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July 31, 2001

Ms. Barbara Z. Sweeney
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, D.C. 20006-1500

Re: **Special NASD Notice to Members 01-35 – Request for Comment on Rule Modernization Project**

Dear Ms. Sweeney:

The Federal Regulation Committee, Self-Regulation and Supervisory Practices Committee, and Compliance & Legal Division (collectively, the "Committees") of the Securities Industry Association ("SIA")[1] appreciate the opportunity to comment on Special NASD Notice to Members 01-35 regarding the rule modernization initiative of NASD Regulation, Inc. ("NASDR"). SIA has long advocated cost-effective regulation that maximizes efficiency, minimizes redundancy and ensures appropriate, up-to-date rules. We therefore embrace the NASDR's most recent efforts to examine both the benefits and burdens, direct and indirect, of existing and prospective NASD rules in light of technical and business developments with the securities industry.

While NASDR already has made strides toward streamlining the NASD rules though its "obsolete" rule review,[2] we believe that more can be achieved through this latest initiative, and look forward to working with the NASDR staff to build and improve upon those prior efforts. As before, we recommend that NASDR utilize the resources and expertise of SIA and its membership in reviewing and crafting regulation. This collaborative effort, we believe, will foster more constructive, effective and resource-efficient rulemaking. SIA would be pleased to assemble a Joint Industry Advisory Group of compliance, operations and legal professionals representing a cross-section of firms to assist the NASDR staff in assessing and expanding many of the issues raised herein.

I. INTRODUCTION

In undertaking to comment on Notice to Members 01-35, SIA assembled several working groups, each of which evaluated the NASDR rules based upon the following four criteria, which we believe will have significant bearing on the success of this project: (1) cost-effectiveness and regulatory burdens of the rule in light of technological or industry developments; (2) obsolescence of the rule or need for modernization; (3) failure

to distinguish between retail and institutional customers in the rule's application; and (4) redundancy or inconsistency with rules of other self-regulatory organizations ("SROs") or the Securities and Exchange Commission ("SEC"). We summarize the results of that review below in sequential order.

Notably, although we recognize that each SRO has its own agenda and focus, duplicative and conflicting regulation across SROs is both costly and inefficient. Such rules yield little benefit while depleting valuable administrative and economic resources from all segments of the securities industry. Specifically, broker-dealers that are members of more than one SRO are often subject to multiple and inconsistent rules on the same subject, as well as each SRO's varying interpretation of what constitutes a rule violation and what the appropriate sanction (if any) is for a violation. By reducing existing redundancy and discrepancies, the totality of self-regulatory costs for broker-dealers, including the cost of compliance and supervision will be reduced significantly, thereby allowing member firms to utilize resources more efficiently and effectively to benefit investors. Similarly, there will be corresponding cost savings to the SROs since each expends valuable staffing and operating resources to monitor and examine broker-dealer activity on identical or similar subjects. In developing the regulatory template within which existing and prospective rules will be examined, it is therefore critical to give adequate consideration to the elimination of regulatory redundancy and inconsistency. Only then, can there be a thoroughly modernized NASD rulebook.

Finally, as a practical matter, the efficacy of regulation in general can be greatly enhanced if regulators solicit the input of affected parties early within the regulatory process. Often, in an attempt to keep pace with rapidly changing conditions and practices within the industry, regulators rush implementation of a rule without adequately canvassing all interested parties. This has resulted in a great deal of confusion and costly back-end action to clarify or correct issues that could have been avoided. By engaging market participants at the outset of the regulatory dialogue, there will be balanced, resource-efficient and expert regulation, which ultimately benefits investors, regulators and broker-dealers alike.

II. COMMENTS AND RECOMMENDATIONS

Due to the breadth of this initiative, we have assigned each of the rules discussed herein a "priority" indicator based upon the urgency with which we believe the comments should be addressed. These indicators are: (i) high priority (delineated with the letter "H"), meaning rules that require immediate attention; (ii) medium priority (delineated with the letter "M"), indicating rules that warrant review as quickly as possible; and (iii) low priority (delineated with the letter "L"), referencing rules that may require reassessment at some later date. For ease of reference, we also provide, at Appendix A, a list of the rules by order of priority. Furthermore, we include, within Appendix B, those comments we view as "housekeeping" or administrative items. Finally, we note that while we attempted to cover as many issues as possible, we view this letter as the starting point of an evolving process within which we hope to participate and build upon.[3]

A. REGISTRATION REQUIREMENTS

Rule 1017 Change of Control

The Rule generally governs the application process for approval of member change in ownership, control or business operations. Rather than require firms to submit an application for approval, SIA believes the Rule should provide for notice filings in those instances involving inconsequential or non-material acquisitions. This approach is more cost-effective and avoids the multitude of filings. *(L)*

Rule 1021 Registration Requirements

SIA continues to believe that the qualification standards currently designed for retail securities business should not apply to persons engaged exclusively in an investment banking capacity. Instead, the registration requirements should be tailored more specifically along functional lines through new, more targeted qualification examinations. Though we recognize the value of the Series 7 and 62 examinations as general thresholds for entry within the securities industry, the contents of those examinations, in large measure, are irrelevant to the business practices of many investment bankers, particularly those that deal exclusively with issuers and foreign governments or sovereigns. Such individuals, therefore, should either be exempt altogether or be required to pass a more specialized examination that tests knowledge germane to their business function. This approach is more effective and resource-efficient while still achieving the objectives of the existing registration requirements. *(H)*

Moreover, as you are aware, SIA is committed to addressing the important role of research analysts. In that regard, SIA recently developed *Best Practices for Research,*[4] which we believe embody the industry's aspirations to strengthen ethical and professional standards for securities analysts, underscore the broker-dealer's dedication to the best interests of clients and buttress the overall integrity of the securities markets. In balancing the cost-benefits of existing NASD qualification requirements for research analysts, we believe these requirements similarly warrant modernization and enhancement. Specifically, SIA does not believe that the existing Series 7 examination is particularly useful to the business functions of research analysts. We, therefore, recommend that the NASDR eliminate the Series 7 requirement for these individuals and instead require that research analysts pass either (i) the NYSE Supervisory Analysts (Series 16) examination, which more accurately tests knowledge relevant to the business activity of research analysts, or (ii) a new, more narrowly tailored qualification examination designed specifically for research analysts. This approach advances investor protection, promotes uniformity of registration requirements and is significantly more cost-effective by eliminating unnecessary duplication. *(H)*

