The Securities Industry Continuing Education Program
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Securities Industry Continuing Education

Program Firm Element Advisory

Each year the Securities Industry/Regulatory Council on Continuing Education (CE Council) publishes the Firm Element Advisory to identify current regulatory and sales practice issues for possible inclusion in Firm Element Training plans. This year's topics have been taken from a review of industry regulatory and self-regulatory organization (SRO) publications issued since the last Firm Element Advisory of September 2003.

The Council recommends that firms use the Firm Element Advisory as part of their Firm Element Needs Analysis to identify training topics that are relevant to the firm, including training for supervisors. New rules or regulations, such as the Research Analyst Rules; major regulatory examination findings, such as those relating to bond sales practices; ethics and professional conduct; and any new products or services the firm plans to offer should be among the subjects considered as topics for Firm Element training.

The CE Council provides a convenient way for firms to access the training resources listed next to each topic in the Firm Element Advisory via the CE Council Web site at ***www.securitiescep.com***. By using the Search function on the site and entering the referenced document, it will be possible to review the content on the CE Web site. In addition to the Firm Element Advisory material, there are also two additional resources to assist with developing Firm Element training plans. The first is the Firm Element Organizer, available at *www.securitiescep.com/TOC/Firm_Element/*. This is an easy-to-use software application that enables the search of an extensive database of regulatory resources related to specific investment products or services. The results of a search can then be edited into a document that will assist in developing a Firm Element training plan. A tutorial on the CE Council Web site demonstrates how to use the Firm Element Organizer. The second potential Firm Element resource is the Regulatory Element Scenario Library, available at *www.securitiescep.com>CEP Training Material*. The Scenario Library is comprised of scenarios that were taken from the Regulatory Element Supervisor (S201) and General (S101) programs, and may be suitable for Firm Element training.

For more information, log on to *www.securitiescep.com*, or call Ann M. Griffith, Associate Vice President, NASD Testing & Continuing Education, at (240) 386-5051; or Joe McDonald, Associate Director, NASD Testing & Continuing Education, at (240) 386-5065; or Roni Meikle, Director, Continuing Education, New York Stock Exchange, at (212) 656-2156.

Alternative Investments

Non-Conventional Investments

Some alternative investments, such as asset-backed securities, distressed debt, and derivative products (collectively termed "non-conventional investments"(NCI)), often have complex terms and features that are not easily understood by investors. In selling NCIs, firms have obligations to: (1) conduct adequate due diligence to understand the features of the product; (2) perform a reasonable-basis suitability analysis; (3) perform a customer-specific suitability analysis in connection with any recommended transactions; (4) provide a balanced disclosure of both the risks and rewards associated with the particular product, especially when selling to retail investors; (5) implement appropriate internal controls; and (6) train registered persons regarding the features, risks, and suitability of these products. *See NASD Notice to Members 03-71: NASD Reminds Members of Obligations When Selling Non-Conventional Investments* (November 2003).

Anti-Money Laundering

Broker-Dealer Customer Identification Rule

Anti-money laundering is an evolving topic, as regulators adopt new rules and regulations to carry out the mandates of the USA PATRIOT Act. On April 29, 2003, the Securities and Exchange Commission (SEC or Commission) and Department of the Treasury jointly issued the broker-dealer customer identification rule (CIP Rule). The rule requires broker-dealers to implement customer identification programs that contain the following elements: (1) procedures for verifying the identities of customers, (2) procedures for maintaining records of the verification process, (3) procedures for comparing customers with lists of known or suspected terrorists or terrorist organizations, and (4) procedures for providing customers with notice that information is being collected to verify their identities. *See 31 C.F.R. 103.122*.

The CIP Rule permits broker-dealers to rely on certain other financial institutions to undertake the required elements with respect to shared customers. On February 12, 2004, the SEC Division of Market Regulation staff issued a No-Action letter to the Securities Industry Association stating that the Division staff will not recommend enforcement action to the Commission under Rule 17a-8 if a broker-dealer relies on an investment adviser to perform customer identification procedures, prior to such adviser becoming subject to an Anti-Money Laundering Rule (AML Rule). Certain additional requirements and conditions in the CIP Rule must also be met, including that: (1) such reliance is reasonable under the circumstances; (2) the investment adviser is regulated by a Federal functional regulator (as defined in the CIP Rule); and (3) the investment adviser enters into a contract requiring it to certify annually to the broker-dealer that it has implemented an anti-money laundering program, and that it will perform (or its agent will perform) specified requirements of the broker-dealer's customer identification program. This letter will be withdrawn without further action on the earlier of: (1) the date upon which an AML Rule for

advisers becomes effective, or (2) February 12, 2005. *See SEC Division of Market Regulation: No-Action Letter to the Securities Industry Association, February 12, 2004. See also* NASD's Anti-Money Laundering Web page at *www.nasdr.com/money.asp;* and the SEC's *Spotlight On: Anti-Money Laundering Rules* at *www.sec.gov/spotlight/moneylaundering.htm. See also NYSE Information Memos 03-48, Rule 445 – Initial Anti-Money Laundering Audit, October 23, 2003*, and 0*3-32, Customer Identification Programs for Broker-Dealers, July 14, 2003* at *www.nyse.com>regulation>information memos*.

