electronic media.[12] Rule 2830 applies to the activities of members in connection with investment company securities.[13] ICI notes that Rules 2830(d), 2830(k)(7), and 2830(l)(1)(C), which apply to sales charges, execution of investment company portfolio transactions, and dealer concessions, respectively, should be included in the NTM to confirm that electronic disclosure meets the requirements in these rules in the case of a prospectus that is delivered electronically.[14] Concerning Rule 3010(g)(2), which defines the term ''branch office,'' ICI believes that the NTM should clarify the requirements of the rule may be satisfied through electronic delivery of sales material.[15]

In its response, the NASDR does not agree that these rules should be added to the NTM.[16] According to the NASDR, ''the rules the ICI suggests adding to the NTM do not specifically address the delivery of information between broker/dealers and customers, but instead concern substantive obligations that arise under NASD rules regardless of whether information is submitted in electronic or non-electronic form.'' [17] Notwithstanding its decision to exclude the rules from the NTM, the NASDR agrees that the disclosure requirements of Rules 2210(d), 2210(f), IM–2210–3, and 3010(g)(2) may be satisfied using electronic media where the communication itself is made electronically.[18] The NASDR also agrees that the disclosure requirements of Rules 2830(d), 2830(d)(4), 2830(k)(7), and 2830(l)(1)(C) may be met if the prospectus is electronically delivered.[19]

In the notice, the Commission requested comment on what types of security measures broker-dealers employ or will employ to reasonably assure themselves that the responses they receive electronically from customers are authentic.[20] According to ICI, while no formal survey of its membership was conducted, one member has indicated that it requires each customer who wishes to communicate electronically regarding his or her securities account, provide his or her social security number, customer account number, and personal identification number before electronic access to the account will be allowed.[21] For certain institutional clients, another member uses a security system which includes encryption technology and a password requirement.[22]

The Commission reiterates its concern that adequate security measures must be implemented by members to protect customers' personal financial information and to prevent unauthorized transactions when ''receiving'' or ''obtaining'' electronic responses from their customers. The Commission recognizes that the security measures instituted will vary depending on the computer's hardware and software capabilities, as well as, on the information being sent or received. However, an effort should be made to secure customers' information, as the two ICI members have done, by developing procedures and improving technology, when feasible.

IV. Discussion

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations promulgated thereunder. Specifically, the Commission believes that approval of the proposed rule change is consistent with Section 15A(b)(6) [23] of the Act.[24] Pursuant to Section 15A(b)(6), the proposed rule change benefits the public, because it not only allows customers easy and efficient access to account information, but also requires an evaluation of systems and procedures by members to ensure that the privacy of personal information is maintained. In using the Commission's releases as a guide,[25] the Association has established a uniform policy concerning electronic delivery of information which should allow members and member organizations to satisfy their delivery obligations under the federal securities laws and the Association's rules. This uniform policy should simplify compliance by members and member organizations and aid the Association in monitoring the same.

For the above reasons, the Commission believes that the proposed rule change is consistent with the provisions of the Act, and in particular with Section 15A(b)(6).

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[26] that the proposed rule change (SR–NASD–97–57) be, and hereby is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[27]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 97–31844 Filed 12–4–97; 8:45 am]

BILLING CODE 8010–01–M

[12] *Id.*

[13] *See* NASD Manual, Conduct Rules, Rule 2830, p. 4621.

[14] ICI Letter, p. 3.

[15] *Id.*

[16] Letter from Mary N. Revell, Associate General Counsel, NASD Regulation, Inc., to Katherine England, Assistant Director, SEC, dated November 13, 1997 (''NASDR Letter''), p. 2.

[17] *Id.* at p. 2.

[18] *Id.*

[19] *Id.* at pp. 2–3.

[20] *See supra* note 10.

[21] ICI Letter at p. 2.

[22] *Id.*

[23] Section 15A(b)(6) requires the Commission to determine that an Association's rules are designed to prevent fraudulent acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

[24] Pursuant to Section 3(f) of the Act, the Commission has considered the proposed rule's impact on efficiency, competition, and capital formation. 15 U.S.C. § 78c(f).

[25] *See supra* notes 6 and 7.

[26] 15 U.S.C. 78s(b)(2).

[27] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–39361; File No. SR–NASD–97–69]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Tape Recording of Conversations

November 26, 1997.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] notice is hereby given that on September 12, 1997, as amended on November 17, 1997,[2] NASD Regulation, Inc. (''NASD Regulation'') 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 have been prepared by NASD Regulation. 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

NASD Regulation is proposing to amend National Association of Securities Dealers, Inc. (''NASD'' or ''Association'') Rule 3010 to require tape recording of conversations where members hire more than a specified percentage of registered persons from certain firms that have been expelled or

[1] 15 U.S.C. § 78s(b)(1).