Rule 1022 Principal Registration

Although NASDR has taken steps to recognize certain qualification examinations of other SROs,[5] we urge the staff to expeditiously resolve all existing redundancies in order to ease the economic and administrative burdens on multi-member firms. We, therefore, recommend that principals should be given the option of either (i) passing the NASD Series 24 General Principal examination and the NYSE Series 9 and 10 (formerly the Series 8 Limited Principal-General Securities Sales Supervisor) qualification examinations, or (ii) passing a new "Super" Principal examination that would satisfy both the Series 24, 9 and 10, including the options and MSRB qualifications. Eliminating this duplication, we believe, is clearly cost-beneficial. *(H)*

Rule 1022(f) Registered Options Principal

SIA understands that the NASDR supports elimination of the Senior Registered Options Principal ("SROP") and Compliance Registered Options Principal ("CROP") designations and is currently in discussions with the SEC regarding the ability of firms to supervise options activity within firms' overall supervisory structure. We urge expeditious adoption of these changes. *(H)*

B. CONDUCT RULES

Rule 2210 Communications with the Public

The Rule currently requires pre-use supervisory review of all advertising and sales literature sent to more than one customer. SIA previously commented in support of the proposed amendments to the "advertising rules."[6] Those amendments exempt all member firm communications to institutional investors from pre-use approval and NASDR filing requirements. Form letters and group e-mail to existing customers and fewer than 25 prospective retail customers also would be eligible for this exemption. Subject to the recommendations set forth in our previous comment letter, SIA reaffirms its support for the proposed amendments as an important step towards modernizing the advertising rules to reflect technological developments, realities of current business practices, and the differing protections required by retail and institutional investors. We urge expeditious adoption of the amendments. *(H)*

In addition, we believe that broader exemptive authority under Rule 2210 would allow NASDR to respond more quickly and effectively to technological developments that make application of Rule 2210 inappropriate to certain communications or communication media. Therefore, we would support an amendment to this rule that grants staff the authority to exempt, from any of the provisions of Rule 2210, certain communications or types of communications. *(H)*

Rule 2220 Options Communications with the Public

The Rule generally requires all advertisements, sales literature, and educational material issued by a member pertaining to options to be approved in advance by the CROP. In keeping with the notion of incorporating options supervision within the overall supervisory structure of a firm (along the same lines as the 1022(f) analysis), we understand that the NASDR is currently in discussions with the SEC regarding elimination of this requirement. We urge expeditious adoption of these changes.

Additionally, we believe that communications with institutional investors regarding options also requires the same exclusions currently proposed under the Rule 2210 amendments. Therefore, we recommend amendment of Rule 2220 to provide exemptions from pre-use approval and NASDR filing requirements for institutional sales material regarding options. *(H)*

Rule 2230 Confirmations

Although the specific language of NASD Rule 2230 is similar to SEC Rule 10b-10, it fails to distinguish between debt and equity transactions. Consequently, Rule 2230 may conflict with various provisions of the SEC Rule and its interpretations. For example, Rule 2230 requires disclosure of the amount of any commission or other remuneration that is received by the member in connection with a transaction with a customer. By contrast, SEC Rule 10b-10 does not require this disclosure in certain riskless principal transactions in debt securities. Therefore, the NASD Confirmation Rule is duplicative of, and at times in conflict with, the SEC Rule and should be eliminated. *(M)*

Rule 2240 Disclosure of Control Relationship with Issuer
Rule 2250 Disclosure of Participation or Interest in Primary or Secondary Distribution

SIA continues to question the utility of these Rules as stand-alone substantive obligations in light of SEC Rule 15c1-5 and 15c1-6. Though we recognize that the NASD rules are slightly broader in that they apply to both members and associated persons, the existing duplication is cost-ineffective and only increases the likelihood of inconsistent rule interpretation. SIA, therefore, recommends that the NASDR modify these Rules to avoid the substantive redundancy while preserving the jurisdictional reach of the NASD over associated persons. *(M)*

Rule 2310(b)(2) Recommendation to Customers (Suitability)

SIA questions the utility of requiring registered representatives in all transactions to make efforts to obtain information concerning the customer's tax status. Such considerations, though highly informative when a broker is recommending a tax-

advantaged investment, can be superfluous when the customer's express investment objectives are short-term gains or long-term growth. Additionally, changes to the Tax Code, like those considered and adopted this year, complicate scenarios by holding a broker delving into the area of tax considerations to an unrealistic standard of expertise. Accordingly, SIA recommends that the tax status requirement be replaced with a provision requiring efforts to learn and record the duration of a customer's trading experience. This standard is both more readily attainable and universally more relevant to a suitability analysis. *(M)*

IM-2310-2 (b)(1) Fair Dealing with Customers/Recommending Speculative Low-Priced Securities

SIA suggests that the term "high pressure telephone sales campaigns" be defined within the Interpretation. Although vaguely familiar to many industry professionals, this term defies precise elaboration for at least three reasons. First, it is not clear whether a course of conduct *vis-à-vis* one customer can constitute a "campaign." Second, the term invites inquiry into whether a "high pressure" sales pitch by itself is violative. Lastly, NASD disciplinary decisions including this violation tend to combine the violation in with more egregious activity, and therefore provide little guidance as to when a broker has passed the demarcation between persistence and unethical behavior.[7] *(L)*

Rule 2320 Best Execution and Interpositioning

Although the NASDR has taken steps to address industry concerns regarding this Rule, particularly with regard to the definition of "primary market" as defined under the latest proposed rule changes, SIA continues to strongly believe that application of the "three quote rule" to foreign markets provides significant and unnecessary burdens to members seeking to ensure best execution. In particular, and as fully detailed in our prior letters to the NASDR, we question the utility of the three quote rule with regard to orders executed on behalf of institutional accounts, since such clients are sophisticated enough to monitor the quality of their executions and are keenly aware of market conditions.[8] Subjecting executing broker-dealers to this rule for institutional orders only serves to delay the execution process and may significantly disadvantage the customer. Therefore, we request that the requirement be eliminated for such transactions or, at the very least, provide a mechanism – short of an affirmative written "opt-out" – that recognizes and accommodates the expectations of institutional investors executing transactions off-shore. *(H)*

