

however, if more than six years have elapsed from the transaction, occurrence, or event giving rise to the claim, under Rule 10304 of the Code, the claim will not be eligible for submission to arbitration.¹¹ All claims involving general securities broker/dealers will continue to be accepted for arbitration consistent with past practice. Claims previously submitted that the Office has already declined to arbitrate under the old policy cannot be resubmitted under the policy being announced herein.

2. Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act¹² in that eliminating a barrier to the arbitration of disputes involving exempted securities, public customers and members will have access to a fair, efficient, and cost-effective forum for the resolution of such disputes.

B. Self-Regulatory Organization's Statement on Burden on Competition

The NASD does not believe that the proposed rule change will impose any inappropriate burden on competition.

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

No written comments were either solicited or received.

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

Within 35 days of the publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

- (A) by order approve the proposed rule change, or
- (B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing,

¹¹ NASD Regulation notes that it has a proposed amendment to Rule 10304, rule filing SR-NASD-97-44, pending approval with the SEC. Under the proposed rule change all claims are presumed to be eligible; however, the presumption can be overcome if the respondent challenges the claim on the basis that more than six years have elapsed since the act or occurrence giving rise to the claim.

¹² 15 U.S.C. 78-3.

including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-98-04 and should be submitted by May 14, 1998.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹³

Margaret H. McFarland,
Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39883; File No. SR-NASD-97-69]

Self-Regulatory Organizations; Order Granting Approval of Proposed Rule Change, as Amended, and Notice of Filing and Order Granting Accelerated Approval of Amendment No. 2 to the Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to the Tape Recording of Conversations

April 17, 1998.

I. Introduction

On September 12, 1997, the National Association of Securities Dealers, Inc. ("NASD"), through its regulatory subsidiary NASD Regulation, Inc. ("NASD Regulation") filed with the Securities and Exchange Commission ("SEC" or "Commission") a proposed rule change pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder.² In this filing, NASD Regulation proposed amendments to Rule 3010 to

¹³ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

require the tape recording of conversations where members hire more than a specified percentage of registered persons from certain firms that have been expelled or that have had their broker/dealer registration revoked for violations of sales practices rules. The proposed rule change also includes a conforming rule change to Rule 9610. Notice of this proposed rule change was published in the **Federal Register** on December 5, 1997 (as amended, the "Notice").³ The Commission received one comment letter, which expressed concerns about using tape recording as a method of supervision, in response to the Notice.⁴ On March 9, 1998, NASD Regulation filed Amendment No. 2 with the Commission.⁵ This order approves the rule change, as amended, and grants accelerated approval of Amendment No. 2 to the rule change.

II. Background

At its meeting in July 1996, the NASD Regulation Board of Directors authorized the staff to issue a Notice to Members soliciting comment on proposed changes to NASD supervisory Rule 3010 to require the tape recording of telephone conversations of registered representatives in certain circumstances. The Rule was developed both to respond to concerns expressed in the *Joint Regulatory Sales Practice Sweep ("Sweep") Report*⁶ regarding the

³ See Securities Exchange Act Release No. 39361 (November 26, 1997), 62 FR 64422 (File No. SR-NASD-97-69). Amendment No. 1 to the proposed rule filing was filed on November 12, 1997. The changes contained in this amendment were included in the Notice. See Letter from Mary N. Revell, Associate General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission (November 17, 1997).

⁴ See Letter from R. Gerald Baker, Securities Industry Association ("SIA"), to Jonathan G. Katz, Secretary, Commission, dated February 11, 1998.