[2] On November 17, 1997, NASD Regulation filed Amendment No. 1 with the Commission. In Amendment No. 1, the NASD clarified that firms will be required to establish procedures required by the Rule when either information supplied by NASD Regulation or the firm's actual knowledge indicates that it is the subject of the Rule, and added a new provision defining the term, ''registered person,'' and moving the definition of a ''disciplined firm'' to a different location in the Rule for ease of reference. *See* Letter from Mary N. Revell, Associate General Counsel, NASD, to Katherine A. England, Assistant Director, Office of Market Supervision, Division of Market Regulation (November 17, 1997).

that have had their broker/dealer registrations revoked for egregious violations of sales practice Rules. The proposed Rule change also includes a conforming Rule change to Rule 9610. Below is the text of the proposed Rule change. Proposed new language is in italics.

Conduct Rules

Rule 3010. Supervision

(a) No change

(b) Written Procedures

(1) Each member shall establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives and associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable rules of this Association.

(2) Tape recording of conversations

(i) Each member that either is notified by NASD Regulation or otherwise has actual knowledge that it meets one of the criteria in paragraph (b)(2)(viii) relating to the employment history of its registered persons at a Disciplined Firm as defined in paragraph (b)(2)(x), shall establish, maintain, and enforce special written procedures for supervising the telemarketing activities of all of its registered representatives.

(ii) The member must establish the supervisory procedures required by this paragraph within 30 days of receiving notice from NASD Regulation or obtaining actual knowledge that it is subject to the provisions of this paragraph.

(iii) The procedures required by this paragraph shall include tape-recording all telephone conversations between the member's registered representatives and both existing and potential customers.

(iv) The member shall establish reasonable procedures for reviewing the tape recordings made pursuant to the requirements of this paragraph to ensure compliance with applicable securities laws and regulations and applicable rules of this Association. The procedures must be appropriate for the member's business, size, structure, and customers.

(v) All tape recordings made pursuant to the requirements of this paragraph shall be retained for a period of not less than three years from the date the tape was created, the first two years in an easily accessible place. Each member shall catalog the retained tapes by registered representative and date.

(vi) Such procedures shall be maintained for a period of two years from the date that the member establishes the procedures required by the provisions of this paragraph.

(vii) By the 30th day of the month following the end of each calendar quarter, each member firm subject to the requirements of this paragraph shall submit to the Association a report on the member's supervision of the telemarketing activities of its registered representatives.

(viii) The following members shall be required to adopt special supervisory procedures over the telemarketing activities of their registered representatives:

** A firm with at least five but fewer than ten registered persons, where 40% or more of its registered persons have been employed by one or more Disciplined Firms within the last two years;*

** A firm with at least ten but fewer then twenty registered persons, where four or more of its registered persons have been employed by one or more Disciplined Firms within the last two years;*

** A firm with at least twenty registered persons, where 20% or more of its registered persons have been employed by one or more Disciplined Firms within the last two years.*

(ix) For purposes of this Rule, the term ''registered person'' means any person registered with the Association as a representative, principal, or assistant representative pursuant to Rule 1020, 1030, 1040, and 1110 Series.

(x) For purposes of this Rule, the term ''disciplined firm'' means a member that, in connection with sales practices involving the officer, purchase, or sale of any security, has been expelled from membership or participation in any securities industry self-regulatory organization or its subject to an order of the Securities and Exchange Commission revoking its registration as a broker/dealer.

(xi) Pursuant to the Rule 9600 Series, the Association may exempt any member from the requirements of this paragraph unconditionally or on specified terms and conditions upon a satisfactory showing that the member's supervisory procedures ensure compliance with applicable securities laws and regulations and applicable rules of the Association.

(3) The member's written supervisory procedures shall set forth the supervisory system established by the member pursuant to Rule 3010(a) above, and shall include the titles, registration status and locations of the required supervisory personnel and the responsibilities of each supervisory person as these relate to the types of business engaged in, applicable securities laws and regulations, and the rules of this Association. The member shall maintain on an internal record the names of all persons who are designated as supervisory personnel and the dates for which such designation is or was effective. Such record shall be preserved by the member for a period of not less than three years, the first two years in an easily accessible place.

(4) A copy of member's written supervisory procedures, or the relevant portions thereof, shall be kept and maintained in each OSJ and at each location where supervisory activities are conducted on behalf of the member. Each member shall amend its written supervisory procedures as appropriate within a reasonable time after changes occur in applicable securities laws and regulations including the rules of this Association, and as changes occur in its supervisory system, and each member shall be responsible for communicating amendments through its organization.

(c) through (f) No change

(g) Definitions

(1) through (3) No change

* * * * *

Rule 9600. Procedures for Exemptions

Rule 9610. Application

(a) File With General Counsel

A member seeking an exemption from Rule 1021, 1022, 1070, 2210, 2340, 2520, 2710, 2720, 2810, 2850, 2851, 2860, Interpretive Material 2860–1, *3010*, 3350, 11870, or 11900, Interpretive Material 2110–1, or Rule G–37 shall file a written application with the Office of General Counsel of NASD Regulation.

