

December 12, 1996

Mr. Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

**RE: Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934 Release No. 34-37850 File No. S7-27-96**

Dear Secretary Katz:

Please accept this comment letter on behalf of the North American Securities Administrators Association ("NASAA") in response to the proposed release ("Release") of the Securities and Exchange Commission ("Commission" or "SEC") regarding amendments to Rules 17a-3 and 17a-4 of the Securities Exchange Act of 1934 (the "'34 Act"). NASAA<sup>1</sup> welcomes this opportunity to provide input on this subject.

**General Observations**

The Release had its origins in the work of the Broker-Dealer Operations Committee (the "Committee") of NASAA. The Committee, comprised of representatives from six state jurisdictions, noted in 1993 that SEC books and records rules did not require broker-dealers to make and preserve certain types of records that are necessary for securities regulators to perform complete sales practice or operational examinations of a broker-dealer, and more specifically, to perform examinations of local branch offices of broker-dealers. While many state regulations had incorporated by reference the SEC books and records rules, in order to address the deficiency of those rules when applied to state inspections, many states promulgated rules requiring supplemental books and records requirements supplemental to those required by the SEC to facilitate state examinations of branch offices.

It should be noted that of the twenty-nine states reporting examination statistics at the time of this writing, in excess of 1,100 broker-dealer examinations were conducted on an annualized basis; the majority of which were conducted in branch offices. Additionally, states receive thousands of investor complaints annually that may not require an on-site examination, but nevertheless will require the production of documents from the broker-dealer branch office.

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<sup>1</sup> In the U.S., NASAA is the national voice of the 50 state securities agencies responsible for investor protection and the efficient functioning of the capital markets at the grassroots level.

Experience from these state-level examinations have revealed several noteworthy facts. First, the broker-dealer community, hearing officers and state courts have divergent interpretations of certain provisions of the SEC's current books and records rules. Second, state examination and enforcement efforts are often hindered by the absence of key records in local offices. Third, states have found many branch records to be poorly organized and inefficiently maintained. Fourth, in those instances where records were maintained at a "central location", states often encountered significant delays in the production of requested records, thus impeding the examination efficiency and casting doubt on the examination results in instances where the delay has afforded opportunity for unscrupulous persons to "sanitize" records prior to production.

The Committee observed that state branch office books and records requirements are not burdensome to the broker-dealer community and focus specifically on those types of records that are necessary for the operation of a branch. For example, state branch books and records requirements commonly called for: (i) blotters relating to receipts and disbursements of cash and receipts and deliveries of securities; (ii) commission reports identifying the types of products sold and the commissions earned by each agent; (iii) customer information documents (commonly referred to as new account applications); (iv) files pertaining to advertising, correspondence, and customer complaints; (v) monthly statements; and (vi) order tickets and trade confirmations.

Most importantly, the Committee noted that state books and records requirements did not require a firm to *generate* new records but only preserve and make available to regulators those records which a prudent broker-dealer would otherwise maintain under normal business conditions and in compliance with supervisory requirements. The absence of these types of records would immediately raise concerns regarding a broker-dealer's ability to properly supervise a branch location.

However, in some respects, state books and record keeping rules have historically differed from state to state and the broker-dealer community emphasized the need to standardize these requirements.

Accordingly, from 1993 through 1995, the Committee worked on drafting a model state rule establishing which specific records should be maintained by broker-dealer branch offices. The Committee in its deliberations was sensitive to the issue of uniformity and encouraged representatives from the broker-dealer community to attend its meetings. As a result, industry had substantial input into the Committee's model rule. In addition, the Committee also sought input from the SEC and from self-regulatory organizations ("SROs") in recognition that the model rule would assist all securities regulators, not just the states, in protecting the public.

The Committee presented its proposed model rule to the NASAA membership at its annual meeting in October 1995. At that meeting, the Honorable Arthur Levitt, Chairman of the SEC, asked the NASAA membership to defer adoption of the model rule to allow the SEC an opportunity to amend its books and records rules to appropriately address the states' concerns. From that time until the present, the Committee worked extensively with SEC staff to incorporate the substance of the state model rule in the form of amendments to the SEC rules. In this process, key industry personnel participated and influenced the final product embodied in this Release.

Recently state securities enforcement cases have uncovered more frequent problems with inadequate supervision at the branch or local level. NASAA believes that a proactive supervisory system at the branch level should be a standard business practice and must, by necessity, include the maintenance and review of those books and records that are essential to the proper operation of any branch office by local managers of such locations. Without these proposed amendments, the present SEC rules are inadequate to insure such a system and fall short of providing efficient and meaningful opportunity for inspection at the local level.