⁵ See letter from Mary N. Revell, Associate General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Office of Market Supervision, Division of Market Regulation (March 9, 1998). In Amendment No. 2, NASD Regulation: (1) Applies the proposal to firms that have a work force comprised of a specified number of registered persons who were employed by a "disciplined firm" within the last three years instead of two years; (2) requires firms to establish special procedures to supervise the telemarketing activities of registered persons instead of registered representatives; (3) amends the definition of registered persons to include those persons who register as municipal securities principals or representatives pursuant to Municipal Securities Rulemaking Board Rule G-3; and (4) provides guidance on what would constitute "reasonable procedures for reviewing the tape recordings made pursuant to the requirements of" the taping rule in a Notice to Members announcing approval of the rule.

⁶ Staffs of the NASD, New York Stock Exchange ("NYSE"), North American Securities Administrators Association ("NASAA"), and the Office of Compliance Inspections and

need for heightened supervision of certain registered representatives with troubled regulatory and compliance records and also to address the particular problems that occur when a firm hires a larger number of individuals who formerly worked at a firm that has been expelled or has had its registration revoked (a "Disciplined Firm") where they were inadequately supervised and trained.

NASD Regulation stated in its filing that one of the key findings of the Sweep Report concerned the willingness of some firms to employ registered representatives with a history of disciplinary actions or customer complaints.⁷ Based on this finding, the Working Group collectively recommended that firms that hire registered representatives with a recent disciplinary history involving sales practice abuse or other customer harm should implement special supervisory procedures tailored to the individual registered representative, which include a heightened level of scrutiny of the registered representative's activities by his or her supervisor, for a period of time.⁸ The Sweep Report recommended that, if firms fail to establish such special supervisory procedures, the self-regulatory organizations ("SROs") should consider revising their rules to specifically require that registered representatives with a recent history of disciplinary actions involving sales practice abuse or other customer harm be placed under special supervision by the firm for a period of time.

NASD Regulation and the NYSE have issued a memorandum discussing the Sweep Report and providing guidance on actions firms could take to provide heightened supervision of problem registered representatives.⁹ While the special procedures designed to provide a heightened level of supervision recommended by the Sweep Report and described in the NASD/NYSE

memorandum may provide adequate supervision of associated persons in most circumstances, NASD Regulation proposes to adopt specific procedures in certain situations in order to provide the level of supervision required by Rule 3010.

NASD Regulation proposes to amend NASD Rule 3010 to require firms that hire a specified number of individuals from Disciplined Firms to tape-record telephone conversations between their registered persons and existing and potential customers. The proposed Rule would apply when a firm hires a substantial number of registered persons from a firm or firms that have been expelled or had their registrations revoked for sales practice abuse. The measures are designed to prevent a reoccurrence of sales practice abuse or other customer harm that caused the Disciplined Firm to be expelled or have its registration revoked. The proposal is similar to an interpretation adopted by the National Futures Association ("NFA") in 1993 to combat abusive cold calling.¹⁰ The NFA's interpretation is discussed below.

A. Notice to Members 96-59 and Original Proposal

In its filing with the Commission, NASD Regulation described Notice to Members 96-59 ("NTM 96-59"), which contained the original proposed Rule ("original proposal" or "original Rule").¹¹ NASD Regulation's original proposal captured a broader swath of firms. It would have been triggered whenever a significant portion of a member's work force was comprised of associated persons who formerly were employed by a Disciplined Firm or firms or when the firm itself was a Disciplined Firm. The original proposal defined a Disciplined Firm, for purposes of the Rule, as one that had been disciplined (e.g., expelled, suspended, or enjoined) by a regulatory entity, an SRO, or a court within the previous five years for telemarketing or sales-practice abuses in connection with the solicitation, offer, or sale of securities.

NASD Regulation's original proposal also stated that if more than 20 percent of a member's sales force of associated persons previously were employed by a Disciplined Firm, the member would have been required to adopt special written procedures to supervise the telemarketing activities of its associated persons. Firms that were themselves

Disciplined Firms also would have been required to adopt these procedures. The procedures would have required, at a minimum, that the employer member tape record all telephone conversations between all of its associated persons and both existing and potential customers, and maintain these procedures for two years. For each firm that was itself a Disciplined Firm, at the end of the two-year period, NASD Regulation would have conducted an evaluation to determine whether, and for how long, the firm would continue to be subject to the requirements of the Rule. The Rule also would have required firms subject to the taping requirement to review the tapes periodically to ensure compliance with securities laws and NASD rules, to submit reports to NASD Regulation on their supervision of telemarketing activities, and to retain and index the tapes.