* * * * *

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

In its filing with the Commission, NASD Regulation 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. NASD Regulation 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 the Statutory Basis for, the Proposed Rule Change

Background

At its meeting in July 1996, the NASD Regulation Board of Directors authorized the staff to issue a Notice to Members soliciting comment on proposed changes to NASD supervisory Rule 3010 to require the tape-recording of telephone conversations of registered representatives in certain circumstances. The original Rule was developed both to respond to concerns expressed in the *Joint Regulatory Sales Practice Sweep (''Sweep'') Report*[3] regarding the need for heightened supervision of certain registered representatives with troubled regulatory and compliance records and also to address the particular problems that occur when a firm hires a large number of individuals who formerly worked at a firm that has been expelled or has had its registration revoked in connection with sales practice violations (a ''Disciplined Firm'') where they were inadequately supervised and trained.

The Sweep was an initiative involving the staffs of the NASD, the SEC, the New York Stock Exchange, and representatives of the North American Securities Administrators Association (collectively, the ''Working Group'') to review the sales-practice activities of selected registered representatives and the hiring, retention, and supervisory practices of the brokerage firms employing them in order to identify possible problem registered representatives, review their sales practices, and assess whether adequate hiring, retention, and supervisory mechanisms are in place.[4] The Sweep Report was released on March 18, 1996.

One of the key findings of the Sweep Report was that some firms are willing to employ registered representatives with a history of disciplinary actions or customer complaints. Based on this finding, the Working Group collectively recommended that firms that hire registered representatives with a recent disciplinary history involving sales practice abuse or other customer harm should implement special supervisory procedures tailored to the individual registered representative, which include a heightened level of scrutiny of the registered representative's activities by his or her supervisor, for a period of time.[5] The Sweep Report recommended that, if firms fail to establish such special supervisory procedures, the self-regulatory organizations (''SROs'') should consider revising their rules to specifically require that registered representatives with a recent history of disciplinary actions involving sales practice abuse or other customer harm be placed under special supervision by the firm for a period of time.

The NASD and the NYSE have issued a memorandum discussing the Sweep Report and providing guidance on actions firms could take to provide heightened supervision of problem registered representatives.[6] While the special procedures designed to provide a heightened level of supervision recommended by the Sweep Report and described in the NASD/NYSE memorandum may provide adequate supervision of associated persons in most circumstances, NASD Regulation proposes to adopt specific procedures in certain situations in order to provide the level of supervision required by Rule 3010.

NASD Regulation proposes to amend NASD Rule 3010 to require firms that hire a specified number of individuals from Disciplined Firms to tape-record telephone conversations between their registered representatives and existing and potential customers. The proposed Rule would apply when a firm hires a substantial number of registered persons from a firm or firms that have been expelled or had their registrations revoked for sales practice abuse. The measures described by the rule are designed to prevent a reoccurrence of sales practice abuse or other customer harm that caused the Disciplined Firm to be expelled or have its registration revoked. The proposal is similar to an interpretation adopted by the National Futures Association (''NFA'') in 1993 to combat abusive cold calling.[7] The NFA's interpretation is discussed below.

Notice to Members 96–59 and Original Proposal

Notice to Members 96–59 (''Notice to Members''), containing the original proposed Rule (''original proposal'' or ''original Rule''), was issued in September 1996. The requirements of the original Rule would have been triggered whenever a significant portion of a member's work force was comprised of associated persons who formerly were employed by a Disciplined Firm or firms or when the firm itself was a Disciplined Firm. The original proposal defined a Disciplined Firm, for purposes of the Rule, as one that had been disciplined (*i.e.*, expelled, suspended, or enjoined) by a regulatory entity, an SRO, or a court within the previous five years for telemarketing or sales-practice abuses in connection with the solicitation, offer, or sale of securities.

Under the original proposal as described in the Notice to Members, if more than 20 percent of a member's sales force of associated persons previously were employed by a Disciplined Firm, the member would have been required to adopt special written procedures to supervise the telemarketing activities of its associated persons. Firms that were themselves Disciplined Firms also would have been required to adopt these procedures. The procedures would have required, at a minimum, that the employer member tape record all telephone conversations between all of its associated persons and both existing and potential customers, and maintain these procedures for two years. For each firm that was itself a Disciplined Firm, at the end of the two-year period, the NASD would have conducted an evaluation to determine whether, and for how long, the firm would continue to be subject to the requirements of the Rule. The Rule also would have required firms subject to the taping requirement to review the tapes periodically to ensure compliance with securities laws and NASD rules, to submit reports to the NASD on their supervision of telemarketing activities, and to retain and index the tapes.

Comments and Response

Comments on the proposed Rule were requested by October 31, 1996. Of the 42 comments received in response to the Notice to Members, 39 were opposed to the proposal, including those filed by the Securities Industry Association, Lehman Brothers, Merrill Lynch, Morgan Stanley, and Smith Barney.[8]

[3] Staffs of the NASD, New York Stock Exchange, North American Securities Administrators Association, and the Office of Compliance Inspections and Examinations, SEC, *Joint Regulatory Sales Practice Sweep: A Review of the Sales Practice Activities of Selected Registered Representatives and the Hiring, Retention, and Supervisory Practices of the Brokerage Firms Employing Them* (March 1996).

