subsection (c)(6) is redundant of other provisions of the securities laws and, therefore, is unnecessary. Bank employees may engage in direct securities activities pursuant to the exemption from broker/dealer registration contained in Section 3(a)(6) of the 1934 Act, subject only to the restrictions on bank securities activities in federal banking law. To the extent the employees of all other types of financial institutions engage in securities activities, they must be registered as associated persons of a registered broker/dealer. Accordingly, the NASD has amended the proposed rule change to delete subsection (c)(6).

6. Compensation of Registered/Unregistered Personnel.

Paragraph (c)(7)(A) of the original proposed rules provided that transaction-related compensation of a member's registered representatives, including dual employees, must be determined solely by the member. In response, the BSA, CBA, and several other commentators have advised the NASD that this requirement conflicts with existing financial institution regulations that require the financial institution to ensure that compensation does not influence sales of unsuitable products.[58] In addition, commentators maintained that this provision would compromise the ability of a financial institution to meet its overall company goals.

Paragraph (c)(7)(B) of the original proposed rule provided that employees of the financial institution who are not registered with the NASD member may not receive any compensation from the member, cash or non-cash, in connection with, but not limited to, the referral of customers of the financial institution to the member. Many commentators, including the ICI, BSA, CBA, and the FRB, argued that the provision is inappropriate and unwarranted because referral fees provide an appropriate incentive to increase customer awareness of all types of deposit and non-deposit products that are available to financial institution customers.[59] Moreover, commentators argued that banning such referral payments would create a competitive disadvantage for financial institution broker/dealers because members who do not operate on the premises of a financial institution have more leeway under SEC no-action letters and enforcement decisions in providing compensation to unregistered persons.

The commentators also argued that the referral fees prohibition is inconsistent with the Interagency Statement and the Chubb No-action Letter, among others. Finally, the commentators stated that the prohibitions regarding referral fees are inconsistent with the NASD's long-standing position that ''one-time fees not tied to the completion of a transaction or the opening of an account'' are permitted.[60] Several commentators were also confused about whether the financial institution and the broker/dealer were both prohibited from paying referral fees to unregistered employees.[61]

Paragraph (c)(7)(B) previously published for comment referred only to compensation paid by an NASD member. It would not have regulated the compensation a financial institution may provide to its own employees. The NASD's longstanding position regarding referral fees has been that if one-time payments by a member to an unregistered individual occur on a regular, on-going basis, the recipient is required to register as an associated person.[62] In addition, an NASD member may not do indirectly what it is prohibited from doing directly, i.e., an NASD member may not compensate employees of the financial institution for referrals through payments made directly to the employee or by payments directed in the first instance to the financial institution.

The NASD also believes the commentators misunderstand the meaning of the ''one-time payment exception'' that has previously been the policy of the NASD and was reflected in the provision published for comment. As stated above, the exception does not permit a series of ''one-time payments'' because such a series of payments would become part of the employee's regular course of business, a circumstance that would require registration. To meet the requirements of the exception that has previously been the policy of the NASD, a payment must be a singularly unusual event; i.e., so infrequent that it cannot be regarded as part of the regular business or activity of the employee.

In response to the comments received, however, the NASD has substantively amended the provisions of the original proposed rule change by clarifying and consolidating them into a single provision, subsection (c)(3), that prohibits a member from providing compensation to the employees of a financial institution who are not registered as associated persons of a member in connection with, but not limited to, locating, introducing, or referring customers of the financial institution to the member.

7. Supervision and Responsibility.

Paragraph (c)(8)(A) of the original proposed rules provided that a designated principal of the member shall supervise registered personnel at the member's location at the financial

[57] *See*, comment letters 6, 16, 27, 64, 84, 104, 110, 119, 130, 142, 172, 192, 206, 208, 213, and 233.

[58] *See*, comment letters 7, 10, 11, 16, 17, 21, 22, 23, 25, 26, 27, 28, 37, 47, 48, 88, 94, 100, 107, 108, 110, 112, 121, 122, 123, 129, 134, 135, 140, 147, 153, 154, 166, 186, 188, 190, 192, 207, 233, 234, 236, 237, 239, 240, 242, 260, 266, 269, 270, 271 and 282.