Bond Sales

Sales Practice Obligations

As the number of retail customers investing in bonds and bond funds grows, regulators are concerned that many investors may not fully appreciate the risks and costs associated with such products. It is the responsibility of firms to take appropriate steps to ensure that their registered representatives understand and inform their customers about the characteristics and risks as well as the rewards of the products they offer and recommend. Firms have the following obligations in connection with the sale of bonds and bonds funds:

1. Understanding the terms, conditions, risks, and rewards of the bonds and bond funds they sell (performing a reasonable-basis suitability analysis);
2. Making certain that a particular bond or bond fund is appropriate for a particular customer before recommending it to that customer (performing a customer-specific suitability analysis);
3. Providing a balanced disclosure of the risks, costs, and rewards associated with a particular bond or bond fund, especially when selling to retail investors;
4. Adequately training and supervising employees who sell bonds and bond funds; and
5. Implementing adequate supervisory controls to reasonably ensure compliance with NASD and SEC sales practice rules in connection with bonds and bond funds.

See NASD Notice to Members 04-30: NASD Reminds Firms of Sales Practice Obligations In The Sale of Bonds and Bond Funds (April 2004).

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Mark-Ups

NASD recently levied $15 million in total fines against four firms for rule violations relating to trading in corporate high-yield bonds. All four firms were cited for charging excessive markups or markdowns, inadequate record keeping and supervision violations. Firms are reminded that they must sell all securities, including corporate high-yield debt, at fair prices. Markups and markdowns generally should not exceed five percent and, for most debt transactions, that figure should be lower.

Business Continuity Plans

On April 7, 2004, the SEC approved new rules pertaining to firms' emergency preparedness and business continuity planning. The rules require firms to, among other things, establish and maintain business continuity plans and, upon request, to provide summaries of such plans to their customers. The rules also require firms to designate two emergency contact persons and to provide this information to NASD or NYSE. NASD Rule 3510 became effective for clearing firms on August 11, 2004, and on September 10, 2004 for introducing firms. NASD Rule 3520 became effective for all firms on June 14, 2004. NYSE Rule 446 became effective August 5, 2004 for all members and member organizations. *See NASD Notice to Members 04-37: SEC Approves Rules Requiring Members to Create Business Continuity Plans and Provide Emergency Contact Information* (May 2004). *See also* NASD's Business Continuity Plan Web page at *www.nasdr.com/business_continuity_planning.asp. See also NYSE Information Memo 04-24, Rule 446 – Business Continuity and Contingency Plans, May 3, 2004.*

Continuing Education

NASD Rule 1120 and NYSE Rule 345A set forth the CE requirements for registered persons. The CE requirements consist of a Regulatory Element and a Firm Element. NASD provides members with e-mail notifications through the Web Central Registration Depository® (Web CRD®) when a person is both 90 days and 30 days away from the end of his or her period to complete the Regulatory Element program before going inactive. Web CRD also notifies members when a registered person at the firm becomes CE inactive. Receipt of the e-mail notifications had been optional, and some firms chose not to receive the notifications. On February 13, 2004, the SEC approved amendments to NASD Rule 1120 to require that each member designate and identify to NASD the individual(s) who will receive the Web CRD Continuing Education Regulatory Element e-mails. *See NASD Notice to Members 04-22: SEC Approves Amendments to Rule 1120 (Continuing Education Requirements) Regarding Regulatory Element Contact Person* (March 2004).

The SEC has approved NASD and NYSE rule filings to eliminate all exemptions from the requirement to complete the Regulatory Element of the Continuing Education Program. The Securities Industry/Regulatory Council on Continuing Education unanimously agreed at its December 2003 meeting to recommend to the self-regulatory organizations (SROs) that they repeal the current exemption for industry members who, when the Continuing Education Program was adopted in 1995, had been registered for at least 10 years and who did not have a significant disciplinary action during that time ("grandfathered" persons) and registered persons who had "graduated" from the Regulatory Element by satisfying their tenth anniversary requirement before July 1998. The rule changes will become effective no later than April 4, 2005. The other SROs are also seeking approval of the same rule change from the SEC. *See Securities Exchange Act Release Nos. 34-50404* (September 16, 2004) (NYSE Approval Order) and *50456* (September 27, 2004) (NASD Approval Order).

Customer Account Transfers

On March 12, 2004, the SEC approved amendments to NYSE Rule 412 (Customer Account Transfer Contracts) and its interpretation. An effective date of September 12, 2004 was established for full compliance with the amendments to allow member organizations sufficient time to develop and implement any necessary systems changes.

Rule 412 prescribes procedures for transferring customer accounts between member organizations. The rule also generally requires use of the Automated Customer Account Transfer Service (ACATS) system for full account transfers, when both the delivering and receiving organizations are members of the National Securities Clearing Corporation (NSCC) which administers the ACATS system.

The amendments:

(1) Mandate use of the ACATS system for "partial" transfers, unless otherwise specifically requested and authorized by a customer;

(2) Require the utilization of all automated functionalities available through the ACATS system in connection with both standard and partial transfers and

(3) Clarify that electronic signatures are a potential means of customer authorization and clarify certain designated exceptions to transfer instructions.