[4] *Id.* at i.

[5] *Id.* at ii, iv.

[6] NASD Notice to Members 97–19 (April 1997); NYSE Information Memo 97–20 (April 15, 1997).

[7] *See* Letter from Lynn K. Gilbert, Deputy Director, Commodity Futures Trading Commission, to Daniel J. Roth, General Counsel, NFA (January 19, 1993).

[8] NASD Regulation received the following comment letters: (1) Letter from Brian C. Underwood, A.G. Edwards & Sons, Inc. (''Edwards''), dated October 31, 1996; (2) Letter from Kevin P. Howe, American Express Financial Advisors (''AEFA''), dated October 31, 1996; (3) Letter from G. Thomas Mitchell, Aurora Insurance and Securities, Inc. (''Aurora''), dated October 10, 1996; (4) Letter from Jerome Snyder, Barington Capital Group, L.P. (''Barington''), dated October 23, 1996; (5) Letter from Leslie D. Smith, Berthel Fisher Company (''Berthel''), dated October 25, 1996; (6) Letter from Walter I. Miller, Capital Growth

Most of the commenters support what they see as NASD Regulation's objective in proposing the taping Rule and agree that something should be done to deter a firm from recruiting groups of registered persons of dubious ethics or training from a Disciplined Firm. They also agree that firms and registered persons who have engaged in sales practice abuses should be disciplined. However, they don't agree with the proposal contained in the Notice to Members and have raised a number of concerns. Many of the commenters object to the concept of taping as a regulatory requirement, and fear that requiring taping in the circumstances described in the proposed Rule is the beginning of a new regulatory regime that may require even more comprehensive taping.

The definition of Disciplined Firm is too broad: Many of the commenters believe the definition of Disciplined Firm in the original Rule was too broad because it did not take into account the nature of the event that led to the disciplinary problem.[9] For example, a firm could be included in the definition because of an injunction resulting from a technical or inadvertent violation of state law or as the result of a consensual injunction involving only a fraction of the firm's employees or business activities. One commenter believes that the definition should be limited to firms that have been permanently barred from the securities industry due to telemarketing or sales practice abuses.[10]

In response, the definition has been revised to include only firms that have been expelled from membership in a securities industry SRO or that have had their registration as a broker/dealer revoked by the SEC in connection with sales practice violations.

The Rule is too broad: Commenters believe the original Rule was too broad in several respects.[11] First, they believe that the Rule would unfairly punish firms and individuals with good disciplinary and compliance records for actions of others of which they have no knowledge and over which they have no control.[12] Second, they believe the Rule should apply only to persons who were employed by a Disciplined Firm at the time of the disciplinary event or within a specified time prior to the event.[13] Finally, commenters believe that the Rule should apply only to personnel who have sales contact with customers (*i.e.*, registered representatives) and that clerical and ministerial employees, who have no opportunity for sales practice abuse, should be excluded from both the 20% calculation and from the taping requirement.[14]

NASD Regulation has responded to these comments in two ways. First, the Rule has been revised to apply only to firms that hire a specified percentage of individuals who were employed at a Disciplined Firm within the last two years. Second, only registered persons, and not other employees, would be counted in determining whether the firm meets the percentage criterion for triggering the taping obligation. Third, only sales personnel would be subject to the taping requirement, since sales activities and contacts with customers or potential customers are the focus of this Rule. Thus, there is no reason to include back office personnel in either the percentage calculation or to require taping of their conversations.

The Rule does not achieve the stated purpose: The Notice to Members soliciting comment on the original proposal states that the purpose of the original proposed Rule is to respond to the Sweep Report recommendation that firms should adopt heightened supervisory procedures tailored to individual registered representatives with troubled regulatory and compliance records. Some of the commenters believe that the original Rule goes beyond the scope of the Sweep Report, and that it will not be effective in achieving the Sweep Report goal difficulties a firm would encounter when attempting to obtain the information that would be required to comply with the Rule.

NASD Regulation believes that the narrower focus of the Rule will result in lower compliance costs, at least for the industry as a whole. First, fewer firms will meet the criteria in the Rule and will be subject to the requirement, and costs, of tape recording conversations. Also, the Rule has been revised to utilize a tiered structure of determining whether a firm must comply with the Rule, with a higher permissible percentage of registered persons from Disciplined Firms being applied to smaller firms; this should result in a more equitable impact on small firms. Finally, with respect to the practical compliance difficulties raised by the Advisory Council, the NASD Regulation staff has spent a significant amount of time since the comment period closed in October responding to this issue and devising methods whereby NASD Regulation can reduce the difficulties and costs of compliance. As a result of