[59] *See*, comment letters 1, 3, 7, 8, 16, 18, 21, 22, 23, 25, 26, 27, 28, 29, 40, 44, 46, 59, 63, 75, 84, 88, 92, 93, 95, 98, 99, 100, 108, 111, 112, 115, 121, 123, 127, 129, 130, 135, 142, 143, 147, 153, 156, 166, 167, 168, 172, 188, 189, 191, 193, 204, 207, 210, 212, 213, 214, 230, 232, 235, 236, 239, 240, 244, 252, 255, 256, 265, 266, 269, 270, 272, 277, 279 and 284.

[60] In support of its argument that paying referral fees is acceptable and consistent with the NASD's long-standing position, the ICI cites NASD Notice to Members 89–3 (January 1993), in which the NASD proposed, but never adopted, a rule to restrict the payment of referral fees. The rule change proposed in NTM 89–3 would have permitted the payment by a member of a small fixed fee for a referral where the payment is occasional, not part of a practice of such payments to the recipient, not determined by the outcome of the referral, and where the recipient does not regularly engage in activity that might reasonably be expected to result in continued referrals.

The NASD believes the ICI is incorrect in its assertion that paying referral fees is acceptable and consistent with the NASD's longstanding position. Quite to the contrary, the rule change proposed herein is consistent with that position. The rule proposed in NTM 89–3 was a codification of the NASD's position that the payment of referral fees is not permitted, except in very narrow circumstances. Permitting the payment of referral fees for activity described in this proposed rule change would not have met the exception proposed in NTM 89–3.

[61] *See*, comment letters 4, 9, 14, 15, 16, 18, 21, 27, 29, 30, 39, 50, 64, 77, 80, 83, 84, 85, 86, 92, 94, 107, 108, 109, 122, 125, 144, 145, 152, 154, 155, 187, 203, 204, 205, 207, 213, 215, 220, 221, 222, 223, 237, 242, 258, 267, 275 and 277.

[62] *See*, NASD Guide to Rule Interpretations, 1994 Net Capital and Customer Protections Rules, p. 108.

institution. Several commentators urged the NASD to amend this provision to clarify that the designated principal deemed to be responsible for supervising registered personnel at the member's location at the financial institution is not required to be physically present at the financial institution location.[63] Further, commentators argued that the provision duplicates existing supervisory requirements applicable to all NASD members, as set forth in Article III, Section 27 of the Rules of Fair Practice.

The ICI argued that the NASD should delete paragraph (c)(8)(C) of the original proposed rules which required a member to supply financial institutions with written procedures that specify the limits of the permissible activities of unregistered persons.[64]

In response to the commentators, the NASD has determined to delete paragraph (c)(8) of the original proposed rules in its entirety as generally redundant of the member's obligations under already existing NASD rules.

8. Customer Disclosure and Written Acknowledgment. Subsection (c)(9) of the original proposed rules required a member to obtain a separate written acknowledgment at the time an account is opened that the securities products purchased or sold by the member through offices located on the premises of a financial institution: (1) Are not insured by the FDIC; (2) are not deposits or other obligations of the financial institution and are not guaranteed by the financial institution; (3) are subject to investment risks, including possible loss of the principal invested; and, (4) are not insured by the Securities Investor Protection Corporation (''SIPC'') as to the loss of principal amounts invested.