See NYSE Information Memo 04-20, Amendments to Rule 412 ("Customer Account Transfer Contracts") and Its Interpretation, April 8, 2004; and *NYSE Interpretation Memo, 04-02, April 20, 2004. See also NASD Notice to Members 04-58: SEC Grants Accelerated Approval of Rule Change Relating to Transfers of Specifically Designated Customer Account Assets through the Automated Customer Account Transfer Service (ACATS)* (August 2004).

Data Retention

On April 29, 2004, the SEC approved amendments to NASD rules to require members to record and report execution price and firm capacity as part of their Order Audit Trail System[SM] (OATS[SM]) Execution Reports. *See NASD Notice to Members 04-48: SEC Approves Amendments to Rule 6954 Requiring Members to Record and Report Execution Price and Firm Capacity in OATS Execution Reports* (June 2004). *See also NYSE Information Memos 03-37, Order Tracking System Technical Specifications; Exchange Rules 132A, 132B and 132C, September 10, 2003 and 03-51, Clarification to Information Memo No. 03-18 re: Books and Records Requirements for Floor Brokers Who Conduct a Public Business – Exchange Rules 36, 123 and 440, November 10, 2003.*

Day Trading

Day trading is the buying and selling of, or selling short and buying to cover, the same security on the same day. NASD recently levied $10 million in total fines against three firms for improperly extending credit in violation of Federal Reserve Board Regulation T, and, in numerous instances, allowing trades that avoided industry day trading margin requirements.

Regulation T Section 220.8(a)(1) states that a broker-dealer may use a cash account to buy a security for a customer if: (1) there are sufficient funds in the account; or (2) the creditors accept in good faith the customer's agreement that the customer will promptly make full cash payment for the security or asset before selling it and does not contemplate selling it prior to making such payment.

Federal Reserve Board interpretations make clear that a customer who sells a security in a cash account on trade date to pay for another security purchased on that day does not have "sufficient funds in the account" on trade date for purposes of Regulation T Section 220.8(a)(1)(i). Rather, a customer must make full payment for each separate purchase transaction in a cash account without regard to the unsettled proceeds of securities sold. If a member firm plans to accept the unsettled proceeds of a securities sale as payment for securities purchased, the transaction must be conducted in a margin account and is subject to the regulations affording protection to customers who trade in margin accounts. *See NASD Notice to Members 04-38: NASD Reminds Member Firms of Their Obligations to Adhere to Credit Extension Requirements and Day Trading Margin Rules* (May 2004). *See also* NASD Rule 3520 and NYSE Rule 431.

Do-Not-Call Registry

On January 12, 2004, the SEC approved amendments to NASD Rule 2212 (Telemarketing) and Rule 3110 (Books and Records). These amendments set forth NASD's requirement that member firms participate in the Federal Trade Commission's national do-not-call registry. *See NASD Notice to Members 04-15: SEC Approves Amendments to NASD Rules Concerning Member Participation in the National Do-Not-Call Registry* (March 2004). *See also* NYSE Rule 440A.

Ethics

The CE Council will introduce an ethics module as part of the Regulatory Element of the CE Program in early 2005; nonetheless, firms should address ethical issues in their own Firm Element training. Such individual programs can tailor general concepts to the values, policies, culture, organization and business model of the particular firm, and allow senior management to participate in the ethics program, thereby modeling and articulating the firm's commitment to high ethical standards in daily business conduct.

Ethics programs should do more than explain industry rules and firm policies. They should provide a context for regulatory requirements by addressing the importance of upholding the firm's values (*e.g.*, integrity, trustworthiness), what *constitutes* the "right" thing, and the spirit—not only the letter—of the law. They should also help employees develop a greater awareness of ethics issues and a stronger ability to make ethical decisions, including dealing with organizational influences on such decision-making. Such programs should be based on the firm's code of ethics (if any), its supervisory procedures, mechanisms for reporting observed misconduct, and other policies that bear on the conduct of its employees—and they should be realistic.

The firm's annual needs assessment should seek to identify ethical dilemmas that employees face (or see their colleagues facing), as well as pressures that may keep employees from acting properly or reporting their ethical concerns. The assessment process might include obtaining feedback from business units, staff functions (human resources, employee relations, legal, compliance, audit, security), as well as employees themselves. Assessments can be based on direct interviews, document review, employee questionnaires, or a combination of techniques including the use of confidential surveys or third parties that often encourage employees to respond candidly.

Depending on the firm's business and structure, the needs assessment may reveal ethics issues such as (A) conflicts of interest (*e.g.*, personal trading, outside activities, gifts/gratuities/entertainment, political contributions), (B) relationships with other employees (*e.g.*, dignity and respect, sexual harassment, discrimination), (C) relationships with customers (*e.g.*, putting the client's best interests first, dealing with improper requests from customers), and (D) representing the firm's interests (*e.g.*, using firm property, accuracy of records, responding to regulatory inquiries). The assessment may also indicate that ethical conduct is especially challenging in an organization due to such influences as peer pressure, lack of information, rationalizations (*e.g.*, believing that one can hold the line after making only one exception, or that one's supervisor would never make an improper request), or "bottom line" pressures.

