

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-97-79 and should be submitted by December 22, 1997.

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

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39349; File No. SR-NASD-97-96]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendment No. 1 by the National Association of Securities Dealers, Inc. To Amend Its Rule 3230 Relating to Clearing Agreements

November 21, 1997.

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 October 14, 1997, the NASD Regulation, Inc. ("NASD Regulation") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by NASD Regulation. On November 20, 1997, the NASD Regulation filed Amendment No. 1 to the proposed rule change.³ The Commission is publishing this notice to solicit comments on the proposed rule change, as amended, from interested persons.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ See Letter from John M. Ramsay, Deputy General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, Division of Market Regulation, Commission, dated November 19, 1997 ("Amendment No. 1"). In Amendment No. 1, the NASD Regulation amended the proposal to: (1) Add a sentence to the rule relating to the responsibility of introducing members to notify clearing members of the specific reports needed by the introducing members to supervise its business; (2) clarify that failure to provide such notification would violate not only the proposed rule but also, the Association's supervisory rules; and (3) delete a series of questions directed to readers of the proposal. Commission staff has incorporated the changes set forth in Amendment No. 1 into the notice.

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

NASD Regulation proposes to amend the National Association of Securities Dealers, Inc.'s ("NASD" or "Association") Rule 3230 to: (1) establish standards for the disposition of written customer complaints received by clearing firms about introducing member firms relating to their functions and responsibilities under the clearing agreement; (2) govern how exception reports are made available to introducing firms and retained by clearing firms; and (3) permit introducing firms to write checks on their clearing firm's account. Below is the text of the proposed rule change. Proposed new language is in italics; proposed deletions are in brackets.

3230. Clearing Agreements

(a) All clearing or carrying agreements entered into by a member, except where any party to the agreement is also subject to a comparable rule of a national securities exchange, shall specify the respective functions and responsibilities of each party to the agreement and shall, at a minimum, specify the responsibility of each party with respect to each of the following matters:

- (1) Opening, approving and monitoring customer accounts;
- (2) Extension of credit;
- (3) Maintenance of books and records;
- (4) Receipt and delivery of funds and securities;
- (5) Safeguarding of funds and securities;
- (6) Confirmations and statements;
- (7) Acceptance of orders and execution of transactions;
- (8) Whether, for purposes of the Commissioner's financial responsibility rules adopted under the Act, and the Securities Investor Protection Act, as amended, and regulations adopted thereunder, customers are customers of the clearing number; and

(9) the requirement to provide customer notification under paragraph [(d)](g) of this Rule.

(b)(1) *In order for the introducing member to carry out its functions and responsibilities under the agreement, each clearing member must forward promptly any written customer complaint received by the clearing member regarding the introducing member or its associated persons relating to functions and responsibilities allocated to the introducing member under the agreement directly to: (A) the introducing member; and (B) the introducing member's examining*

authority designated under Section 17 of the Act ("DEA") (or, if none, to its appropriate regulatory agency or authority). The clearing or carrying agreement must specifically direct and authorize the clearing member to do so.

(2) *The clearing member must also notify the customer, in writing, that it has received the complaint, and that the complaint has been forwarded to the introducing member and to the introducing member's DEA (or, if none, to its appropriate regulatory agency or authority). This written notice to the customer must also contain a statement that reads substantially as follows: "Please be aware that you retain the right, at your discretion, to transfer your account to another broker/dealer of your choice."*

(c)(1) *A clearing member, when it enters into a clearing agreement, must immediately, and annually thereafter, provide the introducing member a list or description of all reports (exception and other types of reports) which it offers to the introducing member to assist the introducing member in supervising its activities, monitoring its customer accounts, and carrying out its functions and responsibilities under the clearing agreement. The introducing member must notify promptly the clearing member, in writing, of those specific reports by the clearing member that the introducing member requires to supervise and monitor its customer accounts.*

(2) *The clearing member must retain as part of its books and records required to be maintained under the Act and the Association's rules, copies of the reports requested by or provided to the introducing member. For purposes of this Rule, the clearing member will be in compliance with the requirements of this paragraph if it retains the data from which the original report was produced, provided, the clearing member can, at the request of the DEA, either (A) recreate the report; or (B) provide the data and the data formatting that was used to prepare the report.*

(3) *Each year, no later than July 31, the clearing member must notify in writing the introducing member's chief executive and compliance officers of the reports offered to the introducing member and the reports requested by or supplied to the introducing member during the previous year ending June 30. The clearing member must also provide a copy of the notice to the introducing member's DEA.*

(4) *The clearing member must provide, at the request of the introducing member's DEA, any reports (or, if the reports are not available, information or data from which the*

reports could have been prepared) that were offered to the introducing member but which the introducing member did not request.