Several commentators argued that the disclosures required in the proposed separate written acknowledgment should be made by all broker/dealers because, as the BSA asserted, investors who purchase securities through non-financial institution broker/dealers would benefit equally from these required disclosures, especially non-financial institution broker/dealers offering insured products.[65]

Other commentators stated that a requirement to obtain written acknowledgment of the disclosures prior to conducting business with a customer who opens an account by telephone would have an adverse impact on members that service the financial institution's customers because many of these accounts are opened by telephone and written documentation is usually sent to the customer by the broker/dealer after the account is opened. These commentators proposed that the rule be amended to permit a member's registered representative to state the disclosure over the telephone and subsequently forward the written documentation for execution.[66]

Some commentators, including the CBA and BSA, opposed the concept of requiring a ''separate'' written acknowledgment of the required disclosures based on their belief that the Interagency Statement permits these disclosures to appear in the customer agreement or account application.[67] Accordingly, the BSA, the CBA, and other commentators proposed that the disclosures be a part of a new account form/account application.[68]

A number of the commentators, including the OCC, expressed concerns about competing disclosures of the NASD and financial institution regulators, especially when the expenses associated with printing disclosure documents are considered.[69] One commentator, Citicorp Investment Services, noted that compliance costs for the Interagency disclosures were in excess of one million dollars, yet the proposed rule change would require existing materials to be reprinted.[70] The commentators urged the NASD to coordinate with financial institution regulators to adopt one standard disclosure.

Many commentators, including the ICI, OCC, and the FRB, said that the proposed SIPC disclosure would cause greater confusion than existing disclosure requirements.[71] The commentators argued that the SIPC disclosure is confusing because it stands alone with no explanation of SIPC. The OCC and a number of other commentators recommended that, in the alternative, the NASD should amend the proposed rule change to require the SIPC disclosure only where sales activities include representations regarding SIPC. A number of commentators also expressed their view that the proposed SIPC disclosure is technically incorrect because the loss of principal amounts invested is protected where a broker/dealer becomes insolvent.[72] One commentator suggested that the SIPC disclosure be amended to state that ''losses due to market fluctuation are not protected by SIPC.''[73]

A large number of commentators also noted that the proposed SIPC disclosures discriminate among broker/dealers. They argued that if the SIPC disclosure requirement is to be adopted at all, the disclosures should apply to all member firms whether operating on financial institution premises or not; limiting SIPC disclosure to financial institution broker/ dealers is not only anti-competitive but misleading.[74]

In response to these comments, the NASD has determined to delete the proposed SIPC disclosure in paragraph (c)(9)(D). The required disclosure set forth in subsection (c)(4) of the proposed rule change is now substantively identical to that contained in the Interagency Statement.

9. Solicitation. Subsection (c)(10) of the original proposed rules prohibited members from using confidential financial information maintained by the financial institution to solicit customers for its broker/dealer services.[75] Many of the commentators argued that, to the extent there are special concerns when a financial institution provides confidential financial information, the concerns are properly the subject of financial institution regulation and existing federal privacy laws, not NASD rulemaking.

Some commentators who opposed the limitations advised the NASD that

[63] *See,* comment letters 17, 21, 27, 28, 64, 77, 121, 129, 138, 140, 156, 177, 181, 192, 234, 242, 245, 267, and 276.

[64] *See,* comment letter 167.

[65] *See,* comment letters 1, 6, 17, 21, 27, 61, 94, 104, 136, 173, 189, 217, 219 and 230.

[66] *See,* comment letters 17, 172 and 242.

[67] *See,* comment letters 10, 27, 84, 101, 102, 104, 115, 166, 172, 173, 192, 207, 212, 239, 250, 279 and 282.

[68] *See,* comment letters 10, 27, 84, 101, 192 and 239.

[69] *See,* comment letters 3, 4, 11, 28, 40, 50, 63, 64, 67, 75, 81, 104, 115, 120, 121, 128, 129, 130, 180, 208, 213, 234, 237, 252 and 279.

[70] *See,* comment letter 67.

[71] *See,* comment letters 1, 7, 9, 11, 12, 16, 19, 30, 37, 50, 54, 75, 76, 80, 81, 84, 90, 92, 93, 103, 107, 112, 113, 115, 121, 122, 123, 129, 137, 140, 143, 167, 172, 173, 177, 183, 204, 207, 210, 211, 224, 230, 234, 236, 244, 252 and 282.