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The ethics curriculum should include ethical situations (cases), approaches to resolving such dilemmas and strategies and resources for dealing with organizational influences (*e.g.*, focusing on long-term success instead of short-term expediency, using confidential help lines). Rather than providing ethical content in isolation, firms should have employees apply ethical principles to realistic fact patterns, hear stories of people who have made the wrong ethical decision and those who have had the courage to make the right choice, and consider the consequences of ethical decisions for customers, employees, the firm, and the industry (especially with regard to investor confidence and integrity of the firm). Firms should bear in mind that experience often varies dramatically among employees of the same firm, or between supervisors and staff, and that the training needs may differ across the firm.

There are a variety of methods to deliver stimulating ethics training, including provision of instruction in person (utilizing outside experts, train-the-trainer methodologies, or in-house personnel), and electronic means. Group interaction is particularly useful in ethics training. Instead of merely providing reading material or lectures, firms should engage employees by providing an opportunity (whether online, in small discussion groups or both) by which employees can express their views and hear the views of their colleagues.

Fee-Based Compensation

Fee-based compensation programs typically charge a customer a fixed fee or percentage of assets under management in lieu of transaction-based commissions. Broker-dealers are reminded that they must have reasonable grounds for believing that a fee-based program is appropriate for a particular customer, taking into account the services provided, cost, and customer preferences. It is generally inconsistent with just and equitable principles of trade—and therefore a violation of SRO Rules—to place a customer in an account with a fee structure that reasonably can be expected to result in a greater cost than an alternative account offered by the member that provides the same services and benefits to the customer. *See NASD Notice to Members 03-68: NASD Reminds Members That Fee-Based Compensation Programs Must Be Appropriate* (November 2003), and related Questions and Answers on NASD's Web site. *See also* proposed NYSE Rule 405A, SR-NYSE-2004-13.

Floor Communications

Members and member organizations of the NYSE are required to adhere to various requirements when conducting a public business from the NYSE trading floor. Such requirements include supervision, registration, employment, financial, operations, sales practices, and record retention. *See NYSE Information Memos 03-54: Reminder Regarding Requirements for Conducting a Public Business on the Trading Floor; Floor Communications, November 25, 2003,* and 01-41: *Requirements for Conducting a Public Business on the Trading Floor; Floor Communications, November 21, 2001.*

Hedge Funds

Hedge funds pool investors' money and invest those funds in financial instruments in an effort to make a positive return. Many hedge funds seek to profit in all kinds of markets by pursuing leveraging and other speculative investment practices that may increase the risk of investment loss. Hedge funds are not currently registered with the SEC.

The SEC has proposed for comment a new rule and rule amendments under the Investment Advisers Act of 1940 (Advisers Act). The proposed new rule and amendments would require advisers to certain hedge funds to register with the SEC under the Advisers Act. The rule and rule amendments are designed to provide the protections afforded by the Advisers Act to investors in hedge funds and to enhance the SEC's ability to protect the securities markets. *See SEC Release No. IA-2266, Registration Under the Advisers Act of Certain Hedge Fund Advisers, July 20, 2004; and SEC Investor Tips: Hedging Your Bets. See also* the SEC's Hedge Fund Web site at *www.sec.gov/spotlight/hedgefunds.htm* and *NASD Notice to Members 03-07: NASD Reminds Members of Obligations When Selling Hedge Funds* (February 2003).

Internal Controls

On June 17, 2004, the SEC approved amendments to NYSE Rules 342, 401, 408, and 410 to strengthen the supervisory procedures and internal controls of members and member organizations. To allow sufficient time for adoption and establishment of necessary systems changes, an effective date of December 17, 2004 has been set for compliance with the amendments. However, good business practice suggests compliance as soon as possible.

The amendments prescribe general standards with respect to internal controls, including the regulatory systems and procedures and their purpose regarding supervision and control, business conduct, discretionary accounts, and records of orders. *See NYSE Information Memo 04-38, Amendments to Rules 342, 401, 408 and 410 Relating to Supervision and Internal Controls, July 26, 2004. Effective date December 17, 2004. See also NYSE Disciplinary Actions 04-128,* dated August 2, 2004, and *02-227, 02-226, 02-225, 02-224, 02-223*, all dated November 15, 2002, regarding e-mail retention.

On June 17, 2004, the SEC approved rule changes (Supervisory Control Amendments) by NASD that both create and amend certain rules and interpretive materials to address a member's supervisory and supervisory control procedures. On September 30, 2004, the SEC granted accelerated approval to proposed rule changes to the Supervisory Control Amendments to conform certain parts of the new rule requirements to the NYSE's recently approved internal control amendments. *See NASD Notice to Members 04-71: SEC Approves New Rules and Rule Amendments Concerning Supervision and Supervisory Controls; Effective date January 31, 2005* (October 2004).

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The SEC has also adopted new rules under the Investment Company Act of 1940, and the Advisers Act, that require each investment company and investment adviser registered with the SEC to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws. Firms must review these policies and procedures annually for their adequacy and designate a chief compliance officer to be responsible for administering the policies and procedures. In the case of an investment company, the chief compliance officer reports directly to the fund board. These rules are designed to protect investors by ensuring that all funds and advisers have internal programs to enhance compliance with the federal securities laws. *See SEC Release No. IA-2204, Compliance Programs of Investment Companies and Investment Advisers, December 17, 2003. Effective Date: February 5, 2004.*

Margin

The SEC approved revisions to NYSE Rule 431 and NASD Rule 2520. These amendments provide for margin requirements on non-equity securities commensurate with the economic risks associated with positions in such securities held by customers. The reduced margin requirements recognize both the quality of the securities and the creditworthiness of the customer and therefore preserve reasonable safety and soundness standards. The types of non-equity securities eligible for exempt account treatment have been expanded. *See NYSE Information Memos 03-42, Amendments to Rule 431 ("Margin Requirements") Regarding "Good Faith" Securities, September 29, 2003,* and *03-46, Correction to Information Memo No. 03-42, October 10, 2003. See also NASD Notice to Members 03-66: Amendments to NASD Rules Regarding Margin Requirements* (October 2003).