Rule 2330(f) Customers' Securities or Funds/Sharing in Accounts

SIA notes that Subsection (f) of the Rule permits sharing in customer accounts, while NYSE Rule 352 flatly prohibits such activity. Heightening this tension is that, while both rules traditionally use of the *immediate family* definition in the "hot issue rule"[9] for purposes of the relevant definitions of "employee-related" accounts, several NYSE disciplinary decisions from last year were premised upon expansive interpretations of "family member" and of the essential facts about customers warranting disclosure on

the new account form.[10] Thus, the SIA requests clarification of the basis for the rule exempting certain situations from the industry's general ban on sharing in customer accounts. Such a clarification would work to prevent Rule 2330's arbitrary application to such novel situations as where the client, for instance, is also a cousin or a tenant. *(L)*

IM-2330(b) Segregation of Customers' Securities

Although SIA does not have an overall position statement on IM-2330, we note that many firms are moving towards a "certificateless" environment, which may call into question the utility of some of the Interpretation's requirements. For instance, Subsection (3) expressly requires the "specific segregation of all certificates of each customer in separate envelopes or folders." In view of this trend, prompted by both new technologies and customer desires, we believe that traditional notions of physical segregation of securities certificates need to be modernized in order to keep pace with technological advancements within the industry. *(L)*

Rule 2340 Customer Account Statements

The Rule was recently amended to require firms to include within their customer account statements per-share estimates for all the Direct Participation Program ("DPP") and Real Estate Investment Trust ("REIT") securities held in the customers' accounts or reflected on the customers' statements. As detailed in our July 9, 2001 comment letter,[11] which we incorporate by reference herein, SIA believes that the mandatory valuation requirement, though well intended, imposes significant administrative and economic hardships upon the membership while producing little yield to investors, who already receive the valuation information directly from the issuer. Accordingly, we respectfully request that valuation of such securities should be voluntary and not mandatory, irrespective of whether or not the annual report includes a per share estimated value for these securities. Moreover, to the extent firms decide to indicate a value on the account statement, firms may be directed to comply with the valuation requirements as recommended by the Rule. This approach, we believe, advances the Rule's disclosure objectives without unduly burdening firms. *(H)*

The SIA also notes, as it did in its letter of February 23, 1999,[12] that there is questionable utility to the requirement for members to deliver a customer account statement every calendar quarter to institutional customers that settle transactions on a delivery versus payment ("DVP") basis, where a statement is already routinely forwarded by the custodian. Given the cost to firms in generating and forwarding this duplicative information, we believe that Rule 2340 should provide the institution with the ability to "opt out" of the customer delivery requirement in writing. We understand that the NASDR staff intends to present this recommendation to the Membership and Financial Responsibility Committee for consideration and hope that these changes are implemented expeditiously. *(H)*

Rule 2341 Margin Disclosure Statement
Rule 2360 Approval Procedures for Day Trading Accounts

SIA believes that the definition of "non-institutional customer" used in these Rules should be narrowed to more accurately encompass the non-institutional market. The current formulation is too broad and defines many accounts as non-institutional that do not need the protections afforded by these rules. Accordingly, we recommend that NASDR modify the existing standard so it more accurately reflects a realistic and workable assessment of non-institutional entities.

To facilitate the dialogue on how to best refine the existing definition, SIA proposes two alternative formulations: (1) lowering the threshold within NASD Rule 3110(c)(4)(C) for defining "institutional investor" to $10 million, as compared to the current $50 million; or (2) broadening the definition of "institutional customer" or "institutional account,"[13] including anyone who satisfies the definition of "accredited investor" as defined in Rule 501 of the Securities Act of 1933. These alternatives, we believe, will afford adequate protection to retail customers and smaller institutions while excluding larger, more sophisticated institutional accounts. In all events, SIA would be pleased to meet with the Staff to explore this matter further. *(H)*

Rule 2410 Net Prices to Persons Not in Investment Banking or Securities Business

The Rule generally prohibits concessions, discounts, or other allowances to persons not engaged in the investment banking or securities business. The SIA believes that the Rule should be thoroughly analyzed in light of the sweeping changes represented by the Gramm-Leach-Bliley Act ("GLBA") with respect to financial holding companies and banks and, particularly, to assure that financial holding companies and banks are permitted to receive such payments for their participation in securities distributions to the extent permitted under the GLBA.[14] *(H)*

Rule 2420 Dealing with Non-Members
IM-2420-1 Transactions Between Members and Non-Members

The Rule and Interpretation should be eliminated since they were developed at a time when there were SEC-only registered broker-dealers.[15] Alternatively, SIA is willing to explore alternatives to modernize this Rule, including the NASDR's suggested clarification that the prohibition against paying concessions, fees or commissions applies to any entity acting as an unregistered broker/dealer under SEC rules. *(M)*

Rule 2430 Charges for Services Performed

The Rule generally requires that charges to customers be reasonable and not discriminate unfairly between customers. SIA believes the Rule is vague and should be eliminated. Customers already have protection from unreasonable and discriminatory

charges under many state and federal disclosures obligations. We understand that the NASDR is willing to consider specific suggestions on how to clarify the Rule, while maintaining the investor protections it provides, and we would be happy to discuss this matter further. *(M)*

Rule 2440 Fair Prices and Commissions
IM-2440 Mark-Up Policy

The Rule and Interpretation establish the NASD's mark-up policy. In response to a recent proposal by the NASD regarding this Policy as it applies to government and other debt securities, SIA urged important modifications.[16] We incorporate those comments here by reference. *(H)*

SIA also notes that one of the dominant considerations for modernization is the ever-expanding role of global markets. This fundamental evolution to a global marketplace, as well as the increased availability of information on the Internet and through other media, has led to increased customer interest and investment in foreign securities. The Policy does not mention or reference to foreign securities and the particular increased costs associated with transacting in such securities. SIA believes that the addition of a reference to the cost of transacting in foreign securities would clarify the Policy and thereby reduce members' costs and uncertainty in applying the Policy. SIA also believes that such change would harmonize the Policy with its longstanding efforts to modernize the NASD's interpretation of the "three quote rule." *(H)*

Rule 2450 Installment or Partial Sales

The Rule is duplicative of the prohibitions against installment payments as contained in Section 11(d) of the Exchange Act and rules thereunder, as well as Regulation T. Therefore, SIA recommends that the Rule be eliminated or modified to reflect more clearly the extent to which this Rule is intended to apply to situations outside the scope of Section 11(d). *(L)*