B. Comments and Response on the Original Proposal

NASD Regulation received 42 comment letters in response to its initial Notice to Members.¹² Of the 42

¹² NASD Regulation received the following comment letters: (1) Letter from Brian C. Underwood, A.G. Edwards & Sons, Inc. ("Edwards"), dated October 31, 1996; (2) Letter from Kevin P. Howe, American Express Financial Advisors ("AEFA"), dated October 31, 1996; (3) Letter from G. Thomas Mitchell, Aurora Insurance and Securities, Inc. ("Aurora"), dated October 10, 1996; (4) Letter from Jerome Snyder, Barington Capital Group, L.P. ("Barington"), dated October 23, 1996; (5) Letter from Leslie D. Smith, Berthel Fisher Company ("Berthel"), dated October 25, 1996; (6) Letter from Walter I. Miller, Capital Growth Planning, Inc. ("Capital"), dated September 24, 1996; (7) Letter from Sanford D. Greenberg, Chatfield Dean & Co. ("Chatfield Dean"), dated October 31, 1996; (8) Letter from Neil Lawrence Lane, Citicorp Investment Services ("CIS"), dated October 31, 1996; (9) Letter from David J. Master, Coastal Securities ("Coastal"), dated October 31, 1996; (10) Letter from John Polanin, Jr., Cowen & Company ("Cowen"), dated November 7, 1996; (11) Letter from Richard L. Sandow, Cullum & Sandow Securities, Inc. ("Cullum"), dated October 17, 1996; (12) Letter from Gregg Thaler, Duke & Company, Inc. ("Duke I"), dated October 10, 1996; (13) Letter from William Rotholz, Duke & Company, Inc. ("Duke II"), dated October 29, 1996; (14) Letter from Shannon Brayman, Duncan-Smith Securities, Inc. ("Duncan-Smith"), dated October 22, 1996; (15) Letter from James H. Pyle et al., E.E. Powell & Company, Inc., dated October 21, 1996; (16) Letter from Nancy K. Port, Equity Services, Inc. ("ESI"), dated October 30, 1996; (17) Letter from Rick Fetterman, Fetterman Investments, Inc., dated October 1, 1996; (18) Letter from Herbert O. Sontz, GKN Securities ("GKN"), dated October 31, 1996; (19) Letter from Lawrence E. Wesneski, Hoak Breedlove Wesneski & Co. ("Hoak"), dated October 21, 1996; (20) Letter from Cabell B. Birdsong, Investors Security Company, Inc. ("ISC"), dated October 22, 1996; (21) Letter from David A. Rich, Jefferies & Company, Inc., dated November 8, 1996; (22) Letter from Thomas P. Koutris, John Hancock Distributors, Inc., dated September 23, 1996; (23) Letter from A.E. Monahan, Keystone Capital Corporation ("Keystone"), dated October 7, 1996;

Continued

Examinations, SEC, *Joint Regulatory Sales Practice Sweep: A Review of the Sales Practice Activities of Selected Registered Representatives and the Hiring, Retention, and Supervisory Practices of the Brokerage Firms Employing Them* (March 1996). The Sweep was an initiative involving the staffs of the NASD, the SEC, the NYSE, and representatives of the NASAA (collectively, the "Working Group") to review the sales practice activities of selected registered representatives and the hiring, retention, and supervisory practices of the brokerage firms employing them in order to identify possible problem registered representatives, review their sales practices, and assess whether adequate hiring, retention, and supervisory mechanisms are in place. The Sweep Report was released on March 18, 1996.