Municipal Securities

Consultants

MSRB Rule G-38 defines a consultant as any person used by a dealer to obtain or retain municipal securities business through direct or indirect communication by such person with an issuer on the dealer's behalf where the communication is undertaken by such person in exchange for, or with the understanding of, receiving payment from the dealer or any other person. Dealers must disclose to issuers certain information about their consultants and report certain information about their consultants to the MSRB on Form G-37/G-38, including certain of their consultants' political contributions to issuer officials and payments to state and local political parties.

See MSRB Rule G-38 in the *MSRB Rule Book* and online at *www.msrb.org.*

Municipal Fund Securities

Municipal fund securities, including 529 college savings plans, are municipal securities regulated by the MSRB. Municipal fund securities represent investments in pools of securities, such as securities issued by registered investment companies. Therefore, certain sales materials for municipal fund securities must comply with the advertising rules of the SEC and NASD, including NASD Rule 2210. Principals supervising the sale of municipal fund securities must be appropriately qualified and hold either a Series 51 (Municipal Fund Securities Limited Principal) or Series 53 (Municipal Securities Principal) license. For more information, see the section on Municipal Fund Securities on the MSRB Web site at *www.msrb.org/msrb1/mfs/default.asp. See also NASD Notice to Members 03-17: Sales Material for Municipal Fund Securities* (March 2003); and *NASD Issues Investor Alert on 529 College Savings Plans, September 13, 2004* at *www.nasdr.com/news/pr2004/release_04_059.html,* a news release regarding expenses and tax incentives associated with investments in 529 college savings plans.

Political Contributions and Prohibitions on Municipal Securities Business

Dealers are prohibited from engaging in municipal securities business with a municipal securities issuer within two years after any contribution to an official of such issuer made by the dealer, any municipal finance professional (MFP), or any political action committee (PAC) controlled by the dealer or any of its MFPs. A dealer that has triggered the ban and desires to do municipal securities business with the issuer must obtain an exemption from the appropriate regulatory agency, or, in certain limited circumstances, use an automatic exemption. MSRB Rule G-37 describes the relevant factors to be considered by the appropriate regulatory agency in determining whether to grant an exemption.

The MSRB published a notice indicating its concern with increasing signs that individuals subject to Rule G-37 may be using indirect political contributions in an attempt to get around the rule. This would be accomplished through: (1) payments to political parties or non-dealer controlled PACs that find their way to issuer officials, (2) significant political contributions by dealer affiliates to both issuer officials and political parties, (3) contributions by associated persons of the dealer who are not MFPs, (4) contributions by the spouses and family members of MFPs to issuer officials, and (5) the use of consultants who make or bundle political contributions. The MSRB reminded dealers that Rule G-37, as currently in effect, covers indirect as well as direct contributions to issuer officials, and the MSRB alerted dealers that it has expressed its concern to the entities that enforce the MSRB's rules that some of the increased political giving may indicate a rise in Rule G-37 violations from "indirect" contributions. *See Notice Concerning Indirect Rule Violations: Rules G-37 and G-38* (August 6, 2003), MSRB Rule Book.

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Municipal Securities Transaction Reporting

Broker-dealers have an obligation to report their municipal securities transactions to the MSRB accurately and on time. Transaction information is made available to the public, and to regulators for market surveillance and enforcement activities.

Firms may need to adapt their procedures and systems for processing municipal securities transactions in order to report their trades in real time by January 2005. The MSRB has filed a proposed rule change with the SEC regarding Rule G-14 on transaction reporting, Rule G-12(f) on automated comparison of inter-dealer transactions, and the implementation of a system for real-time transaction reporting and price dissemination (the Real-Time Transaction Reporting System or RTRS). The proposed changes would require broker-dealers to report nearly all transactions in municipal securities within 15 minutes of the time of trade execution instead of by midnight on trade date, as is currently required. Broker-dealers would also be required to submit inter-dealer transactions to the central comparison system within the same time frame. The proposed rule change is planned to become effective in January 2005, at which time the MSRB would begin to disseminate transaction data electronically in real-time immediately after receipt.

Adapting to real-time reporting will require that a firm's traders provide several more data items for transaction processing than what currently is provided. An example of a new data item is the firm's capacity in an inter-dealer trade, whether as principal or as agent for a customer. All information must be provided accurately and within a short time frame. The MSRB will publish a user manual for real-time trade reporting in the second half of 2004 to assist in identifying necessary changes and to aid in staff training.

See the Transaction Reporting System section of the MSRB Web site, *www.msrb.org.* In particular, *see MSRB Notice 2004-13, Notice of Filing of Proposed Rule Change to Rules G-14 and G-12(f)* (June 1, 2004); *MSRB Notice 2004-20, Summary of Certification Test Plan* (June 24, 2004); *MSRB Notice 2004-21, MSRB Will Make Form RTRS Available On-Line* (June 24, 2004); and *MSRB Notice 2004-29, Approval by the SEC of Real-Time Transaction Reporting and Price Dissemination* (September 2, 2004).