Rule 2510(c) Discretionary Accounts -- Approval and Review of Transactions

The Rule generally requires approval in writing of each discretionary order. SIA has long supported elimination of this requirement in favor of integrating supervision of discretionary accounts within the firm's overall supervisory system. We understand that the NASDR staff generally agrees with SIA's recommendation and is developing a proposal to eliminate the requirement in Rule 2510(c) for the member to approve each discretionary order in writing. We urge expeditious adoption of this amendment. *(H)*

SIA also notes that the Rule was written at a time prior to the modern wrap fee-based or other advisory fee accounts, which are governed extensively under the Investment Advisers Act. Therefore, to avoid potentially inconsistent interpretation, SIA believes the Rule should be modified to specifically exclude all such accounts.[17]

Rule 2520 Margin Requirements

The Rule sets out margin requirements and closely tracks NYSE Rule 431, which has a body of published interpretations. Although the NASD has generally accepted members' reliance on NYSE interpretations of Rule 431, we suggest that NASDR issue clear guidance on when members may rely upon NYSE interpretations of NYSE Rule 431. We also recommend, to the extent any inconsistency exists between NASDR and NYSE interpretations of firms' margin obligations, such inconsistency be rectified. We understand that the NASDR's Financial Responsibility Committee supports SIA's view and recommends that NASDR staff issue a formal statement approving reliance on NYSE interpretations, unless otherwise specifically noted. We urge expeditious release of the formal statement. *(H)*

Rule 2522 Definitions Related to Options Transactions

The NASD Rule defines certain option terms and closely tracks various Chicago Board Options Exchange ("CBOE") Rules, which have a body of published interpretations. Although the NASD may generally accept members' reliance on CBOE interpretations, it would be helpful to have a clear statement in the form of an interpretation that reliance on CBOE interpretations is acceptable. *(L)*

Rule 2710 Corporate Financing Rule: Underwriting Terms and Arrangements

SIA supports the NASD's efforts to bring clarity and consistency to the underwriting compensation review process, but believes this goal can be achieved through a more narrowly tailored rule. SIA's views on the proposed amendments to NASD Rule 2710[18] are included in two comment letters to the SEC.[19] SIA's principal recommendation in these letters is to include an exemption from the rule for offerings of larger well-financed companies coming to the capital markets for the first time. SIA believes that the policy concerns underlying Rule 2710 are not present in the context of all offerings of securities covered by the rule, and that NASD and broker-dealer resources dedicated to information gathering and review could be better utilized by targeting the rule to those offerings that have raised these issues. Our previous letters cited vigorous competition among underwriters for issuance business and the difficulties of "retrofitting" a prior financing rule into one of the safe harbors as reasons for providing a clear exemption from the Rule.

The SIA comment letters also included specific recommendations relating to the definition of "institutional investor," the equitable treatment of insurance companies, banks and broker-dealers, and the scope of the rule's lock-up provisions.

In particular, with respect to the exemption for shelf offerings under Rule 2710(b)(7)(C), this section of the Rule should refer to the current version of SEC Form S-3 or F-3, not the versions in effect prior to October 21, 1992. The NASD should apply

the same standard as the SEC to avoid confusion and delay (e.g., in the case of large block trades constituting a distribution), since issuers meeting current S-3 or F-3 eligibility standards wield sufficient bargaining power in negotiating underwriting terms so that NASD review is unnecessary.[20]

In addition, the definition of "bona fide independent market" as contained in Rule 2710(c)(5)(A) should be amended to include certain foreign exchanges whose rules provide protection comparable to US securities exchanges or Nasdaq.[21]

Finally, Rule 2710(c)(8) requires a qualified independent underwriter ("QIU") to perform due diligence and provide a pricing opinion when more than ten percent of net offering proceeds are intended to be paid to members participating in the distribution of the offering or to their affiliates or associated persons. This requirement, however, should not apply in situations where (i) the proceeds are being used to repay loans from a bank or other financial institution providing such financing in the ordinary course of business; and (ii) the securities are sold solely to institutional investors. Currently, this requirement has a discriminatory effect on members affiliated with banks or other financial institutions. Eliminating this requirement would also remove a substantial due diligence burden in situations where investor protection should not be a concern.[22] *(H)*

Rule 2720 Distribution of Securities of Members and Affiliates - Conflicts of Interest

SIA recommends that Rule 2720 be amended so that offerings exempt from filing under Rule 2710 are no longer subject to filing merely because they are subject to Rule 2720. For example, a shelf offering of investment grade debt registered on Form S-3 qualifies for two exemptions from the filing requirements of Rule 2710. If the issuer of the debt is the parent company of the member, however, the offering must be filed for review, even though the equivalent bargaining power of the issuer and the underwriter render NASD review of the underwriting terms and conditions unnecessary.[23]

Offerings issued by an affiliate of a member, other than the member's parent, or by an issuer with whom a member has a conflict of interest should be exempt from both the filing and the substantive requirements of Rule 2720 if the securities are sold solely to institutional investors. Such offerings are usually negotiated transactions and do not require participation of a QIU, a heightened suitability standard, or NASD review.[24]

Rule 2720(k) subjects a member to a heightened suitability standard when offering its own securities, those of an affiliate or those of a company with which it has a conflict of interest. SIA believes that this requirement should not apply to offerings solely to institutional investors.[25] Rule 2720(l) provides that, with respect to offerings of securities of a member, affiliate of a member or an issuer with whom a member has a conflict of interest, *no member* may execute a transaction in a discretionary account without the customer's prior written approval. This restriction is overly broad and unnecessarily restricts sales by *other members* who have no special economic interest in the transaction other than to receive a sales commission. SIA, therefore, recommends that this provision be amended to apply solely to the member that is offering *its own*

securities, those of *its affiliate* or those of an issuer with which *that member* has a conflict.[26] *(H)*

Rule 2740 Selling Concessions, Discounts and Other Allowances

The Rule prevents selling concessions in a fixed price offering except to other broker-dealers that provided investment banking services in connection with the actual distribution. In light of banks' increasing participation in distributions of "bank eligible securities" and the effects of Gramm-Leach-Bliley, the Rule should be amended to allow payments to banks acting in a broker or dealer capacity as permitted by law.[27] *(M)*

Proposed Rule 2790 Trading in Hot Equity Offerings

SIA commends the NASDR for its efforts to focus and streamline firms' obligations with regard to trading in hot equity offerings through proposed new Rule 2790 (SR-NASD-99-60), which represents a significant improvement over the current Free-Riding and Withholding Interpretation (IM-2110-1). Overall, the proposed Rule more precisely targets the types of offerings and persons that should be subject to the restrictions. SIA, therefore supports expeditious adoption of proposed Rule 2790 and makes the following three suggestions, which we view as entirely consistent with the stated objectives of the proposed new Rule.