(d) The clearing or carrying agreement may permit the introducing member to issue negotiable instruments directly to the introducing member's customers using instruments for which the clearing member is the maker or drawer. The clearing member may not grant the introducing member the authority to issue negotiable instruments until the introducing member has notified the clearing member in writing that it has established, and will maintain and enforce, supervisory procedures with respect to the issuance of such instruments.

[(b)](e) Whenever a clearing member designated to the Association for oversight pursuant to Section 17 of the Act, or a rule of the Commission adopted thereunder, amends any of its clearing or carrying agreements with respect to any item enumerated in subparagraphs (a)(1) through (a)(9) or enters into a new clearing or carrying agreement with an introducing member, the clearing member shall submit the agreement to the Association for review and approval.

[(c)](f) Whenever an introducing member designated to the Association for oversight pursuant to Section 17 of the Act, or a rule of the Commission adopted thereunder, amends its clearing or carrying agreement with a clearing member designated to another self-regulatory organization for oversight with respect to any item enumerated in subparagraphs (a)(1) through (a)(9) enters into a new clearing agreement with another clearing member, the introducing member shall submit the agreement to its local Association district office for review.

[(d)](g) Each customer whose account is introduced on a fully disclosed basis shall be notified in writing upon the opening of his account of the existence of the clearing or carrying agreement.

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

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

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

1. Purpose

Recent concerns about questionable sales practices and potentially fraudulent activity by certain introducing firms, and the handling of customer complaints about those firms by their clearing firms, caused the staffs of NASD Regulation and the New York Stock Exchange, Inc. ("NYSE") to examine the relationship between clearing firms and their client introducing firms. The examination resulted in proposals to amend the NASD's and NYSE's Rules relating to the content and approval of clearing agreements to specify requirements for handling customer complaints, for providing, requesting and retaining exception reports, and for issuing checks. The NYSE's proposal to amend their Rule 382 has been filed with the Commission.⁴ The NASD believes its proposal to amend Rule 3230 discussed below is consistent with the current NYSE proposal to amend NYSE Rule 382.

While the Board of Directors of NASD Regulation ("Board") approved the proposed rule in recognition of the importance of maintaining consistency with the NYSE's proposal, the Board expressed strong concerns regarding the proposal, including those relating to two particular issues. First, the Board expressed concern that the proposed rules not change or be interpreted as changing the fundamental nature of the relationship between introducing and clearing firms, or otherwise affect rights, responsibilities or liabilities of the introducing or clearing firm under law or contract. Other than to establish limited requirements to enable the introducing member to carry out its responsibilities under its clearing or carrying agreement with the clearing member, the proposals are not intended to change the fundamental nature of the relationship between introducing and clearing firms, or otherwise affect any existing rights, responsibilities or liabilities under law or contract.

Second, the Board expressed concern that the requirement that the customer be notified by the clearing firm that he or she has the right to transfer his or her account to another firm may unfairly single out a particular category of complaints, create an unfair implication that each such complaint would warrant

the customer's transferring his account, or otherwise operate inappropriately to distinguish this class of complaints from others. In recognition of the importance of maintaining consistency with the NYSE's proposal, the NASD requests that the SEC defer approval of the NYSE's proposal until the NASD and the SEC have had an opportunity to consider comments in response to the publication for comment of the NASD proposal in the **Federal Register**.

Description of Proposed Rule Change

Customer Complaints. It is generally the practice of clearing firms to forward to introducing firms customer complaints they receive relating to matters that are the responsibility of the introducing firm. Under NASD Rule 3070, a member is required to report to the Association any written customer complaint against it involving allegations of theft or misappropriation of funds or securities or of forgery. Recently, however, there have been instances where introducing firms may not have complied in a timely manner with the requirements of Rule 3070 when their clearing firms forwarded customer complaints to them. Thus, the Association does not get the reports in a timely manner and NASD Regulation staff is not aware of the customer complaints until long after the fact. Since there is no mechanism other than Rule 3070 designed to provide this information to NASD Regulation, such late reporting undermines the purpose of Rule 3070, which is to provide NASD Regulation with early warning indicators to generate a regulatory response to problems. In addition, receipt by clearing firms of large numbers of complaints regarding introducing firms may be indicative of sales practice problems requiring prompt regulatory attention.

To address this concern, proposed new paragraph (b) states that when a clearing firm receives a customer complaint about an introducing firm relating to the functions and responsibilities of the introducing firm, the clearing firm must forward the complaint to the introducing firm and send a copy of the complaint to the introducing firm's DEA. The requirement may provide an early warning to the DEA of potential problems at introducing firms. The proposed amendment also provides that the clearing agreement must expressly direct and authorize the clearing firm to forward the complaint to the introducing firm and send a copy of the complaint to the introducing firm's DEA.