[72] *See,* comment letters 20, 21, 22, 25, 27, 75, 76, 85, 94, 99, 104, 133, 137, 142, 147, 148, 156, 167, 168, 170, 178, 183, 186, 188, 190, 196, 210, 211, 216, 233, 266, 269, 270, 271 and 272.

[73] *See,* comment letter 233.

[74] *See,* comment letters 1, 3, 4, 7, 8, 17, 18, 22, 23, 25, 27, 37, 40, 47, 48, 50, 52, 54, 56, 63, 64, 77, 81, 84, 88, 92, 94, 99, 100, 104, 107, 109, 110, 115, 119, 121, 122, 123, 129, 130, 140, 142, 147, 153, 155, 167, 168, 169, 174, 177, 184, 186, 189, 190, 193, 197, 204, 207, 208, 212, 216, 225, 226, 227, 230, 236, 239, 240, 242, 256, 258, 266, 269, 270, 271 and 279.

[75] *See,* comment letters 1, 3, 8, 9, 10, 11, 12, 16, 17, 18, 19, 21, 22, 25, 26, 27, 28, 29, 30, 37, 40, 41, 44, 46, 52, 59, 60, 61, 62, 63, 64, 67, 72, 73, 75, 76, 82, 83, 84, 86, 88, 90, 91, 92, 95, 99, 100, 102, 104, 106, 110, 111, 112, 113, 115, 119, 121, 122, 123, 127, 129, 130, 131, 133, 136, 137, 138, 141, 142, 145, 147, 153, 154, 156, 166, 167, 168, 169, 170, 172, 173, 174, 176, 177, 178, 180, 183, 184, 186, 189, 190, 191, 192, 193, 197, 202, 204, 208, 209, 210, 211, 212, 216, 220, 224, 225, 226, 227, 230, 232, 233, 234, 236, 237, 239, 240, 242, 244, 255, 256, 258, 265, 266, 272, 274, 278, 281, 282 and 294.

prohibitions on a member's use of confidential financial information should apply equally to all broker/dealers. The commentators argued that there is no public policy reason why customer information possessed by affiliates of non-financial institution broker/dealers on real estate holdings, consumer finance loans, insurance, or other financial matters should be treated differently than customer information provided by a financial institution.

The commentators asked, however, if the NASD determines to retain this aspect of the proposed rule change, that the provision be amended to allow a member's use of confidential financial information where a customer has approved of such use. In addition, the OCC recommended that the provision be amended to require members to establish policies and procedures regarding the use of confidential financial information instead of banning the use of such information. Many commentators asked that the term ''confidential financial information'' be defined, if the NASD retains the provision in the proposed rule change.[76]

Finally, some commentators asked how a member could restrict the use of confidential information where dual employees have access to the information.[77] Another commentator asked that the rule be amended to permit the financial institution to control abusive use of confidential financial information where a wholly-owned broker/dealer subsidiary is involved.[78] Another commentator also urged that sharing confidential information should be permitted where the financial institution and the broker/dealer are affiliates.[79]

In response to the comments, the proposed rule change has been amended in subsection (c)(5) under a new heading entitled ''Use of Confidential Information'' to allow the use of confidential financial information with the prior written approval of the customer. In addition, a definition of the term ''confidential financial information'' has been added to the proposed rule change which provides that information will not be regarded as confidential if it can be obtained from unaffiliated credit bureaus or similar companies in the ordinary course of business.[80] Further, a customer's name, address and telephone number are not confidential information unless the customer specifies otherwise.

10. Communications with the Public. Paragraph (c)(11)(B) of the original proposed rule change required that all communications regarding securities transactions and long and short positions, including confirmations and account statements, must clearly indicate that the broker/dealer services are provided by the member and not by the financial institution, and must be sent directly to the customer by the member. Commentators, including the ICI, ABA, BSA, CBA, FRB, and the OCC, asked that this provision be amended to permit combined account statements of a broker/dealer and a financial institution as a customer service.[81] These commentators argued that requiring a separate statement would increase costs, reduce efficiencies and frustrate consumers. These commentators also noted that the prohibition is particularly problematic with respect to ''sweep accounts'' and individual retirement accounts at financial institutions which allow for investments in securities products offered through an NASD member.