Dealer Pricing Responsibilities

The MSRB published a notice reviewing the fair pricing requirements of MSRB Rules G-18 and G-30, including a review of the responsibility of broker's brokers to use a "reasonable effort" to find a price that is fair and reasonable in light of the prevailing market. The MSRB notice reviews the Rule G-18 and G-30 application in light of the MSRB's review of certain transaction patterns that have appeared in the MSRB's Transaction Reporting System. The patterns, which show abnormally large price variance in a relatively small number of issues each day, suggest that brokers, dealers, and municipal securities dealers may not always be making the requisite efforts to ensure that transaction prices are reasonably related to market value. *See MSRB Notice 2004-3, Review of Dealer Pricing Responsibilities* (January 26, 2004)

Mutual Funds

The following types of mutual fund transactions are under increased scrutiny from regulators.

Breakpoint Discounts

Breakpoint discounts are volume discounts applicable to front-end sales charges on Class A mutual fund shares (front-end loads). The SEC and SROs determined that many investors were not receiving correct breakpoint discounts on their mutual fund purchases. It was estimated that at least $86 million was owed to investors for 2001 and 2002 alone. Firms must disclose applicable breakpoint discount information to their customers and must have procedures reasonably designed to ascertain information necessary to determine the availability and appropriate level of breakpoints. Failure to provide customers with appropriate breakpoint discounts is conduct in violation of Section 17(a)(2) of the Securities Act of 1933, NASD Rule 2110 and NYSE Rule 401. *See* NASD's Mutual Fund Breakpoints Web page at *www.nasdr.com/breakpoints_members.asp; NASD Investor Alert Net Asset Value Transfers: Look Before You Leap Into Another Mutual Fund, February 26, 2004;* NASD's Mutual Fund Sales Practices Web page at *www.nasdr.com/mutual_funds.asp;* and the SEC's Breakpoints Web site at *www.sec.gov/spotlight/breakpoints.htm.*

The Joint NASD/Industry Breakpoint Task Force developed recommendations to facilitate the complete and accurate delivery of breakpoint discounts in the future. The Task Force Report, which is available at *www.nasdr.com/breakpoints_report.asp*, made recommendations that will impact virtually every level of the mutual fund distribution chain. *See also www.nasdr.com/breakpoints_members.asp* (which reports the implementation status of Task Force recommendations).

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Late Trading Transactions

Late trading is the practice of placing mutual fund orders received after the time at which point the fund calculates its daily net asset value (NAV)—usually 4 p.m. ET—at the previous day's NAV price. Late trading also includes the after-close cancellations of orders that were placed prior to the time a fund calculates the NAV. Firms that permit late trading provide customers with an unfair information advantage, allowing them to trade based on news that breaks after the close of the market. NASD Rules 2110 and 2120 and SEC rules prohibit late trading.

There are situations where firms legitimately receive orders prior to the close of trading, but enter such orders after the market's close. Firms should take great care to ensure that these trades are executed at the appropriate price. Firms must have in place policies and procedures that are reasonably designed to detect and prevent the occurrence of late trading. *See NASD Notice to Members 03-50: NASD Reminds Member Firms of their Obligations Regarding Mutual Fund Transactions and Directs Review of Policies and Procedures* (September 2003). *See also* the following NASD news release: *NASD Fines Five Firms $625,000 For Supervisory System Failures Relating to Late Trading of Mutual Funds* (June 24, 2004).

Market Timing Transactions

Market timing is the rapid buying and selling of mutual funds (funds). In some cases, market timers pace their orders to profit from short-term inaccuracies in the NAV of the fund. Many funds have implemented procedures to counteract the efforts of market timers, and have represented in their prospectuses that they are utilizing these procedures to prevent market timing of the fund.

When a fund has made these representations, a member firm and its associated persons may not knowingly or recklessly act in conjunction with the fund, or its affiliated persons, to facilitate a market timing transaction. In addition, member firms must have in place policies and procedures that are reasonably designed to prevent this collusion with funds and their affiliated persons to circumvent the funds' stated procedures. *See NASD Notice to Members 03-50: NASD Reminds Member Firms of their Obligations Regarding Mutual Fund Transactions and Directs Review of Policies and Procedures* (September 2003). *See also* the following NASD news release: *NASD Fines State Street Research Investment Services $1 Million For Market Timing Supervision Violations; Firm Ordered to Pay More than $500,000 in Restitution* (February 19, 2004).

New and Secondary Offerings

The SEC has approved a number of new NASD rules and amendments to remedy inequities in public offerings.

Restrictions on the sale of new issues

Rule 2790 generally prohibits a member from selling a "new issue" to any account in which a "restricted person" has a beneficial interest. The term "restricted person" includes most associated persons of a member, most owners and affiliates of a broker-dealer, and certain other classes of persons. The rule requires that a member, before selling a new issue to any account, meet certain "preconditions for sale." These generally require the member to obtain a representation from the beneficial owner of the account that the account is eligible to purchase new issues in accordance with the rule. *See NASD Notice to Members 03-79: SEC Approves New Rule 2790 (Restrictions on the Purchase and Sale of IPOs of Equity Securities); Replaces Free-Riding and Withholding Interpretation* (December 2003).