⁴ See Securities Exchange Act Release No. 39200 (October 3, 1997) 62 FR 53369 (October 10, 1997) (noticing File No. SR-NYSE-97-25).

In addition, the proposed rule provides that the clearing firm must notify the customer in writing that the complaint was received, and was forwarded to the introducing firm and to the introducing firm's DEA. This requirement will serve to alert the customer that the complaint has been received and forwarded to the appropriate entity (the introducing firm) for a response, and that the introducing firm's regulator has also been made aware of the customer's complaint. This written notice to the customer must also contain a statement that reads substantially as follows: "Please be aware that you retain the right, at your discretion, to transfer your account to another broker/dealer of your choice."

The requirement that the complaints be forwarded to the appropriate DEA is intended to provide notice to the DEAs of the types of complaints that are being received and to provide information that may be useful for examining or investigating particular conduct. It is not intended, however, to result in an investigation of each, or any proportion, of complaints that are received by the DEA.

Exception Reports. All NASD member firms are required under NASD and federal regulations to establish, maintain and enforce supervisory systems and procedures that are designed to address all areas of a member's business. A key aspect of these supervisory procedures is exception and other compliance reports that a member creates to help meet these supervisory responsibilities. In a fully disclosed clearing arrangement, the clearing member generally provides exception reports that are available to assist the introducing member in carrying out its supervisory obligations. In addition, officers and managers of introducing members should be on notice of the reports and information that were available to them in meeting their supervisory and monitoring obligations. Paragraph (c) of the proposed amendment addresses these issues.

Proposed new paragraph (c)(1) requires the clearing firm to provide its introducing firm, both at the commencement of the introducing/clearing arrangement and annually thereafter, a list or description of all exception or other reports which it offers to introducing firms to assist the introducing firm in supervising its activities, monitoring its accounts and carrying out its functions and responsibilities under the clearing agreement. Proposed new paragraph (c)(1) also requires the introducing member to notify promptly the clearing

member, in writing, of those specific reports offered by the clearing member that the introducing member requires to supervise and monitor its customer accounts. Failure to provide notification would not only be a violation of this rule, but also of Rule 3010, which requires that members establish and maintain proper supervisory systems.

Even though the language of the proposed amendment requires the clearing firm to provide the introducing firm with a list or description of reports that it will provide, the staff recognizes that some clearing firms do not create such reports, but rather provide data and data formatting software to their introducing clients that allow the introducing firms to prepare their own reports. The proposal would permit compliance with the provision where clearing firms communicate with their introducing firms about the data and data formatting which they make available so that the introducing firms can determine which reports they will create in order to meet their supervisory and monitoring needs.

Paragraph (c)(2) requires the clearing firm to retain as part of its books and records, copies of any reports requested or provided to the introducing firm. The provision permits a clearing firm to meet the requirement if it retains the data that was used to prepare the report but only if the clearing member, at the request of the DEA, can recreate the report or provide the data and data formatting that was used to prepare the report. Similarly, if the clearing firm provided data and report formatting to the introducing firm, the clearing firm could provide the data and data formatting that was provided to the introducing firm to the DEA to fulfill this requirement.

Paragraph (c)(3) requires the clearing member, immediately after entering into the clearing agreement, to notify the introducing member's chief executive and compliance officers of the reports that it offers to the introducing member, and the reports requested by or supplied to the introducing firm. The clearing member must provide this notice each year thereafter as of June 30, to be provided no later than the following July 31.

Finally, paragraph (c)(4) requires the clearing member, at the request of the introducing member's DEA, to provide to the DEA reports that were offered to the introducing member but which the introducing member did not request. As with the record retention provision in paragraph (c)(2), this requirement may be met if the clearing member retains the data from which the original report was produced and then either recreates

the report or provides the data and data formatting that was used to prepare the report.

Check Writing. Under proposed new Paragraph (d), the clearing agreement may permit the introducing firm to issue checks to the introducing firm's customers that are drawn on the clearing member's account upon written representation from the introducing firm that it has established, and will maintain and enforce, supervisory procedures with respect to the issuance of negotiable instruments. This rule is intended to protect customers by clearly establishing that the clearing member will be the maker or drawer of such instruments and, therefore, liable for any mistakes or fraud by the introducing firm in the making or drawing of the check. This provision is intended to establish that clearing firms are liable to the introducing firm's customer if the introducing firm misuses the authority and, thereby, to protect the customer with the clearing member's funds.

2. Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,⁵ which require that the Association adopt and amend its rules to promote just and equitable principles of fair trade, and generally provide for the protection of investors and the public interest in that the proposed rule change is designed to establish standards for the disposition of written customer complaints about introducing member firms, govern how exception reports are made available to introducing firms and retained by clearing firms, and permit introducing firms to write checks on their clearing firm's account.

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

NASD Regulation does not believe the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

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

Comments were neither 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

⁵ 15 U.S.C. 78o-3(b)(6).

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

A. By order approve such proposed rule change, or

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

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing. In addition to any other issues that the public may wish to address, the Commission specifically requests comments on the following questions:

General

Will the respective obligations imposed on clearing and introducing firms by the proposal help introducing firms and regulators better address sales practice problems?

To what extent would the proposal discourage either introducing or clearing firms from agreeing to enter into new clearing relationships, or to renew existing ones, or affect the degree of care employed when entering into such a relationship?

Customer Complaints

How quickly are customer complaints that are directed to clearing firms and that concern introducing firms or their associated persons currently forwarded to introducing firms? What proportion of these complaints concerns matters identified in NASD Rule 3070(a)(2), *i.e.*, allegations of theft or misappropriation of funds or securities, or of forgery? What other types of complaints typically are received?

Why in general are complaint letters addressed to clearing firms rather than introducing firms, when they concern conduct of the introducing firms? Please address the extent to which this occurs because of confusion by customers over the relative responsibilities of the firms based on the contacts with the customer, such as confirmations, or for other reasons, *e.g.*, the failure to receive a response from the introducing firm?

Should the requirements of the proposed rule regarding customer complaints apply equally to complaints against a clearing firm sent by a customer to an introducing firm with whom the clearing firm has a clearing agreement?

Presently, copies of customer complaints that are received by securities firms are not required to be

forwarded to the SEC or any self-regulatory organization ("SRO"). Rather, the firms are required to submit summaries of complaints to their SRO. To the extent that this requirement is imposed, should clearing firms be required to send summaries or actual complaint letters to the SROs?

Will the requirement that, upon the clearing firm's receipt of a customer complaint, the customer be notified by the clearing firm that he or she has the right to transfer his or her account to another firm serve a useful purpose, in informing customers that they are not tied to the introducing broker in the case of sales problems? Does it create an unfair implication that each such complaint would warrant the customer's transferring his account, or otherwise unfairly tarnish the introducing firm? To the extent that this type of information is useful to investors, does it make sense to provide this notice only in the circumstances identified?

Exception Reports

What compliance or cost burdens would result from the requirement that clearing firms retain copies of exception reports or data that is provided to introducing firms? To what extent is this data now stored, and for how long?

What are the relative costs and benefits of the requirements for annual reports to the executive and compliance officers of introducing firms as to the exception reports that were offered and supplied? Is it feasible for the clearing firm to provide reports to the DEAs that the introducing firm did not request?

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 Section, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such filing will also be available for inspection and copying at the principal office of the above-mentioned self-regulatory organization. All submissions should refer to File No. SR-NASD-97-76 and should be submitted by December 22, 1997.

For the Commission, by the Division of Market Regulations, pursuant to delegated authority.⁶

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-39344; File No. SR-NYSE-96-34]

Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Granting Approval to Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 1 to Proposed Rule Change To Adopt a New Specialist Performance Measure

November 21, 1997.

I. Introduction

On December 3, 1996, the New York Stock Exchange, Inc. ("NYSE" or "Exchange") submitted to the Securities and Exchange Commission ("Commission"), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act")¹ and Rule 19b-4 thereunder,² a proposed rule change to adopt a new specialist performance measure.³

Notice of the proposed rule change, together with the substance of the proposal, was published for comment in Securities Exchange Act Release No. 38150 (January 10, 1997), 62 FR 2704 (January 17, 1997). No comments were received on the proposal. The Exchange filed Amendment No. 1 to the proposed rule change on October 23, 1997.⁴

II. Description

The Exchange proposes to add on a one-year pilot basis, solely for use by the Allocation Committee in evaluating specialist performance, the concept of

⁶ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ The Commission notes that it previously approved the portion of the proposed rule filing making permanent the Near Neighbor, Capital Utilization and Rule 103A pilot programs for measuring specialist performance. See Securities Exchange Act Release No. 38150 (January 10, 1997), 62 FR 2704 (January 17, 1997). This order approves the remaining portion of the proposed rule change to adopt a new specialist performance measure, "adjusted stabilization."

⁴ Amendment No. 1 states that the new performance measure, adjusted stabilization, will be solely for use by the Allocation Committee, and that the information will be provided to the Allocation Committee on a one-year pilot basis. See letter from James E. Buck, Senior Vice President, NYSE, to Michael Walinskas, Senior Special Counsel, Market Regulation, Commission, dated October 22, 1997.