Exemption for Collective Investment Accounts - SIA is concerned that it may be difficult, if not impossible, for members to verify that no restricted person receives, on a *pro rata* basis, 100 shares or more of a new issue sold to a collective investment account. This requirement would seem to require an additional, deal-by-deal verification process beyond the collective investment account's annual verification. This additional verification is inconsistent with the stated objectives of the Proposed Rule - simplifying and streamlining the compliance process. SIA suggests that the Proposed Rule be modified to provide that members may meet their obligations under section (c)(4)(b) by obtaining from an account, at the time of the annual verification, a representation that the account will not accept a new issue allocation unless it has taken steps to ensure that, on a *pro rata* basis, no restricted person will receive 100 or more shares of any new issue subject to the Proposed Rule.

Exemption for Certain Foreign Investment Companies - SIA believes that the utility of this exemption is greatly reduced by the requirement that "no person owning more than 5% of the shares of the investment company is a restricted person." The problem with the 5% limitation is that foreign privacy laws often prohibit managers of foreign investment companies from obtaining information about their investors necessary to determine whether the investors are "restricted persons." SIA proposes an exemption for foreign investment companies that are traded on a "designated offshore securities market" as defined in Rule 902(b) under the Securities Act of 1933. This benchmark is reliable because these markets have been specifically selected by the Securities and Exchange Commission based on the standards set forth in Rule 902(b)(2), which include,

among other things, oversight by a governmental or self-regulatory body and oversight standards set by an existing body of law.

Exemption for Under-Subscribed Offerings - SIA questions the absence of any exemption in the Proposed Rule for purchases by restricted accounts (including restricted collective accounts and restricted foreign accounts) in the context of under-subscribed offerings. The Proposed Rule permits underwriters to place a portion of an under-subscribed offering in its investment account. This provision should be broadened to permit a portion of an under-subscribed offering to be sold to restricted accounts if the offering trades flat or below the initial public offering price. *(H)*

Rule 2830 Investment Company Securities

The Rule is a holdover from a time when there were SEC-only registered broker-dealers and should be eliminated. We understand that the staff is considering this issue as part of its comprehensive review of Rule 2420, and we would be pleased to meet with staff to discuss this matter further. *(L)*

Rule 2860 Options

The Rule, among other things, establishes sales practice requirements with respect to options, and sets options position limits. The primary stated purpose for the adoption of position limit rules was to reduce the possibility for market manipulation by means of "cornering the market" in a class or series of options. SIA recognizes and appreciates the strides that the NASD has taken to relax the limits. However, we continue to support the total elimination of limits and believe that theses concerns can be more appropriately addressed through enhanced reporting and supervision rather than by position limits that unduly restrict the execution of legitimate, non-manipulative transactions which often are applicable to limited classes of market participants (e.g., NASD position limit rules apply only to transactions executed by or for accounts carried through a member firm and do not apply to banks.)

In order to provide greater depth and liquidity to the U.S. options markets, to facilitate the ability of U.S. participants to engage in legitimate hedging activity, and to decrease the existing competitive disadvantage faced by NASD member firms (as compared to banks and other firms with respect to over-the-counter options), we strongly endorse the approach approved by the Commission in its Broker-Dealer Lite Release[28] that recognizes delta hedging strategies for purposes of the hedge fund exemption. Specifically, we believe that both the NASD's current hedge exemption and that used by the organized options exchanges should be amended to provide that SRO members (and other market participants) will be deemed to be fully hedged for purposes of the exemption if the SRO member or participant maintains a "delta neutral" position in the underlying stock or stock equivalents.

We understand that the staff is willing to consider these issues, and we welcome the opportunity to meet with the NASDR and SEC staffs to discuss this further. *(H)*

IM-2860-2 Diligence in Opening Option Accounts

This Interpretation requires members to follow certain procedures to obtain information before opening an options account for natural persons. SIA endorses and incorporates by reference the conclusions of the Bond Market Association ("BMA") letter to the NASD, dated January 15, 1999, which, among other things, recommended elimination of the requirement that such account information be collected in situations where an individual's account is managed by a professional fiduciary. In those circumstances, the determination of the suitability of the transaction is the responsibility of the professional fiduciary, not the broker-dealer. Moreover, professional fiduciaries often strongly resist providing information about their clients to broker-dealers with the result that broker-dealers must struggle to collect information for which they have no genuine use.

Finally, the BMA also noted that with regard to SEC's Rule 17a-3(a)(9), which requires that a broker-dealer make and maintain records of each cash or margin account, including the name and address of the beneficial owner of such account, there should be some relief for a broker-dealer unable to obtain, through good faith efforts, beneficial owner information for managed accounts. *(H)*

Rule 2910 Disclosure of Financial Condition of Other Members

This Rule requires members to share financial information under certain circumstances. As a general matter, SIA believes that this Rule is irrelevant since parties to transactions and ongoing relationships, such as securities loan, routinely share financial information. In addition, financial information is available on a variety of electronic media. *(M)*

Rule 3110(b)(2) Books and Records

This Rule generally requires members to indicate on a memorandum the name of each dealer contacted when trading in non-Nasdaq securities. We note that this requirement has been the subject of considerable comment, especially in the context of foreign securities, and we reiterate our concerns and recommendations, to the extent they have not been yet been adopted by the NASD. *(H)*

C. TRADING RULES

Before addressing the specific trading rules, SIA makes two preliminary observations. The first relates to the Nasdaq Trader Manual ("the Trader Manual"), which supplements the NASD Manual and was created specifically to assist traders and their staff with the practical application of the NASD and Nasdaq trading rules. While the Trader Manual was not intended to replace the rules contained in the NASD Manual or other published rule interpretations, it has increasingly become an authoritative document

used by NASDR staff in determining whether violations of NASD Rules have occurred. In its efforts to modernize the NASD Rules, NASDR should review the Trader Manual to ensure there are no discrepancies between this document and the body of law it intends to augment.