⁷ The current proposal focuses on the disciplinary history of the firm that formerly employed the registered representative.

⁸ *Id.* at ii, iv.

⁹ NASD Notice of Members 97-19 (April 1997); NYSE Information Memo 97-20 (April 15, 1997).

¹⁰ See Letter from Lynn K. Gilbert, Deputy Director, Commodity Futures Trading Commission, to Daniel J. Roth, General Counsel, NFA (January 19, 1993).

¹¹ See Notice to Members 96-59 (September 1996).

comment letters, 39 were opposed to the proposal, including those filed by the Securities Industry Association, Lehman Brothers, Merrill Lynch, Morgan Stanley, and Smith Barney. NASD Regulation stated that most of the commenters supported the NASD's objective in proposing the taping Rule and agreed that firms should be discouraged from recruiting groups of registered persons from a Disciplined Firm, however, they did not believe that tape recording of conversations was an appropriate regulatory requirement and feared that regulators will require even more comprehensive tape recording in the future.

The definition of a Disciplined Firm is too broad: NASD Regulation stated that many of the commenters believe the definition of a Disciplined Firm in the original Rule was too broad. For example, the original definition would have included a firm that was the subject of an injunction for a technical or inadvertent violation of state law or as the result of a consensual injunction involving only a fraction of the firm's business and employees. NASD Regulation responded by narrowing the definition of a Disciplined Firm to include firms that have been expelled from membership in a securities industry SRO or that have had their

registration revoked by the SEC due to telemarketing or sales practice abuses.

The Rule is too broad with respect to the individuals included in the percentage calculation and the time frame: NASD Regulation stated that commenters complained the Rule was too broad in several respects. First, commenters said the Rule would target firms and individuals for the actions of other firms and individuals of which they had no knowledge or control.¹³ Second, the commenters criticized the Rule's application to all individuals that had ever been employed by a Disciplined Firm in the calculation of the percentage that would trigger the special supervisor procedures.¹⁴ Finally, NASD Regulation stated that commenters believed the Rule should be limited to personnel who have contact with customers, such as registered representatives, and should exclude clerical and ministerial employees from both the 20% calculation and the taping requirement.¹⁵

In response, NASD Regulation narrowed the scope of the original Rule to apply only to firms that hire a specified percentage of individuals who were employed at a Disciplined Firm within the last three years. NASD Regulation also limited the individuals calculated in the percentage to register persons, leaving out clerical and ministerial personnel. Also, NASD Regulation limited the persons subject to the taping requirement to registered representative in conversations with both existing and potential customers.

The Rule does not achieve the stated purpose: NASD Regulation noted that several commenters questioned whether the original Rule goes beyond the scope of the Sweep Report and would be effective in achieving the Sweep Report recommendations because taping is not an effective means of supervising sales efforts.¹⁶

NASD Regulation responded by emphasizing that the taping requirement is being restricted to particularly egregious situations. They stated their concern that when a firm hires high percentages of employees from firms that have been expelled by an SRO or that have had their registration revoked by the Commission, these groups of employees are unlikely to have been trained or supervised adequately. In

addition, NASD Regulation stated its belief in the *in terrorem* effect of recording telephone conversations to deter sales practice abuses. Finally, the NASD believes the Rule directly addresses the issues raised when a firm hires a high percentage of individuals who were employed by a Disciplined Firm where they were inadequately trained and supervised.

The costs of the Rule are too great: The NASD noted that some commenters expressed concerns that the costs of the original Rule would be too high, considering the limited benefits of the Rule. The commenters also stated that the Rule would have a disproportionate effect on small firms.¹⁷

The NASD stated that its narrowing of many aspects of the Rule would result in lower compliance costs. Specifically, in the revised proposal, the NASD exempted firms with five or fewer registered persons from the Rule and tiered the structure for determining the percentage of employees that trigger the taping requirement so that smaller firms would have to hire 30% or more of their registered persons from Disciplined Firms before they would trigger the requirement. In addition, the NASD stated that by narrowing the definition of a Disciplined Firm, fewer firms will be subject to the taping requirement.¹⁸ Finally, with respect to certain practical compliance difficulties, the NASD agreed to provide firms with all the relevant information they need to determine whether they are in compliance with the Rule.