Planning, Inc. (''Capital''), dated September 24, 1996; (7) Letter from Sanford D. Greenberg, Chatfield Dean & Co. (''Chatfield Dean''), dated October 31, 1996; (8) Letter from Neil Lawrence Lane, Citicorp Investment Services (''CIS''), dated October 31, 1996; (9) Letter from David J. Master, Coastal Securities (''Coastal''), dated October 31, 1996; (10) Letter from John Polanin, Jr., Cowen & Company (''Cowen''), dated November 7, 1996; (11) Letter from Richard L. Sandow, Cullum & Sandow Securities, Inc. (''Cullum''), dated October 17, 1996; (12) Letter from Gregg Thaler, Duke & Company, Inc. (''Duke I''), dated October 10, 1996; (13) Letter from William Rotholz, Duke & Company, Inc. (''Duke II''), dated October 29, 1996; (14) Letter from Shannon Braymen, Duncan-Smith Securities, Inc. (''Duncan-Smith''), dated October 22, 1996; (15) Letter from James H. Pyle et al., E.E. Powell & Company, Inc., dated October 21, 1996; (16) Letter from Nancy K. Port, Equity Services, Inc. (''ESI''), dated October 30, 1996; (17) Letter from Rick Fetterman, Fetterman Investments, Inc., dated October 1, 1996; (18) Letter from Herbert O. Sontz, GKN Securities (''GKN''), dated October 31, 1996; (19) Letter from Lawrence E. Wesneski, Hoak Breedlove Wesneski & Co. (''Hoak''), dated October 21, 1996; (20) Letter from Cabell B. Birdsong, Investors Security Company, Inc. (''ISC''), dated October 22, 1996; (21) Letter from David A. Rich, Jefferies & Company, Inc., dated November 8, 1996; (22) Letter from Thomas P. Koutris, John Hancock Distributors, Inc., dated September 23, 1996; (23) Letter from A.E. Monahan, Keystone Capital Corporation (''Keystone''), dated October 7, 1996; (24) Letter from Paul B. Uhlenhop, Lawrence, Kamin, Saunders & Uhlenhop (''Lawrence, Kamin''), dated October 29, 1996; (25) Letter from Kathryn S. Reimann, Lehman Brothers Inc. (''Lehman''), dated October 31, 1996; (26) Letter from Kenneth S. Spirer, Merrill Lynch, Pierce, Fenner & Smith (''Merrill Lynch''), dated November 14, 1996; (27) Letter from Jack G. Levin, Montgomery Securities (''Montgomery''), dated January 16, 1997; (28) Letter from Frederick W. Bogdan, Morgan Stanley & Co., Incorporated (''Morgan Stanley''), dated October 30, 1996; (29) Letter from Dennis S. Kaminski, Mutual Service Corporation (''MSC''), dated October 29, 1996; (30) Letter from Richard Berenger, Nathan & Lewis Securities, Inc. (''Nathan & Lewis''), dated October 18, 1996; (31) Letter from Douglas L. Dunahay, Neidiger/Tucker/Bruner Inc. (''Neidiger''), dated October 29, 1996; (32) Letter from Edward T. Borer, Philadelphia Corporation (''PC''), dated October 17, 1996; (33) Letter from Michael Flannigan, Protective Group Securities Corporation (''PGSC''), dated September 24, 1996; (34) Letter from Robert A. Fitzner, Jr., RAF Financial Corporation (''RAF''), dated October 29, 1996; (35) Letter from Glen F. Hackmann, Robert W. Baird & Co., Incorporated (''Baird''), dated October 31, 1996; (36) Letter from Douglas F. Schofield, Schofield Investments, Inc., dated September 18, 1996; (37) Letter from Richard O. Scribner, Allen B. Holeman, and C. Evan Stewart, Securities Industry Association (''SIA''), dated November 4, 1996; (38) Letter from Dov S. Schecter, Smith Barney Inc. (''Smith Barney''), dated October 31, 1996; (39) Letter from Patrick G. Haayes, Stratton Oakmont, Inc. (''Stratton''), dated October 30, 1996; (40) Letter from Walter H. Schlobohm, dated February 10, 1997; (41) Letter from John Maceranka, The Windmill Group, Inc., dated September 28, 1996; and (42) Letter from Stanley J. Allen Jr., Yee, Desmond, Schroeder & Allen, Inc. (''Yee''), dated October 28, 1996.

[9] *See, e.g.*, letters from Edwards, Coastal, Cullum, ESI, Keystone, Lehman, Montgomery, Morgan Stanley, and Baird.

[10] *See* letter from Smith, Barney.

[11] *See, e.g.*, letters from Edwards, Aurora, Barington, Chatfield Dean, CIS, Coastal, Cullum, Duke II, ESI, ISC, Lehman, Morgan Stanley, Nathan & Lewis, PC, PGSC, RAF, Baird, Smith Barney, SIA, and Stratton.

[12] *See, e.g.*, letters from Lehman and Morgan Stanley.

[13] *See, e.g.*, letters from Edwards, Morgan Stanley, Nathan & Lewis, PC, SIA, and Stratton.

[14] *See, e.g.*, letters from Edwards, Barington, Chatfield Dean, Cullum, Duke II, ESI, ISC, Morgan Stanley, Baird, and Stratton.

research, NASD Regulation staff believes that it can assist firms by providing them with all the relevant information they require to determine whether they are in compliance with the Rule. However, comment is specifically requested on the cost of compliance with the Rule.