Paragraph (c)(11)(B) of the original proposed rule change also required that all communications sent by the member to a customer must clearly indicate that the broker/dealer services are provided by the member and not by the financial institution. Several commentators asserted that requiring the member to disclose that the financial institution is not the broker/dealer may lead to customer confusion.[82] These commentators also asked whether the requirement that the communication ''clearly indicate that the broker/dealer services are provided by the member'' requires an affirmative statement to that effect. Finally, one commentator argued that identifying a specific financial institution in the disclosure is burdensome where a member is networking with more than one financial institution.[83]

Finally, paragraph (c)(11)(B) of the original proposed rules also required the member to ensure that any documentation regarding securities transactions sent directly to a member's customer by an issuer, transfer agent, or principal underwriter is in compliance with the federal securities laws and NASD rules. Several commentators argued that the member should not be responsible for correspondence from the issuer, transfer agent, or underwriter, particularly in the absence of SEC rules requiring these entities to submit such communications to the NASD member firm for review prior to dissemination.[84]

One commentator also argued that smaller members may not have the economic clout to require the issuer, underwriter, and others to submit such documentation to the member in order to ensure that they comply with the rules.[85] Another commentator asserted that ensuring that documents sent by third parties comply with SEC and NASD rules would impose strict liability upon members for matters that are often beyond their knowledge or control.[86] Another commentator stated that the rule would make the member liable for misrepresentations appearing in prospectuses and offering circulars about which the member has no knowledge.[87]

In response to the comments received, the proposed rule change has been amended to permit a joint account statement where the member's securities products are clearly distinguished from FDIC-insured products of the financial institution, which is included as paragraph (c)(6)(A) of the proposed rule change. In addition, the provision has been amended to delete the requirement for members to ensure the accuracy of communications sent by third parties.

Paragraph (c)(11)(C) of the original proposed rules provided that any advertisement or sales literature, as defined in Article III, Section 35 of the NASD Rules of Fair Practice, used to describe or promote the availability of broker/dealer services of the member on the premises of a financial institution

[76] *See*, comment letters 13, 16, 17, 18, 21, 22, 24, 26, 29, 31, 32, 37, 38, 39, 45, 47, 54, 56, 72, 74, 79, 80, 81, 85, 108, 110, 111, 112, 118, 119, 121, 127, 128, 129, 130, 131, 132, 135, 138, 144, 146, 147, 148, 151, 157, 165, 169, 182, 183, 187, 188, 189, 190, 192, 193, 194, 198, 201, 205, 206, 216, 220, 221, 224, 231, 239, 240, 241, 243, 246, 251, 259, 263, 271, 276 and 280.

[77] *See*, comment letters 6, 10, 59, 193 and 244.

[78] *See*, comment letter 138.

[79] *See*, comment letter 94.

[80] The NASD has indicated that credit bureaus obtain and report information concerning the creditworthiness of individuals such as loan payment histories, checking and savings account activity, available credit, and total debt information. Similarly, the NASD staff has stated its belief that credit bureaus do not maintain net worth information including the value of the customer assets such as property, depository accounts, certificates of deposits, securities and other investments. *See* Letters from Elliott R. Curzon and Suzanne E. Rothwell, Assistant General Counsel, NASD, to Mark Barracca, Branch Chief, SEC, note 2, *supra*.

[81] See, comment letters 15, 23, 26, 28, 30, 31, 35, 39, 40, 42, 43, 46, 47, 48, 53, 54, 56, 58, 69, 71, 75, 76, 77, 78, 80, 83, 86, 110, 115, 116, 117, 119, 122, 123, 124, 126, 127, 128, 129, 131, 135, 136, 140, 143, 145, 146, 148, 152, 156, 158, 159, 162, 163, 167, 184, 186, 187, 188, 189, 190, 192, 194, 199, 200, 201, 205, 207, 224, 233, 239, 241, 243, 245, 246, 248, 251, 276, 279, 280 and 281.