Privacy concerns: The NASD stated that many commenters felt the original Rule would invade the privacy of both a firm's customers as well as the firm's registered representatives, which would be unfair to both firms and registered representatives that did not have disciplinary histories. Commenters also believe that the Rule would conflict with federal and state wiretapping laws. Finally, they are concerned that the

¹⁷The commenters stated that small firms would be disproportionately effected both in the cost of taping and in the numbers of firms likely to become subject to the threshold percentage of 20%. See letters from Capital, Cowen, Duncan-Smith, Hoak, SIA, and Yee.

¹⁸The NASD revised the definition of Disciplined Firm to include only expelled and revoked firms in order to focus, at least initially, on the most egregious cases with the greatest supervisory and disciplinary problems. For the two-year period 1995-1996, 14 firms met the definition of Disciplined Firm: 4 firms were expelled from SRO membership and 10 had their registrations revoked. This approach is similar to the one taken by the NFA, and will allow the NASD to gain experience with the implementation of the Rule before it considers expanding the definition of Disciplined Firm to include firms that have been suspended from SRO membership or from SEC registration.

(24) Letter from Paul B. Uhlenhop, Lawrence, Kamin, Saunders & Uhlenhop ("Lawrence, Kamin"), dated October 29, 1996; (25) Letter from Kathryn S. Reinmann, Lehman Brothers Inc. ("Lehman"), dated October 31, 1996; (26) Letter from Kenneth S. Spierer, Merrill Lynch, Pierce, Fenner & Smith ("Merrill Lynch"), dated November 14, 1996; (27) Letter from Jack G. Levin, Montgomery Securities ("Montgomery"), dated January 16, 1997; (28) Letter from Frederick W. Bogdan, Morgan Stanley & Co., Incorporated ("Morgan Stanley"), dated October 30, 1996; (29) Letter from Dennis S. Kaminski, Mutual Service Corporation ("MSC"), dated October 29, 1996; (30) Letter from Richard Berenger, Nathan & Lewis Securities, Inc. ("Nathan & Lewis"), dated October 18, 1996; (31) Letter from Douglas L. Dunahay, Neidiger/Tucker/Bruner Inc. ("Neidiger"), dated October 29, 1996; (32) Letter from Edward T. Borer, Philadelphia Corporation ("PC"), dated October 17, 1996; (33) Letter from Michael Flannigan, Protective Group Securities Corporation ("PGSC"), dated September 24, 1996; (34) Letter from Robert A. Fitzner, Jr., RAF Financial Corporation ("RAF"), dated October 29, 1996; (35) Letter from Glen F. Hackmann, Robert W. Baird & Co., Incorporated ("Baird"), dated October 31, 1996; (36) Letter from Douglas F. Schofield, Schofield Investments, Inc., dated September 18, 1996; (37) Letter from Richard O. Scribner, Allen B. Holeman, and C. Evan Steward, SIA, dated November 4, 1996; (38) Letter from Dov S. Schecter, Smith Barney Inc. ("Smith Barney"), dated October 31, 1996; (39) Letter from Patrick G. Haayes, Stratton Oakmont, Inc. ("Stratton"), dated October 30, 1996; (40) Letter from Walter H. Schlobohm, dated February 10, 1997; (41) Letter from John Maceranka, The Windmill Group, Inc., dated September 28, 1996; and (42) Letter from Stanley J. Allen Jr., Yee, Desmond, Schroeder & Allen, Inc. ("Yee"), dated October 28, 1996.

¹³ See, e.g., letters from Lehman and Morgan Stanley.