Restrictions on Underwriting Compensation

On December 23, 2003, the SEC approved amendments to Rule 2710 (Corporate Financing Rule). The Corporate Financing Rule regulates underwriting compensation and prohibits unfair arrangements in connection with the public offerings of securities. The rule requires members to file information about initial public offerings and certain secondary offerings with NASD. The NASD Corporate Financing Department reviews this information prior to commencement of the offering to determine whether the underwriting compensation and other terms and arrangements meet the requirements of applicable NASD rules. As amended, Rule 2710(c)(3)(A) sets forth a non-exclusive list of specific types of "items of value" that will be included for purposes of determining the amount of underwriting compensation received or to be received. Rule 2710(c)(3)(B), in turn, provides a list of items that will not be considered "items of value" for purposes of the rule. *See NASD Notice to Members 04-13: SEC Approves Amendments to Rule 2710 (Corporate Financing Rule) and Rule 2720 (Distribution of Securities of Members and Affiliates-Conflicts of Interest)* (February 2004).

NASD Rule 2810 (Direct Participation Programs), among other things, establishes limits on the level of underwriting compensation for public offerings of direct participation programs. In a change of policy, NASD staff will consider all trail commissions paid in connection with commodity pool direct participation programs in calculating whether the level of underwriting compensation meets the requirements of Rule 2810. *See NASD Notice to Members 04-50: Treatment of Commodity Pool Trail Commissions under Rule 2810 (Direct Participation Programs Rule)* (July 2004).

Registered Representative Regulations

Lending Restrictions

On August 29, 2003, the SEC approved the adoption of NASD Rule 2370, prohibiting registered persons from borrowing money from, or lending money to, a customer unless: (1) the member has written procedures allowing such lending arrangements consistent with the rule; (2) the loan falls within one of five prescribed permissible types of lending arrangements set forth in the rule; and (3) the member pre-approves the loan in writing. On February 18, 2004, the SEC approved amendments to NASD Rule 2370 exempting from the rule's notice and approval requirements lending arrangements involving a registered person and a customer that is: (1) a member of his or her immediate family (as defined in the rule); or (2) a financial institution regularly engaged in the business of providing credit, financing, or loans (or other entity or person that regularly arranges or extends credit in the ordinary course of business), provided the loan has been made on commercial terms that the customer generally makes available to members of the general public similarly situated as to need, purpose, and creditworthiness. The amendments to Rule 2370 also limit the scope of the rule to lending arrangements between registered persons and their customers, rather than any customer of the firm. *See NASD Notice to Members 04-14: SEC Approves Amendments to Rule Governing Lending Between Registered Persons and Customers* (March 2004). *See also* proposed amendment to NYSE Rule 350 (SR-NYSE-2004-47).

Reporting and Disclosure Requirements

On June 14, 2004, the SEC approved amendments to NASD Rule 6230(a) of the Trade Reporting and Compliance Engine (TRACE) Rules (the Rule 6200 Series), reducing the period for reporting a transaction to NASD. In the first stage, which began on October 1, 2004, the period to report a transaction in a TRACE-eligible security was reduced from 45 minutes to 30 minutes. In the second stage, set to begin July 1, 2005, the reporting period will be reduced to 15 minutes. *See NASD Notice to Members 04-51: SEC Approves Amendments to TRACE Rule 6230 to Reduce the Reporting Period to 30 Minutes on October 1, 2004, and to 15 Minutes on July 1, 2005* (July 2004).

On September 3, 2004, the SEC approved amendments to NASD Rules 6210, 6250, and 6260 of the TRACE Rules. The most significant amendments, which are set forth in NASD Rule 6250, effect a fundamental change in the corporate bond markets by requiring that information on all transactions in TRACE-eligible securities de disseminated, except those transactions in TRACE-eligible securities that are issued pursuant to Section 4(2) of the Securities Act of 1933 (Securities Act) and purchased or sold pursuant to Rule 144A under the Securities Act. *See NASD Notice to Members 04-65: SEC Approves Amendments to TRACE Rules to Disseminate Transaction Information on All TRACE-Eligible Securities, Modify and Supplement Defined Terms, and Enhance Notification Requirements* (September 2004).

Research Analyst

New Qualification Requirements for Research Analysts

Effective March 30, 2004, the SEC approved amendments to NASD and NYSE rules to implement the research analyst registration requirements and examination program. Any associated person who functions as a research analyst must pass the new Research Analyst Qualification Examination (Series 86/87) or qualify for an exemption or waiver. There is no grandfathering provision for this new qualification requirement. Research analysts will be subject to Regulatory Element and Firm Element training. Firm Element training for research analysts and their immediate supervisors will be required to include ethics, professional responsibility, and the requirements of the new research analyst rules. *See NASD Notice to Members 04-25: SEC Approves New NASD Research Analyst Qualification and Examination Requirements (Series 86/87) (March 2004). See also NYSE Information Memos 04-16, Research Analyst Qualification Examination ("Series 86/87") and Registration Requirements, March 31, 2004; 04-05, Study Outline for Research Analyst Qualification Examination ("Series 86/87"), February 3, 2004;* and *03-61, Rule 344 – Research Analyst Qualification Examination Requirement ("Series 86/87"), December 31, 2003.*

