Securities Industry Association
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May 13, 1997

Joan Conley
Office of the Corporate Secretary
NASD Regulation, Inc.
1735 K Street, NW
Washington, DC 20006-1500

Re: NASD Regulation Notice To Members 97-12 and 97-11

Dear Ms. Conley:

The Securities Industry Association's ("SIA")**1** Self-Regulation and Supervisory Practices, Bank Retail Broker-Dealer, Investment Adviser, and Financial Institutions Services Steering Committees ("Committees") appreciate this opportunity to comment on the proposed rules set forth in the above-captioned Notices To Members. Proposed Rule 3121 governs a member's use of customer confidential financial information that is obtained from a business affiliate and the release of such information to any third party, whether affiliated or unaffiliated. Proposed Rule 2460 restricts the payment of referral fees by NASD members to unregistered third parties for the referral of retail business. For the reasons discussed below, the Committees urge NASD Regulation to reconsider the proposals.

I. Proposed Rule 3121

The Notice states that proposed Rule 3121 was originally part of a proposed rule governing broker-dealer conduct on the premises of a financial institution.**2** The purpose of the proposed bank broker-dealer rule was to address concerns about customer confusion over the distinction between the insured products of financial institutions and the uninsured securities products of broker-dealers operating on the premises of financial institutions, and to provide a regulatory framework for regulating bank broker-dealer activities. When commenters raised objections to the provision that would have prohibited bank broker-dealers from using customer confidential financial information provided by the financial institution without the prior written approval of the individual customer, NASD Regulation deleted the provision from the bank broker-dealer rule and is now proposing it as a rule of general applicability to all NASD members.

The proposed rule would require that before releasing confidential financial information to a person other than a business affiliate, a member must disclose that the information may be released and must obtain the written consent of the customer. Where information is released to

a business affiliate, a member must provide the same disclosure and provide the customer with a meaningful opportunity to object to the release of the information.

A. Proposed Rule Will Impair Ability of Firms to Manage Risk

The Committees believe the proposed new rule will have serious implications for diversified financial services firms that are far more serious than the marketing practices that it was intended to address. By restricting the use of customer information without the affirmative consent of the customer, NASD Regulation will disrupt established business practices and may impair the ability of firms to manage risk. Such broad restrictions on the sharing of information are highly impractical for multi-discipline companies that have developed sophisticated systems for monitoring and controlling financial and operational risks across business and company lines.

Restrictions on the prudent use of customer information between affiliated companies also run counter to recent developments in credit and risk management. Congress recognized the potential risk to a broker-dealer arising out of the activities of affiliated companies and in the Market Reform Act of 1990 expressly granted the Securities and Exchange Commission the authority to obtain information on affiliated companies. The temporary risk assessment rules adopted under this grant of authority clearly contemplate that broker-dealers will use information from all available sources in order to assess their financial exposure. The ability of a customer to "opt-out" of such sharing would frustrate the purpose of these rules and would make risk assessment more difficult where customers deal with various affiliates around the globe.

Additionally, the government's anti-money laundering efforts place increasing reliance on financial institutions to "know your customer" and to report suspicious activity. Regulations issued by the Financial Crimes Enforcement Network ("FinCEN") governing the reporting of suspicious activity by banks and other depository financial institutions, including subsidiaries of bank holding companies, became effective on April 1, 1996. It is expected that the FinCEN regulations will soon be extended to broker-dealers. These rules, which clearly contemplate that financial institutions will obtain all available information on customers, will be undermined if Rule 3121 is adopted.

B. Proposed Rule Restricts Use of Customer Information for Purposes Unrelated to Marketing

The Committee supports the efforts of NASD Regulation to address the confusion that may arise when affiliated or unaffiliated institutions use confidential financial information to solicit the sale of products or services to retail customers. The proposed rule, however, places severe restrictions on the use of customer information for purposes unrelated to marketing. Diversified financial services companies routinely provide customer information that would fall within the definition of "confidential financial information" to affiliated companies. This is a legitimate and necessary business practice. For example, firms may introduce customers on a fully disclosed basis to a subsidiary or affiliate for execution and clearing services. Brokerage accounts may be linked to checking, savings, or money market accounts at affiliated financial institutions for purposes of settling securities transactions ("sweep accounts"). In addition, in a diversified holding company structure, XYZ Credit Corporation may share confidential financial information

with the XYZ broker-dealer and may do so through a central database. If customers are given the opportunity to object to the sharing of information, such established practices would be precluded.

To create an additional level of disclosure absent a showing that such information is being misused or abused is unnecessary. Unlike the situation that led to the adoption of the Fair Credit Reporting Act ("FCRA") which is referenced in the Notice, there are no demonstrated instances of the public being adversely affected by the sharing of confidential financial information between broker-dealers and their affiliates. In fact, because the NASD proposed rule is more restrictive than the FCRA, adoption of the proposed rule will result in different standards for the exchange of customer information within a diversified financial services company depending on whether the information is used or released by an NASD member. Moreover, as the Notice points out, such information may be available from sources other than the NASD member and, therefore, the disclosures and any customer objection may be ineffective.

II. Proposed Rule 2460

The Committees believe that proposed Rule 2460 is inconsistent with both current business practices and current regulatory structure and should be withdrawn and replaced with a rule that allows for, and requires the disclosure of, the direct or indirect payment of non-transaction based referral fees. As drafted, the rule would prohibit a member from giving cash or non-cash compensation to any person (other than persons registered with the member and other members) in connection with locating, introducing, or referring prospective brokerage account customers to the member.

This blanket prohibition is unworkable. It is not clear how the proposed rule impacts other rules, such as NASD Rule 1060(b) and Rule 206(4)-3 of the Investment Advisers Act of 1940, that expressly allow for the payment of referral fees. It also differs from the position taken by the New York Stock Exchange, Inc. in Rule Interpretation 345(a)(i)/02. Moreover, although Securities and Exchange Commission no-action letters are referenced in the Notice, the proposed rule would appear to be inconsistent with the approach accepted by the SEC staff. Payments to non-registered employees for certain marketing activity that is currently permitted, would be prohibited under the rule. Nevertheless, the Committees would urge that, instead of clarification, NASD Regulation consider withdrawing the proposal in favor of an approach that provides for disclosure where referral fees are paid to unregistered third parties.

III. Conclusion

As discussed above, the Committees oppose proposed Rules 3121 and 2460. The sharing of customer financial information and the payment of non-transaction-based referral fees are established business practices. The Committees would be happy to discuss this further and to share more specific examples of how business would be impeded. We believe, however, that NASD Regulation has not demonstrated abuses in either of these areas and restrictions on these practices, therefore, are unwarranted. The Committees respectfully urge NASD Regulation to reconsider the proposals.

Sincerely,

R. Gerald Baker
Chairman
Self-Regulation and Supervisory Practices Committee
Dwight Moody
Chairman
Bank Retail Broker-Dealer Committee
Burton M Fendelman
Chairman
Investment Adviser Committee
Brewster M. Ellis
Chairman
Financial Institutions Services Steering Committee

cc: Mary N. Revell

Footnotes

[1] The Securities Industry Association ("SIA") is the trade association representing the business interests of about 760 securities firms in North America. Its members include securities organizations of virtually all types - investment banks, brokers, dealers, and mutual fund companies, as well as other firms functioning on the floors of the exchanges. SIA members are active in all exchange markets, in the over-the-counter markets, and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for 90% of securities firm revenue in the United States.

[2] See Securities Exchange Act Release No. 34-36980; 61 FR 11913.