¹⁴ See, e.g., letters from Edwards, Morgan Stanley, Nathan & Lewis, PC, SIA, and Stratton.

¹⁵ See, e.g., letters from Edwards, Barington, Chatfield Dean, Cullum, Duke II, ESI, ISC, Morgan Stanley, Baird, and Stratton.

¹⁶ See, e.g., letters from CIS, Duke II, ESI, Lehman, Merrill Lynch, MSC, Nathan & Lewis, and SIA.

Rule does not restrict the accessibility and manner in which the tapes may be used.¹⁹

As stated above, because the Rule has been revised to address only the most egregious situations, the impact on privacy will be minimized. Also, upon approval, NASD Regulation will inform NASD members that, in complying with this Rule, they must also comply with federal and state civil and criminal statutes governing the tape recording of conversations. This is the same approach the NFA has taken with respect to this issue.²⁰

Each state has a statute governing wiretapping; there also is a federal statute governing wiretapping and electronic surveillance.²¹ The federal statute and the majority of the state statutes permit taping of telephone conversations with the consent of one party ("one-party statutes"),²² a minority of state statutes require the consent of all parties to the conversation ("two-party statutes").²³ Three issues arise from the proposed Rule: what is necessary to comply with one-party statutes; what is necessary to comply with two-party statutes; and how to comply where a conversation occurs between a person in a one-party state and a person in a two-party state. The NASD has left compliance with the state statutes on wiretapping and privacy for each broker-dealer.

C. Proposed Rule

As revised and filed with the Commission, the proposed Rule would apply whenever a specified percentage of a member firm's sales force is

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

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

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

NASD Regulation will compile and maintain several lists that firms will be able to review on a quarterly basis to assist them to determine if they are in compliance with the Rule. The primary list that will be prepared will be a list of firms that meet the definition of Disciplined Firm. Two additional lists will be prepared that should be helpful.

One list will contain an alphabetical listing of all registered persons who had worked for Disciplined Firms within the last three years. Another list will be compiled containing the same list of people grouped according to the firm for which they currently work. In order to alert firms that they are approaching the percentage that would make them subject to the requirements of the Rule, the second list will contain a computation of the percentage of all registered persons at the firm represented by registered persons who had been employed at a Disciplined Firm within the last three years.

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

¹⁹ See, e.g., letters from AEFA, Duke II, Lawrence, Kamin, Lehman, Morgan Stanley, MSC, Neidiger, Montgomery, SIA, and Smith Barney.

²⁰ See Interpretive Notice to NFA Compliance Rule 2-9, *Supervision of Telemarketing Activity*, ¶ 9021 (February 18, 1997).

²¹ 18 U.S.C. §§ 2519 *et seq.*

²² In one-party statute states, the only issue is whether the registered representative knows of and consents to the tape recording. Since the recording requirement would run to the firm, and the equipment would be the firm's, it might be argued that the firm, and not the representative, is doing the recording. Therefore, it would be necessary for the firm to insure that the representative has notice and consents to the tape recording of his or her telephone conversations. This could be accomplished through a clause in an employment agreement or employee handbook or other written notice to the representative.

²³ In two-party statute states, it would be necessary to insert on the firm's telephone line a recording stating that all telephone conversations are being taped, similar to customer service lines in other industries. Some states require a system of beeps or buzzers that sound throughout the conversation. Another possibility is to insert a clause into the customer agreement notifying customers that their calls will be tape recorded. Some states also have a "business use exception" to the two-party statute consent requirement, but it is worded and applied differently in each state.

²⁴ See Interpretive Notice to NFA Compliance Rule 2-9, *Supervision of Telemarketing Activity*, ¶ 9021 (February 18, 1997).