Privacy concerns: Many commenters stated that the Rule would result in an invasion of the privacy of both a firm's customers as well as the firm's associated persons, which would be especially unfair both to firms and associated persons that do not have disciplinary histories. Commenters also believe that the Rule would conflict with federal and state wiretapping laws. Finally, they are concerned that the Rule does not restrict the accessibility and appropriate use of heightened supervision because taping is not an effective means to supervise sales personnel.[15]

In response, NASD Regulation believes that restricting application of the Rule to only the most egregious situations, *i.e.*, employees who formerly were employed at firms that were expelled from the industry, addresses some of these concerns. Also, NASD Regulation believes that the in terrorem effect of tape recording all telephone conversations may be useful in deterring sales practice abuses. In addition, NASD Regulation notes that the Rule is designed to go beyond the problems raised by hiring individual problem registered representatives and is meant to address the concerns raised when a firm hires a large number of individuals who formerly were employed by a Disciplined Firm where they were inadequately trained and supervised.

The costs of the Rule are too great: Some commenters believe that the costs of the original Rule will be too high, particularly considering the limited benefits that will be achieved. The commenters state that the costs for purchasing tape-recording equipment, hiring personnel to review the tapes, and record retention would be enormous.[16] Also, some commenters state that the Rule would have a disproportionate effect on small firms both in terms of the costs and because small firms are more likely to become subject to the 20% threshold.[17] Finally, while not discussed in a formal comment letter, the Advisory Council raised as an issue the practical effect of the tapes.[18]

As stated above, because the Rule has been revised to address only the most egregious situations, the impact on privacy will be minimized. Also, if the Rule is adopted, NASD Regulation will inform NASD members that, in complying with this Rule, they must also comply with federal and state civil and criminal statutes governing the tape recording of conversations. This is the same approach the NFA has taken with respect to this issue.[19]

Each state has a statute governing wiretapping; there also is a federal statute governing wiretapping and electronic surveillance.[20] The federal statute and the majority of the state statutes permit taping of telephone conversations with the consent of one party (''one-party statutes''); a minority of state statutes require the consent of all parties to the conversation (''two-party statutes''). Three issues arise from the proposed Rule: what is necessary to comply with one-party statutes; what is necessary to comply with two-party statutes; and how to comply where a conversation occurs between a person in a one-party state and a person in a two-party state.

In one-party statute states, the only issue is whether the registered representative knows of and consents to the tape recording. Since the recording requirement would run to the firm, and the equipment would be the firm's, it might be argued that the firm, and not the representative, is doing the recording. Therefore, it would be necessary for the firm to insure that the representative has notice and consents to the tape recording of his or her telephone conversations. This could be accomplished through a clause in an employment agreement or employee handbook or other written notice to the representative.

In two-party statute states, it would be necessary to insert on the firm's telephone line a recording stating that all telephone conversations are being taped, similar to customer service lines in other industries. Some states require a system of beeps or buzzers that sound throughout the conversation. Another possibility is to insert a clause into the customer agreement notifying customers that their calls will be tape recorded. Some states also have a ''business use exception'' to the two-party statute consent requirement, but it is worded and applied differently in each state.

The issue of choice of law for conversations between persons in one-party statute and two-party statute states is an open issue that depends on the individual laws of each state and the individual facts. Firms would be required to independently determine that state laws are satisfied. The safest course of action in each case would be to notify their representatives and customers that their telephone calls are being tape recorded. If all parties know of the tape recording, then there is no violation of any statute.

Proposed Rule

As revised, the proposed Rule would apply whenever a specified percentage of a member firm's sales force is comprised of registered persons who were employed within the last two years by a firm that has been expelled from membership in a securities industry SRO or has had its registration as a broker/dealer revoked by the SEC.[21] The requisite percentage varies depending on the size of the firm, from 40 percent for a small firm to 20 percent for a larger firm. The firm must establish the required supervisory procedures within 30 days of receiving notice from NASD Regulation or obtaining actual knowledge that it is subject to the provisions of the Rule.

Under the proposed Rule, if a significant portion of a member's sales force previously was employed by a Disciplined Firm, the member would be required to adopt special written procedures to supervise the telemarketing activities of its registered representatives. The procedures would require, at a minimum, that the member tape-record all telephone conversations between all of its registered representatives and both existing and potential customers, and maintain these procedures for two years. The Rule would require firms to ensure that they tape record all regularly used means of telecommunications, including cellular phones. The Rule also would require firms subject to the taping requirement to establish reasonable procedures for reviewing the tape recordings to ensure compliance with securities laws and NASD rules, to submit reports to the NASD on their supervision of

[15] *See, e.g.*, letters from CIS, Duke II, ESI, Lehman, Merrill Lynch, MSC, Nathan & Lewis, and SIA.

[16] *See, e.g.*, letters from Berthel, CIS, Coastal, Duke II, ESI, GKN, Keystone, Lehman, Morgan Stanley, Nathan & Lewis, Baird, and Smith Barney.

[17] *See, e.g.*, letters from Capital, Cowen, Duncan-Smith, Hoak, SIA, and Yee.