Second, notwithstanding the responsibility of NASD members to ensure compliance with NASD Rules, SIA strongly believes, in the interests of cost-savings and efficacy of the Nasdaq marketplace, Nasdaq should make every effort to implement the requisite changes to its own systems in order to prevent inadvertent violations of NASD rules. Consider for example the recent amendments to Rule 3340 governing trading halts. Rather than requiring each market participants to alter their own systems, Nasdaq simply could modify the SuperSoes or SelectNet system in order to prevent entry of orders during a trading halt. Not only is this approach vastly more cost-effective, it promotes the interests of the investors and significantly enhances the integrity of the marketplace. These system enhancements could serve as a supplemental measure to the modernization efforts already taking place with regard to the text of the NASD Rules.

Rule 3340 Prohibition on Transactions During Trading Halts

The Rule prohibits members from effecting any transactions in a security during a trading halt of that security. We believe that it would be helpful to members to have further guidance as to the types of trading halts specifically governed by the Rule. For instance, the Rule does not address situations when the NYSE halts trading in a NYSE-listed security due to the circuit breaker rules or due to an order imbalance, in which case firms are not immediately notified that trading has been halted. As a result, there is a "quote gap" where trades take place after the "halt" that can only be pulled back.[29] *(M)*

Moreover, since even a short delay in receipt of the trading halt message can impact trade prices, SIA further recommends that trading halt restrictions be triggered upon the firms' receipt of the message, rather than the time of message entry by Nasdaq. This modification not only better preserves the integrity of the marketplace, it is cost-beneficial since it avoids needless back-end corrective action. *(M)*

Rule 3380 SelectNet

This Rule will need to be updated in light of the sweeping changes in the marketplace structure represented by July 30, 2001 implementation of SuperSoes. For example, SelectNet will be impacted since it will now only apply to entities that are not full participants in SuperSoes, primarily electronic communications networks ("ECNs"). Moreover, to the extent a member uses SelectNet instead of SuperSoes to access another market makers quote, it must be for a minimal acceptable quantity ("MAQ") of 100 shares in excess of the display size. *(L)*

D. MARKETPLACE RULES

Rule 4613(e) Locked and Crossed Markets

The SEC limit order display rule and NASD rules governing the entry of quotations that would lock or cross the market are in direct conflict. To date, neither the SEC nor NASD has published practical or reasonable guidance to member firms as to how to cope with the differences between these rules. The lack of guidance on this imposes unreasonable regulatory costs on members. In addition, this inconsistency in rules undermines orderly markets, particularly at the open. We recommend that the NASD alone or in conjunction with the SEC work to harmonize the conflicting rules through amendments or reasonable interpretive guidance that can be practically applied by market participants. *(H)*

IM-4613 Autoquote Policy

SIA believes that the prohibition on autoquoting is unnecessary and should be eliminated. In the alternative, the interpretation should be amended to allow for autoquoting in certain circumstances and to align Nasdaq's procedures more closely with the provisions of the Intermarket Trading System ("ITS Plan") for listed securities. Specifically, autoquoting should be permitted for up to 100 shares or to disseminate a quote representing a customer market or marketable limit order for the purpose of exposing it for price improvement (as the ITS Plan currently permits). In addition, market makers should be permitted to autoquote to maintain their principal quote at the National Best Bid and Offer ("NBBO"), or to add size to a quote that is already at the NBBO (again as permitted by the ITS Plan).

SIA understands that the interpretation reflects Nasdaq's concerns about its systems' capacity and its ability to handle the numerous quote changes that would result from these changes. SIA notes, however, that Nasdaq has successfully implemented its Nasdaq National Market Execution System and will be implementing its SuperMontage trading platform in early 2002. These significant and historic upgrades to the Nasdaq system and its capacity should be more than sufficient to handle the increased quote activity. In addition, the changes outlined above will bring Nasdaq's market practices in line with those allowed under the ITS Plan and further the goal of eliminating conflicting and unnecessary regulations. *(H)*

Rule 4630 and Rule 4640 Principal Trading Prohibitions

Advisory or fee based customer relationships are rapidly growing throughout the industry. Consequently, market makers encounter more frequently the conflict between NASD rules and the prohibitions on acting as principal on a customer order set forth in ERISA or the Investment Advisers Act of 1940. The NASD has issued interpretative guidance relieving members from limit order protection obligations in these situations

because ERISA and the Advisers Act were interpreted to "supercede" the limit order protection interpretation. SIA believes that specific areas of NASD rules where similar interpretative guidance would be appropriate are the trade reporting rules (4630 and 4640) and ACT rules (6100-6190). SIA also would encourage the NASD to look at all trading rules that could be streamlined for the same reasons. *(H)*

Rule 4632 and Rule 4652 Transaction Reporting

Rules 4632(a)(9) and 4652(a)(9) govern trade reporting modifiers and appear to permit the .PRP modifier for certain "stop" stock situations, particularly where the stop price is based on a price from a prior reference point in time. According to NASD Notice to Members 99-66, however, the .PRP modifier is not to be used for "stop" stock situations. Alternatively, NASD could add another modifier to address "stopped" situations that are based on price from a prior reference time, which we believe will enhance market information and transparency.

Currently, reporting of "stopped" executions does not accurately reflect that the trade was negotiated based on a price from a previous point in time. Moreover, since market price on "stopped" executions may be unrelated to the prevailing market, "stopped" executions are more susceptible to being rejected from ACT because the price is outside the override price parameters on Nasdaq. Consequently, these trades either hit the tape late or the market maker has to call Nasdaq to obtain the print. *(M)*

Rule 4700 Series – SOES Rules

This Rule Series previously governing Small Order Execution System will require thorough analysis and modernization in light of the sweeping changes to the marketplace structure represented by the July 30, 2001 implementation of SuperSoes. *(L)*

E. INVESTIGATIONS, SANCTIONS AND DISCIPLINARY PROCEDURES

Rule 8210(a) Testimony and Inspection of Records

In the interests of cost-savings and convenience, SIA suggests that the Rule be amended to require testimony for investigations be taken in the city of the witness's residence or workplace rather than "at the location to be specified by the Association." *(L)*

Rule 8320 Payment of Fines

The Rule, among other things, requires that fines and other monetary sanctions imposed by the NASD be paid "promptly." We believe the term "promptly" is vague and in need of further clarification as to the number of days a respondent must pay a fine before becoming subject to summary suspension. *(L)*