Conflicts of Interest

In March of 2004, NASD and the NYSE issued a joint memorandum providing interpretation of rules governing research analysts and research reports. The memorandum defines the terms "research report" and "public appearance," and clarifies required research analyst disclosures, trading restrictions, and the applicability of the "significant news or event" exception to blackout period publishing restrictions. The memorandum is available in *NASD Notice to Members 04-18: NASD and NYSE Provide Further Guidance on Rules Governing Research Analysts' Conflicts of Interest* (March 2004). *See also NYSE Information Memos 04-11, April 1st Reporting Requirement – Attestations – Rules 351 and 472, March 9, 2004; 04-10, Amendments to Disclosure and Reporting Requirements, March 9, 2004; 04-03, Extension of Effective Dates for Certain Provisions of Rule 472 ("Communications with the Public") and Rule 344 ("Research Analysts and Supervisory Analysts"), January 20, 2004;* and *03-36, Rule 472 – Amendments to Disclosure and Reporting Requirements, August 25, 2003.*

Short Sales

On July 28, 2004, the SEC adopted new Regulation SHO, under the Securities Exchange Act of 1934. Regulation SHO will provide a new regulatory framework governing short selling of securities. Among other things, Regulation SHO:

1. Requires broker-dealers to mark sales in all equity securities "long," "short," or "short exempt";
2. Includes a rule that suspends temporarily the operation of the current "tick" test and any short sale price test of any exchange or national securities association, for specified securities;
3. Requires short sellers in all equity securities to locate securities to borrow before selling;
4. Imposes additional delivery requirements on broker-dealers for securities in which a substantial number of failures to deliver have occurred.

Within Regulation SHO, the SEC is also: (1) adopting an amendment that removes the shelf offering exception in Rule 105 of Regulation M; (2) issuing interpretive guidance addressing sham transactions designed to evade Regulation M; (3) deferring consideration of the proposal to replace the current "tick" test with a new uniform bid test restricting short sales to a price above the consolidated best bid; and (4) deferring consideration of the proposed exceptions to the uniform bid test.

The SEC is deferring further action on the proposals mentioned in (3) and (4) of the preceding paragraph until after the completion of the pilot program established by Regulation SHO. There is no set end date for the pilot program, which will need a separate SEC order to be terminated, and will last "only as long as [is] absolutely necessary to allow the [SEC] to gather sufficient data."

See SEC Release No. 34-50103, Short Sales, July 28, 2004. See also the SEC's Short Sale Web site at *www.sec.gov/spotlight/shortsales.htm*. The effective and compliance dates for Regulation SHO vary. For example, certain interpretive material under Regulation M went into effect on August 6, 2004. Rule 105 of Regulation M became effective on September 7, 2004. The compliance date for the suspension of the tick test and locate and delivery requirements is January 3, 2005.

Industry rules require that no member or associated person shall effect a short sale order for any customer in any security unless the member or associated person makes an affirmative determination that the member will receive delivery of the security from the customer, or that the member can borrow the security on behalf of the customer by the settlement date. The SEC has approved amendments to Rule 3370 that expand the scope of the affirmative determination requirement to include orders received from non-member broker-dealers. *See NASD Notice to Members 04-03: SEC Approves NASD Rule Proposal Requiring Members to Make Affirmative Determinations for Short Sale Orders Received from Non-Member Broker-Dealers* (January 2004). *See also NASD Notice to Members 04-08: Effective Date of Amendments to NASD Rule 3370 (Affirmative Determination Requirements) Extended to April 11, 2004* (February 2004), and *NASD Notice to Members 04-21: NASD Provides Further Guidance on Amendments to NASD Rule 3370—Affirmative Determination Requirements* (March 2004). *See also NYSE Rules 440B, Short Sales and 440C, Deliveries Against Short Sales, and NYSE Information Memo 04-39, Expiration of Short Exemption (Exchange Rule 440B/SEC Rule 10a-1), August 2, 2004.*

NASD clarified that under Rule 6130, a "short sale" or "short sale exempt" indicator is required in all short-sale transactions reported to the Automated Confirmation Transaction Service (ACT), including transactions in: (1) NASDAQ National Market securities; (2) NASDAQ SmallCap securities; (3) over-the-counter (OTC) transactions in exchange listed securities; (4) OTC Bulletin Board; and (5) OTC equity securities. *See NASD Notice to Members 04-40: NASD Clarifies ACT Short Sale Reporting Requirements* (May 2004).

Unit Investment Trusts

Unit Investment Trusts (UITs) are investment companies that offer redeemable shares, each of which represents an undivided interest in a unit of specified securities. Most UITs terminate on a specified date. In addition, many UITs offer sales charge discounts based on the amount invested. Accordingly, firms have the same duty to understand, inform customers about, and correctly apply price breaks in the sale of UITs that they have with regard to breakpoint discounts in the sale of Class A mutual fund shares. They should develop and implement the same type of procedures for ensuring the proper application of such discounts in connection with the sale of mutual funds. *See NASD Notice to Members 04-26: NASD Reminds Members of Their Duty to Ensure Proper Application of Discounts in Sales Charges to Sales of Unit Investment Trusts (UITs)* (March 2004).

To Obtain More Information

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