[18] *See, e.g.*, letters from AEFA, Duke II, Lawrence, Kamin, Lehman, Morgan Stanley, MSC, Neidiger, Montgomery, SIA, and Smith Barney.

[19] *See* Interpretive Notice to NFA Compliance Rule 2–9, *Supervision of Telemarketing Activity*, 9021 (February 18, 1997).

[20] 18 U.S.C. §§ 2519 et seq.

[21] The revised definition of Disciplined Firm includes only expelled and revoked firms in order to focus, at least initially, on the most egregious cases with the greatest supervisory and disciplinary problems. This approach is similar to the one taken by the NFA, and will allow us to gain experience with the implementation of the Rule before we consider expanding the definition of Disciplined Firm to include firms that have been suspended from SRO membership or from SEC registration.

telemarketing, and to retain and catalog the tapes.

While each firm will be responsible for meeting its own obligations under the Rule, NASD Regulation will provide firms with all of the information that they need to determine if they are subject to the requirements of the Rule. NASD Regulation believes that firms should be able to rely on the accuracy of the information provided to them, and that a firm should be disciplined for failure to comply with the Rule only if it has actual knowledge of information that would make the firm subject to the Rule that is inconsistent with information provided by NASD Regulation to the firm that indicated that the firm was not subject to the Rule.

NASD Regulation will compile and maintain several lists that firms will be able to review on a quarterly basis to assist them to determine if they are in compliance with the Rule. The primary list that will be prepared will be a list of firms that meet the definition of Disciplined Firm.[22] Two additional lists will be prepared that should be helpful. One list will contain an alphabetical listing of all registered persons who had worked for Disciplined Firms within the last two years. Another list will be complied containing the same list of people grouped according to the firm for which they currently work. In order to alert firms that they are approaching the percentage that would make them subject to the requirements of the Rule, the second list will contain a computation of the percentage of all registered persons at the firm represented by registered persons who had been employed at a Disciplined Firm within the last two years.

The Rule is thus very similar to an NFA interpretation concerning supervision of telemarketing activity.[23] NFA member firms subject to the requirements of the interpretation must tape record all sales solicitations.[24] The NFA interpretation applies to firms that meet criteria relating to the percentage of the firm's associated persons who formerly were employed at a firm that was closed down and barred from the industry through enforcement actions for deceptive telemarketing practices.[25] These firms are required by the NFA interpretation to tape record sales solicitations. An NFA member subject to these procedures may seek a waiver of the taping requirement upon a satisfactory showing that its current supervisory procedures provide effective supervision over its employees, including enabling the member to identify potential problem areas before customer abuse occurs. The NFA has rarely granted such waivers. In one instance, a waiver was granted to a firm that did not engage in telemarketing and had only institutional customers. In two other instances, partial waivers were granted to firms that hired outside consultants. NFA informed NASD Regulation that they were not satisfied with the work performed by the outside consultants and would not grant such waivers in the future.[26] In response to commenter requests, NASD Regulation has included a waiver provision in the proposed Rule, and also has proposed a conforming change to the Rule 9600 Series.[27]

Statutory Basis

NASD Regulation believes that the proposed Rule change is consistent with Section 15A(b)(6) of the Act,[28] which requires, among other things, that the Association's rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The NASD believes that requiring members that hire more than a certain percentage of registered representatives who formerly were employed by a Disciplined Firm will further these requirements.

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

NASD Regulation does not believe that 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 NASD Notice to Members 96–59 (September 1996). Forty-two comments were received in response to the Notice.[29]

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

Within 35 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 90 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 the self-regulatory organization 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. The Commission requests comments on all aspects of the proposal as well as the following specific items.

1. Should customers be notified by firms that their calls are being taped? Should firms be required to obtain their customers' written consent to be taped? Why or why not?

2. Should registered representatives subject to the Rule be notified by the firms that their calls are being taped? Why or why not?

3. In light of the information already available on the Central Registration Depository, is a list of all registered persons who have worked for a Disciplined Firm within the last two years necessary to ensure compliance with the Rule? Would such a publicly available list be used in other ways (for example, as a screening device for applicants for registered representative positions)?

The Commission also is soliciting comments concerning whether the Rule captures the appropriate registered persons in the percentage calculation that triggers the taping requirement. The Rule would apply whenever a specified percentage of a member firm is comprised of registered persons who were employed within the last two years by a firm that has been expelled from

[22] For the two-year period 1995–1996, 14 firms met the definition of Disciplined Firm: 4 firms were expelled from SRO membership and 10 had their registration revoked.

[23] *See* Interpretive Notice to NFA Compliance Rule 2–9, *Supervision of Telemarketing Activity*, ¶ 9021 (February 18, 1997).

[24] NASDR states that no NFA member firm is currently taping sales solicitations. Due to recent changes to the NFA interpretation that were approved by the Commodity Futures Trading Commission in December, 1996, seven new firms became subject to the requirements of the interpretation, but all are in the process of seeking waivers from the taping requirement. If these firms do not obtain waivers from the NFA, or adjust their personnel numbers, they will be required to tape-record conversations.