[82] See, comment letters 7, 23, 37, 75, 107, 108, 115, 137, 142, 155, 167, 208, 212, 213, 236, 267 and 279.

[83] See, comment letter 213.

[84] See, comment letters 7, 17, 21, 25, 27, 63, 64, 84, 110, 121, 129, 140, 156, 181, 207, 234, 242, 276 and 282.

[85] See, comment letter 7.

[86] See, comment letter 25.

[87] See, comment letter 63.

must be approved by the member prior to distribution, in compliance with Article III, Section 35(b)(1) and, where required, filed with the NASD Advertising Regulation Department. Several commentators asserted that this provision would expand the filing requirements of members because it would require that all advertisements issued by a financial institution that mention the member be filed with the NASD.[88] The FRB asserted that the NASD does not need to review financial institution advertisements that describe products and services offered by an NASD member because such materials are reviewed by financial institution regulators to ensure that the materials are accurate and not misleading.[89]

In response to the comments received, the NASD has deleted this provision and substituted more general requirements in paragraphs (c)(6)(B) and (C) to require that the financial institution may only be referenced by a member in a non-prominent manner in advertisements, sales literature or similar materials, and that such material, if jointly issued by the member and the financial institution, must distinguish clearly between the products and services offered by the member and the financial institution.

Paragraph (c)(11)(D) of the original proposed rule provided that advertisements and sales materials issued by the member which relate exclusively to its broker/dealer services must indicate prominently that the broker/dealer services are being provided by the member and not the financial institution; that the financial institution is not a registered broker or dealer; and whether the member is or is not affiliated with the financial institution. The ICI and other commentators asserted that requiring a member to reference the financial institution for the sole purpose of complying with this provision, although the financial institution is not otherwise affirmatively mentioned, may lead to customer confusion.[90] The BSA and other commentators also argued that stating that the bank is not a broker/dealer ignores the fact that the bank may be operating as a broker/dealer exempt from registration under the 1934 Act. Indeed, one commentator suggested that stating that the bank is not a broker/dealer connotes inferiority and misleads the public by implying that the bank is required to be registered.[91] Another commentator noted that stating that the bank is not a broker/dealer would be inaccurate with respect to its particular arrangement because the financial institution in its case operates a bond department which is in fact a registered broker/dealer.[92]

Some commentators, including the ABA and CBA, stated that no disclosures should be required beyond what is presently required by the Interagency Statement (i.e., deposits are not FDIC insured, obligations of the financial institution or guaranteed by the financial institution, and involve risks.)[93]

In response to the commentators, the NASD has amended this provision, now set forth in paragraph (c)(6)(B), to delete the requirements that members disclose that the financial institution is not a registered broker/dealer, and whether the member is or is not affiliated with the financial institution. The provision now requires disclosure of any material relationship between the member and the financial institution.

Paragraph (c)(11)(D) of the original proposed rules also permits advertisements and sales literature issued by the member which relate exclusively to its broker/dealer services to reference the financial institution in a non-prominent manner solely for the purpose of identifying the location where broker/dealer services are available. The ICI, BSA, CBA, and the FRB said that restrictions on references to the financial institution may be misleading where the financial institution acts as an investment adviser to proprietary funds.[94] These commentators believe that the restrictions on references to the financial institution may prevent truthful advertising of the affiliation between the financial institution and the broker/dealer. The NASD has modified this requirement, which is now set forth in paragraph (c)(6)(B) of the proposed rule change, consistent with the provisions of the Chubb Letter.

Other commentators stated that the limitations on references to the financial institution set forth in paragraph (c)(11)(D) are inconsistent with Article III, Section 35, which allows a member to use a ''generic name,'' provided that the identity of the member firm and its relationship to the name are conspicuously set forth.[95] The NASD does not intend for the proposed rule change to modify the ability of members to rely on Article III, subsection 35(f)(3)(B) to use a generic name.