Rule 9145 Rules of Evidence

SIA believes that use of the Federal Rules of Evidence as a guide for evidentiary rulings would add uniformity and predictability to hearings. *(M)*

Rule 9210 Complaint and Answer
Rule 9216 Acceptance, Waiver and Consent

SIA believes that a formal Wells submission process should be incorporated within these Rules. Specifically, member firms and associated persons should automatically be given the opportunity to make a Wells submission before the commencement of formal disciplinary proceedings or issuance of an acceptance, waiver and consent letter ("AWC"). Such a procedure would be cost-beneficial to both NASDR and industry respondents because it promotes more efficient use of regulatory staff and resources. It would also ensure that potential respondents receive adequate notice. Currently, firms often first learn of a complaint or AWC in which they are named upon its issuance, thereby automatically triggering a reportable event on the firm's Form BD. SIA, therefore, recommends that the Rules be amended to expressly provide for Wells submissions prior to the issuance of the AWC or complaint. *(H)*

IM-9216 Minor Rule Violation Plan

SIA believes that it would be helpful if the Interpretation were harmonized with NYSE Rule 476A so that comparable minor rule violations across SROs receive like treatment. This approach, we believe promotes consistency, efficiency and uniform protection of all customers regardless of the broker-dealer or market involved. *(H)*

Moreover, in the interest of overall regulatory efficiency, SIA urges the NASDR to build upon the recent amendments to IM-9216 to develop a mechanism that can informally and expeditiously address *de minimis* violations of NASD rules without the need for formal (and often protracted) review and disciplinary action. Although we recognize the importance of member compliance with all NASD rules, we believe that, as a general matter, regulation should focus less on enforcement of technical rule violations and more on the evaluation and remediation of a firm's deficiencies and weakness. In that regard, we recommend that NASDR examination staff be given the flexibility to negotiate and resolve minor uncontested rule infractions outside the rigidity of formal enforcement proceedings. In so doing, the effectiveness, efficiency and instructional value of regulatory examinations would be greatly enhanced, while conserving already strained regulatory resources for more egregious situations where there is substantive harm to markets or investors. *(H)*

Rule 9231 Appointment of Hearing Panel

This Rule generally governs the appointment and composition of a disciplinary hearing panel. SIA believes this Rule should be harmonized with NYSE Rule 476(b) to require, whenever possible, that at least one member of the disciplinary hearing panel have expertise similar to that of the respondent named in the disciplinary proceeding. *(M)*

Rule 9251 Inspections and Copying of Staff Documents

The Rule generally governs the procedures for inspection and copying of documents prepared and obtained in connection with an investigative proceeding. SIA believes that the Rule should be amended to expressly address privileges and work-product immunity issues for both the staff and respondents. *(M)*

Rule 9261 Evidence and Procedure at Hearing

The Rule generally requires that parties exchange documentary evidence and witness lists no later than 10 days prior to the hearing. SIA believes that the Rule should be amended to require that this exchange occur no later than 30 days prior to hearing. This change, we believe, will add greater predictability, avoid last-minute preparation, and improve the efficacy of the process. *(H)*

Rule 9262 Testimony

To harmonize this Rule with the NYSE rules, this Rule should be amended to permit taking of pre-hearing testimony, including video depositions, of witnesses who may be unavailable for the hearing. *(H)*

Rule 9270 Settlement Procedure

Under NYSE procedures, a Hearing Panel that rejects a Stipulation and Consent ordinarily will not then hear the contested hearing. This Rule should be amended to include such a safeguard. *(H)*

F. ARBITRATION

Rule 10106 Legal Proceedings

The Rule should be amended to include the phase "unless permitted by law" to preserve the rare instances where it might be still necessary and appropriate to seek judicial intervention after an arbitration has been filed, such as eligibility issues or possible emergency provisional remedies. Also, we note that the Rule should specifically cross-reference Rule 10301(d)(2), which allows for court intervention to preclude arbitration of claims otherwise covered by class actions. *(M)*

Rule 10303(b) Hearing Requirements – Waiver of Hearing

This Rule expressly authorizes arbitrators, notwithstanding the parties' written waiver of an arbitration hearing, to compel a hearing and demand submission of further evidence. SIA believes that this provision should be eliminated as it is unnecessary and undermines the express terms of the parties' agreement. If parties consent to waive a hearing, then arbitrators should not have an express right to call for a hearing, absent extreme or urgent circumstances. *(H)*

Rule 1031 Notice of Selection of Arbitrators
Rule 10311 Preemptory Challenge

In light of Rule 10308 governing the Neutral List Selection System (NLSS), Rules 10310 and 10311 appear to be redundant and should be modified to accurately reflect their application outside the scope of NLSS. *(L)*

Rule 10321(c) General Provisions Governing Pre-Hearing Proceedings

This Rule requires parties in arbitration to serve each party with copies of all documents in their possession at least 20 days prior to the hearing date. SIA believes this Rule should be harmonized with NYSE Rule 619(c), which provides that if a document has already been produced it may be listed and not produced again. We believe this approach to be more cost-effective and achieves the intended disclosure objectives of the existing Rule. *(M)*

Rule 10333 Member Surcharge and Process Fees

This Rule generally requires that each member named in the proceeding be assessed a non-refundable surcharge. For member firms that have undergone numerous mergers, this Rule presents a significant economic burden. Often because claimants are uncertain which firm is the proper party in interest, they name *all* affiliated member firms as respondents within the Statement of Claim. Consequently, several firms within a single corporate structure are assessed multiple surcharges, even though there is only one real party in interest. Not only is this practice unfair, it can cost firms tens, if not hundreds, of thousands of dollars per year. We, therefore, recommend that the Rule be amended to clarify that only the real party in interest will be assessed the surcharge. Moreover, to the extent it is initially unclear which entity is the proper party in interest, NASDR should allow the members to make that determination so that a surcharge paid in error may be refunded accordingly. *(H)*

G. UNIFORM PRACTICE CODE

Rule 11210(a) Comparisons or Confirmations

This Rule generally requires parties to a transaction, other than a cash transaction, to send uniform comparisons or confirmations on or before the first day of the transaction. SIA recommends that this provision be amended to include "unless such

transaction is compared or confirmed through a registered or a recognized domestic or international Clearing Corporation." *(L)*