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

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

conforming change to the Rule 9600 Series.²⁷

III. Discussion

For the reasons discussed below, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and the regulations thereunder applicable to registered securities associations, in particular the requirements of Section 15A(b)(6) of the Act.²⁸ Among other things, Section 15A(b)(6) of the Act requires that the rules of a national securities association be designed to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and in general, to protect investors and the public interest.

In particular, the Commission believes that the proposed rule change will discourage the revival of disciplined firms that have been barred by the industry or that have had their registrations revoked by the Commission. In essence, firms that decide to hire significant numbers of employees from disciplined firms will be required to ensure a proper supervisory environment that protects investors and prevents fraudulent and manipulative telemarketing acts and practices. The monitoring of registered persons' telephone conversations will help to provide additional supervision of individuals who formerly worked at a disciplined firm where they were inadequately trained and supervised.

In the Notice, the Commission requested comments on all aspects of the proposal, as well as the need to inform investors that their calls are being taped. The Commission received one comment letter concerning the proposal. The SIA expressed general concerns about tape recording conversations as a method of supervision. While the Commission recognizes the limitations of this form of supervision, the Commission believes that if registered persons know their phone calls are being taped then they are more likely to avoid making false or exaggerated representations. In addition, compliance officials will have another tool to monitor persons who worked previously at firms with significant sales practice problems. Moreover, the fact

that tapes of the telephone conversations will be available to persons who have disputes with broker-dealer firms will spur firms with a substantial percentage of representatives from an expelled firm to take extra measures to supervise these persons.

No comments were received concerning the issue of notice to investors that their calls are being taped. NASD Regulation has indicated its belief that the issue of notification is addressed by state privacy laws and that firms will be required to independently determine that state laws are satisfied. The Commission believes that the best practice would be for member firms to notify their registered persons and customers that their telephone calls are being tape recorded.

The Commission expects the NASD to monitor the Rule and assess its effectiveness. For example, the NASD should monitor the number of firms that become subject to the Rule as well as firms that hire representatives from disciplined firms but do not trigger the taping requirement to see if there is a need to adjust the percentages. Also, the NASD should monitor the number of firms exempt from the Rule because they have five or fewer employees to determine if this is an effective exclusion. Furthermore, the NASD should make sure firms comply with state laws on notification.

The Commission finds good cause for approving Amendment No. 2 prior to the thirtieth day after the date of publication of notice thereof in the Federal Register. Amendment No. 2 applies the proposal to member firms with a work force comprised of a specified number of registered persons who were employed by a "disciplined firm" within the last three years instead of two years.²⁹ In the Notice, the Commission requested comment on whether the original two-year time frame was appropriate. Although no comments were received on this issue, NASD Regulation and the Commission believe that a three-year time frame will better capture registered persons who worked at disciplined firms during a period of inadequate training, supervision, and sales practice abuses. Therefore, the Commission believes that granting accelerated approval to Amendment No. 2 is appropriate and consistent with Section 15A of the Act.³⁰

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning Amendment No. 2 to the proposed rule change, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to Amendment No. 2 that are filed with the Commission, and all written communications relating to Amendment No. 2 between the Commission and any persons, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. § 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of the filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR-NASD-97-69 and should be submitted by May 15, 1998.

V. Conclusion

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,³¹ that the proposed rule change (SR-NASD-97-69), including Amendment No. 2 thereto, is approved on an accelerated basis.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.³²

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39881; File No. SR-PCX-98-16]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 Thereto by the Pacific Exchange, Inc., Relating to Communication Devices on the Trading Floor

April 16, 1998.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"),¹ and Rule 19b-4 thereunder,² notice is hereby given that on March 31, 1998, the Pacific Exchange, Inc. ("PCX"

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

²⁸ 15 U.S.C. § 78o-3(b)(6).

²⁹ Amendment No. 2 also makes several technical amendments which clarify the application of the previously noticed changes to Rules 3010 and 9610.

³⁰ 15 U.S.C. § 78o-3.

³¹ 15 U.S.C. § 78s(b)(2).

³² 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.