Paragraph (c)(11)(E) of the original proposed rule change permitted jointly issued material if the name of the member is displayed prominently in the section of the materials that describes the broker/dealer services offered by the member, which section will be deemed material of the member. This concept of segregated advertising, according to the ICI, the FRB, and other commentators, will prove to be problematic in practice because it is difficult to physically separate the discussion of broker/dealer services when the product offered includes services from both the depository institution and the broker/dealer.[96] In response to these comments, the NASD has amended the provision set forth in paragraph (c)(6)(C) of the proposed rule change to require that joint sales materials ''distinguish'' the products of the member from those of the financial institution.

Some commentators suggested that the NASD amend paragraph (c)(11)(E) to provide for introductory letters permitting the financial institution to introduce financial institution customers to the broker/dealer.[97] The NASD has determined not to amend the proposed rule change as requested, because it does not believe the proposed rules currently prohibit such letters.

Finally, paragraph (c)(11)(D) of the original proposed rules provided that the financial institution must appear in a non-prominent manner in advertising relating exclusively to broker/dealer services, while paragraph (c)(11)(E) of the original proposed rules states that the name of the member must be displayed prominently in the section of jointly issued material that describes broker/dealer services offered by the member. Some commentators asked that the term ''prominently'' be defined.[98] Further, some of these commentators maintained that the provisions are inherently inconsistent with one another in that they require the financial institution to appear in a non-prominent manner, while also requiring the member to disclose that the financial institution is not a broker/dealer and broker/dealer services are not offered by the financial institution.[99] The NASD has amended these provisions which are set forth in paragraph (c)(6)(B) and (C)

[88] *See*, comment letters 30, 115, 129 and 211.

[89] *See*, comment letter 103.

[90] *See*, comment letters 7, 23, 37, 75, 107, 108, 115, 137, 142, 154, 167, 208, 212 and 279.

[91] *See*, comment letter 121.

[92] *See*, comment letter 90.

[93] *See*, comment letters 3, 7, 40, 92, 94, 166, 184, 204 and 239.

[94] *See*, comment letters 19, 25, 27, 29, 52, 67, 68, 81, 84, 104, 114, 115, 119, 129, 172, 192, 196, 212 and 245.

[95] *See*, comment letters 17, 21 and 242.

[96] *See*, comment letters 63, 80, 103, 104, 115, 233, 279 and 167.

[97] *See*, comment letters 9, 154, 180 and 213.

[98] *See*, comment letters 80, 135, 140, 181, 213 and 215.

[99] *See*, comment letters 1, 27, 84 and 208.

by eliminating the provisions which create the apparent inconsistency.

Some commentators asserted that communications with the public should be uniform among all broker/dealers if eliminating customer confusion is truly the NASD's goal.[100] The NASD agrees and believes the proposed rule change advances that goal.

D. Financial Institution Logos. While the proposed rule change does not specifically address the issue of the use of financial institution logos in advertisements and sales literature, several commentators, including the FRB, asked the NASD to clarify its position on the use on financial institution logos by NASD members to dispel any confusion about the permissibility of using financial institution holding company family logos. The FRB urged the NASD to permit the broker/dealer to use an affiliated financial institution logo to advertise its services.[101] Subsequent to the publication of Notice to Members 94–94, the NASD issued Notice to Members 95–49 to clarify its previous statements on the use of logos of financial institutions in advertisements and sales literature of members in a manner consistent with the Chubb Letter. The Notice stated that the logo of a non-member (representative only of the non-member) may only be used in member communications to identify the non-member entity.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

The NASD consents to an extension of the time for Commission action to 30 days from the end of the comment period specified in Item IV below. At such time, the Commission will:

A. By order approve such proposed rule change, or

B. Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by May 21, 1996.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[102]

Margaret H. McFarland,

Deputy Secretary.

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[100] *See,* comment letters 48, 63, 66, 84, 129 and 208.

[101] *See,* comment letters 11, 85, 103, 121, 140, 184, 189, 191, 216, 234, and 282.

[102] 17 CFR 200.30–3(a)(12).