[25] In early 1997, 44 firms met the NFA definition of Disciplined Firm. *See* Interpretive Notice to NFA Compliance Rule 2–9, *Supervision of Telemarketing Activity*, ¶ 9021 (February 18, 1997).

[26] Telephone conversation between Mary N. Revell, Associate General Counsel, NASD, and Daniel Driscoll, Vice President, Compliance, NASD (February 26, 1997).

[27] *See, e.g.*, letters from Edwards, Barington, Cullum, Duke I, Duke II, Duncan-Smith, GKN, Hoak, Morgan Stanley, Baird, and Montgomery.

[28] 15 U.S.C. § 78o–3(b)(6).

[29] *See* discussion *supra* Section II(A) Comments and Response.

membership in an SRO or has had its registration as a broker-dealer revoked by the SEC. The requisite percentage varies from 40 to 20 percent, depending on the size of the firm.

4. As proposed, the Rule captures registered persons who have worked at a Disciplined Firm within the past two years. Is the proposed time frame appropriate?

5. Should the percentage of registered persons counted in the calculation exclude registered persons who have worked at a Disciplined Firm within the past two years, but who themselves have no disciplinary history or customer complaints?

6. Should the percentage of registered persons counted in the calculation include registered persons who may not have worked at a Disciplined Firm, but who have, as individuals, been barred by the Commission from association with any broker, dealer, investment adviser, investment company, or municipal securities dealer?

7. Should firms with fewer than five registered persons be excepted from the Rule?

8. As proposed, the Rule limits the taping requirement to registered representatives in conversation with existing or potential customers. Should the taping requirement apply to registered principals in conversation with existing or potential customers? Should it apply to any other associated person of a member firm?

9. What are the estimated costs to comply with the Rule? Please comment generally on the benefits and costs of the Rule, as well as ways to reduce the costs while preserving the benefits of the Rule.

Persons making written submissions should file six copies thereof with Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 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 File No. SR–NASD–97–69 in the caption above and should be submitted by December 29, 1997.

For the Commission, by the Division of the Market Regulation, pursuant to delegated authority.[30]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 97–31846 Filed 12–4–97; 8:45 am]

BILLING CODE 8010–01–M

[30] 17 CFR 200.30–3(a)(12).

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–39371; File No. SR–NASD–97–47]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Punitive Damages in Arbitration

November 26, 1997.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''), 15 U.S.C. 78s(b)(1), notice is hereby given that on July 8, 1997,[1] 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 have been prepared by the self-regulatory organization. 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

NASD Regulation is proposing to amend the NASD's Code of Arbitration Procedure to add a new rule relating to the award of punitive damages. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

Rules of the Association

10000. Code of Arbitration Procedure

10300. Uniform Code of Arbitration

10336. Punitive Damages

This Rule explains when a party may seek punitive damages, what standards and limitations apply to the claim, and what the arbitration award must state.

(a) The Availability of Punitive Damages

(1) This Rule applies to any claim that must be arbitrated under Rule 10301 between a public customer and a member, or between a public customer and an associated person.

(2) A party may request punitive damages if, at the time the party files a claim, the party is a citizen of a state that allows its courts to award punitive damages for the same type of claim.

(3) A member or an associated person may request punitive damages from a public customer only if the public customer is a citizen of a state that allows its courts to award punitive damages for one or more of the public customer's claims.

(4) A party seeking punitive damages must state the amount in its claim.

(5) For purposes of this Rule, the term ''claim'' means any dispute or controversy described in the Statement of Claim (including Counterclaims, Third-Party Claims, and Cross-Claims) for which the claimant is seeking any form of remedy.

(b) Arbitrators to Apply State Standard

(1) When arbitrators decide whether to award punitive damages, they will apply the same standard of conduct applied by courts in the state where the requesting party is a citizen at the time a claim is filed.

(2) Arbitrators will apply this standard even if the parties signed a choice of law agreement that specifies a different state.

(c) Limitations on the Amount and Availability of Punitive Damages

(1) Punitive damages may be awarded in an amount up to two times compensatory damages or $750,000, whichever is less.

(2) For purposes of this paragraph only, compensatory damages do not include attorneys' fees, costs of arbitration, or post-award interest.

(3) Arbitrators cannot award punitive damages if they have already awarded multiple damages for the same claim under:

(A) the Racketeer Influenced and Corrupt Organizations Act (RICO), or

(B) any other federal or state statute that provides for multiple damages awards.

(4) The limitations in this Rule apply even if state laws differ.

(d) Statement in Award

If the arbitrators award compensatory and punitive damages, they must state separately the amount they awarded for each.

[1] The NASD filed Amendment Nos. 1 and 2 to the proposed rule filing on October 17, 1997 and November 14, 1997, respectively, the substance of which is incorporated into the notice. *See* letters from Joan C. Conley, Corporate Secretary, NASD Regulation, to Katherine A. England, Assistant Director, Market Regulation, Commission, dated October 17, 1997 (''Amendment No. 1'') and November 14, 1997 (''Amendment No. 2'') respectively.