Rule 11320 Dates of Delivery

SIA recommends all references to a delivery location in Subsections (a) through (h), which are described currently in the Rule as "at the office of the purchaser," be amended to also identify "Registered Depository or Purchasers Clearing Agent." SIA further suggests Subsection (h) include language to the effect "or, within such time frames scheduled by the rules of a Registered Depository." *(L)*

Rule 11330 Payment

SIA recommends that the Rule be updated to reflect that "Fed Funds" and "ACH" Clearing House Funds are also acceptable means of payment. *(L)*

Rule 11340 Stamp Taxes

This Rule is obsolete and should be eliminated. *(L)*

Rule 11360 Units of Delivery

SIA recommends that this provision be amended to exclude deliveries made through the facilities of a registered Clearing Agency or Depository. *(L)*

Rule 11510 Delivery of Temporary Certificates

This Rule is obsolete and should be eliminated. *(L)*

Rule 11810(b)(2) Buying-In

This Rule generally governs the information contained in a notice of "buy-in." SIA suggests that the Rule be modified to allow 48-hour notice in those situations where the initial buy-in notice was a continuous net settlement ("CNS") notice received from the National Securities Clearing Corporation. *(L)*

III. CONCLUSION

We thank you for the opportunity to provide comments on NASD Notice to Members 01-35 and again commend the NASDR for undertaking this important and timely review of the NASDR rulebook in light of developments with the securities industry. We hope this letter has been helpful and look forward to working with the staff and continuing the regulatory dialogue as this modernization initiative develops further. If we can provide any further information or clarification of points made in this letter, please contact Amal Aly, SIA Assistant Vice President and Assistant General Counsel, at (212) 618-0568.

Sincerely,

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Self-Regulation and Supervisory Practices Committee

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cc: Mary L. Schapiro, NASDR, Inc., President
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Robert Glauber, NASD, Inc., Chairman
Annette L. Nazareth, SEC, Director, Division of Market Regulation
Robert L. Colby, SEC, Deputy Director, Division of Market Regulation

[1] The Securities Industry Association brings together the shared interests of nearly 700 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign

markets and in all phases of corporate and public finance. The U.S. securities industry manages the accounts of nearly 80-million investors directly and indirectly through corporate, thrift, and pension plans. In the year 2000, the industry generated $314 billion of revenue directly in the U.S. economy and an additional $110 billion overseas. Securities firms employ approximately 770,000 individuals in the United States. (More information about the SIA is available on its home page: http://www.sia.com.)

[2] *See* NASD Notice to Members 98-81.

[3] Notably, there are several initiatives, such as T+1, decimalization, and TRACE, we do not address within this letter since they are already subject of ongoing discussions with the NASDR.

[4] Available at SIA's website at http://www.sia.com/publications/html/bp_research.html

[5] In 1998, the NASD amended its advertising rule to permit persons qualified as supervisory analysts by the NYSE (Series 16) to approve certain research reports.

[6] Letter to Joan Conley, NASD Regulation, Inc. from R. Gerald Baker, Chairman, Self-Regulation and Supervisory Practices Committee, and Colette D. Kimbrough, Chairman, Investment Company Committee, SIA, dated November 4, 1999.

[7] *See*, for example, Baxter, Banks & Smith, Ltd. (NASD Case #C07010014)(reported May 2001).

[8] *See* NASD Notice to Members 00-84.

[9] *See* IM-2110-1, subparagraph (l)(2) and Rule 2720 (b)(7)(9).

[10] *See*, for example, *Phillip Allen Hudson* (NYSE Hearing Panel Decision #00-76; May 11, 2000) (books and records violation premised upon a new account form that failed to identify a customer who was a first cousin once removed to the broker as a "relative"), and *Frank Ocello* (Hearing Panel Decision #00-110; June 29, 2000)(NYSE Rule 405 violation premised upon the failure to disclose that customer had listed broker in her will and had moved into the basement of the broker's home).

[11] Letter to Thomas Selman, NASD Regulation, Inc., from Michael Viviano, Chairman, SIA Operations Committee, July 9, 2001.

[12] Letter to Joan Conley, Office of the Corporate Secretary, NASD Regulation, Inc., from James A. Tricarico, President, SIA Compliance and Legal Division, February 23, 1999.

[13] Rule 501 generally defines "accredited investor" as (1) any natural person whose individual net worth, or joint net worth with that person's spouse, is greater than $1 million, or (2) any individual whose annual income is $200,000, or combined annual income with that person's spouse, is greater than $300,000.

[14] Pub. L. No. 106-102.

[15] We recognize, however, that there may be SEC-only registered broker-dealers under the SEC's Broker-Dealer Lite program, which may necessitate further review and modifications. *See* Securities Exchange Act Release No. 34-40594 (October 23, 1998).

[16] Letter to Margaret H. McFarland, Deputy Secretary, SEC, from Lee B. Spencer, Jr., Chairman, Federal Regulation Committee, and R. Gerald Baker, Chairman, Self-Regulation and Supervisory Practices Committee, dated December 14, 1998.

[17] For example, the Rule requires written trading authorization to a named individual or firm. This obligation, however, is inconsistent with situations where a firm only has specific trading authority if a sub-advisor is terminated, or there is cause to sell securities to meet unpaid fees. In the latter situation, margin personnel, or personnel in the firm's wrap/advisory account department often execute these sell-outs, even though they are not listed in the discretionary account authorization documents. Unlike the Rule, the Investment Advisors Act contemplates the complexities of these accounts by providing for firms' discretionary or trading authority within the ADV or the Schedule H.

[18] SR-NASD-00-04.

[19] Letters from SIA to SEC (June 9, 2000 and April 9, 2001; available on SIA website at http://www.sia.com/2001_comment_letters/.

[20] Letter from The Bond Market Association to NASD Regulation, Inc. (January 15, 1999) ("TBMA Letter"), p. 17.

[21] TBMA Letter at 18.

[22] TBMA Letter at 19.

[23] TBMA Letter at 19-20.

[24] TBMA Letter at 20.

[25] TBMA Letter at 20.

[26] TBMA Letter at 20.

[27] TBMA Letter at 14.

[28] *See* endnote 14.

[29] Notably, the Rule only cross-references Nasdaq's authority to initiate trading halts and the trading halt procedures. It should also reference Notice to Members 98-26.