[Release No. 34–36981; File No. SR–PSE–95–28]

Self-Regulatory Organizations; Order Approving Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval of Amendment Nos. 1, 2, and 3 to the Proposed Rule Change by the Pacific Stock Exchange, Inc., Relating to Establishing a Hedge Exemption for Narrow-Based Index Options

March 15, 1996.

On November 1, 1995, the Pacific Stock Exchange, Inc. (''PSE'' or ''Exchange'') submitted to the Securities and Exchange Commission (''SEC'' or ''Commission''), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] a proposed rule change to amend PSE Rule 7.6, ''Position Limits for Index Options,'' to establish a hedge exemption from industry (narrow-based) index option position and exercise limits.[3]

The proposed rule change was published for comment in the Federal Register on December 6, 1995.[4] On January 31, 1996, on February 29, 1996, and on March 15, 1996, the PSE amended its proposal.[5] No comments were received on the proposed rule change.

The PSE proposes to amend its rules to provide that industry index option positions may be exempt from established position and exercise limits for each contract ''hedged'' by an equivalent dollar amount of the underlying component securities or securities convertible into such components, provided that each option position to be exempted is hedged by a position in at least 75% of the number of component securities underlying the index, and that the underlying value of the option position does not exceed the value of the underlying portfolio. The value of the portfolio is: (a) The total market value of the net stock position, less (b) the value of (1) any offsetting calls and puts in the respective index option; (2) any offsetting positions in related stock index futures or options; and (3) any economically equivalent positions.[6] The values of any such index option position or related futures position are determined by aggregating the notional value[7] of each option contract comprising the position. Under the proposed exemption, position and exercise limits for any hedged industry

[1] 15 U.S.C. § 78s(b)(1) (1988).

[2] 17 CFR 240.19b–4 (1995).

[3] Position limits impose a ceiling on the number of option contracts which an investor or group of investors acting in concert may hold or write in each class of options on the same side of the market (*i.e.*, aggregating long calls and short puts or long puts and short calls). Exercise limits prohibit an investor or group of investors acting in concert from exercising more than a specified number of puts or calls in a particular class within five consecutive business days.

[4] *See* Securities Exchange Act Release No. 36526 (November 29, 1995), 60 FR 62517.

[5] On January 31, 1996, the PSE amended its proposal to indicate that the requirements of subsections (a), (b), (c), (f), (g), (h), and (i) of Commentary .02, ''Broad-Based Index Hedge Exemption,'' will apply to narrow-based index option hedge exemptions. In addition, the PSE clarified its rules by indicating that exercise limits will correspond to position limits under both the narrow-based and broad-based index hedge exemptions. Finally, the PSE stated that whenever the Exchange grants a narrow-based index option hedge exemption, it will monitor the equity position used as a hedge on a daily basis. *See* Letter from Michael D. Pierson, Senior Attorney, Market Regulation, PSE, to Yvonne Fraticelli, Attorney, Office of Market Supervision (''OMS''), Division of Market Regulation (''Division''), Commission, dated January 30, 1996 (''Amendment No. 1''). On February 29, 1996, the PSE amended its proposal to indicate that economically equivalent positions must be deducted from the market value of the net stock position in order to determine the value of the underlying portfolio. The amendment also provides examples of the number of contracts that a market participant may hold and exercise pursuant to the exemption. *See* Letter from Michael Pierson, Senior Attorney, Market Regulation, PSE, to Yvonne Fraticelli, Attorney, OMS, Division, Commission, dated February 29, 1996 (''Amendment No. 2''). On March 15, 1996, the PSE clarified the test of its rule by indicating that the position in a narrow-based index option may not exceed the total of: (a) the limit established under PSE Rule 7.6, plus (b) two times that limit (for hedged positions). *See* Letter from Michael D. Pierson, Senior Attorney, Market Regulation, PSE, to Yvonne Fraticelli, Attorney, OMS, Division, Commission, dated March 14, 1996 (''Amendment No. 3'').

[6] *See* Amendment No. 2, *supra* note 5.

[7] Notional values are determined by adding the number of contracts and multiplying the total by the multiplier, expressing that number in dollar terms.