According to information provided by the SEC, approximately 46 million direct investors carry accounts with about 5,300 broker-dealers. The public now believes securities enforcement personnel have unimpeded access to records which would aid and support investor protection. If current state record keeping requirements intended to protect individual investors were to be reduced, NASAA believes public confidence in the securities markets might be seriously undermined.

### **Specific Comments**

Therefore NASAA respectfully offers the following comments:

Proposed Rule 17a-3(a)(1) would require that records of purchases and sales of securities for customer accounts be accessible with respect to the activities of each branch office. NASAA recommends that the proposed rule also include records of receipts and disbursements of cash and the receipt and delivery of securities. Such records will provide examiners with a method of tracing deposits and will also aid in the discovery of possible misappropriations of funds and securities.

Proposed Rule 17a-3(a)(6) would add a new requirement that memoranda of brokerage orders reflect the agent effecting such transactions and whether the order was solicited or unsolicited. This is a common practice at present within the brokerage industry and NASAA strongly supports its codification.

Proposed Rule 17a-3(a)(16) would mandate a new SEC requirement that broker-dealers maintain an account application for each customer account. States have noted that the securities industry currently collects and maintains basic identification and background information about its customers to ensure compliance with the "know your customer" requirement. The key element of the proposal requires broker-dealers to provide customers with a copy of that information upon which broker-dealers will base their investment recommendations. States with a similar provision have observed that the requirement greatly reduced disagreements between customers and broker-dealers arising over the nature of clients' investment objectives. The Commission sought comment on a proposed one year phase-in period with respect to the account form requirement for existing customers. Since many firms are already complying with state books and records requirements, including the requirement to forward copies of new account information to clients, the one-year phase-in period is an appropriate and perhaps even generous time frame. NASAA strongly endorses this provision.

Proposed Rule 17a-3(a)(17) requires broker-dealers to maintain a record of all written and oral complaints which originate at each local office. This rule is essential for identifying and addressing disputes at the local level. It also requires the sorting of complaints by associated persons which will enable each local manager to more closely supervise those individuals who are the subject of frequent complaints.

Proposed Rule 17a-3(a)(18) provides for record keeping relating to compensation identified by transaction, person receiving said compensation, customer account, name of security and date of transaction. NASAA strongly urges that this rule be amended to provide that associated person compensation records be accessible at local offices. State examiners review compensation records to determine whether associated persons may be placing their own financial well being before that of their customers. As broker-dealers currently forward compensation information to their associated persons, any burden from this change would be negligible.

Proposed Rule 17a-3(a)(19) is particularly important to NASAA. We believe it provides branch supervisory personnel with a proactive mechanism to prevent potential sales practice abuses. The identification of "red flags" materially aids in the early detection and timely resolution of problems which might otherwise lead to more extensive patterns of abuse.

Proposed Rule 17a-3(a)(20) will codify the records that a broker-dealer must maintain with respect to each associated person. These records include: registration and licensing materials; contracts and documents governing the relationship between the broker-dealer and the associated person; records relating to the associated person's compensation, copies of customer complaints received and client trading records. Based on the experience of NASAA's membership, these records are generally maintained at local

offices. It is unlikely that codification of these requirements will impose any noticeable burden on industry. NASAA strongly supports this provision. NASAA recognizes that creating a client trading record for each customer of each associated person may initially appear to impose an additional record keeping requirement. In practice, however, broker-dealers now maintain this information in various formats, perhaps as customer statements.

Proposed Rule 17a-3(a)(21) requires broker-dealers to maintain a list identifying each associated person and designating the local office where such person conducts the greatest portion of his or her securities business. State enforcement efforts are sometimes hindered by delays created because records for an associated person domiciled in one state may be retained in another. NASAA strongly supports this rule.

Proposed Rule 17a-4(b)(10) should be amended to require that all advertisements, marketing material, sales scripts and other paper or electronic records, including audio and video tapes emanating from a local office be retained at that location and be available to examining authorities. Since local offices would only be required to maintain the material which they already have on hand, this change will not burden broker-dealers. NASAA strongly urges the SEC to amend Proposed Rule 17a-4(b)(10) as noted. This rule change would also be consistent with similar provisions contained in Proposed Rule 17a-4(b)(4) concerning the handling of local office communications.

We recommend that Proposed Rule 17a-4(b)(11) be amended to require any information relating to the basis for any recommendation of a security that is underwritten by that broker-dealer and each security that the broker-dealer trades as principal and recommends to its customers originating from a local office be retained at that location and be available to examining authorities. It is the experience of states that certain broker-dealers permit market-making activities to be conducted from branch locations. NASAA strongly urges that records documenting market-making activity be retained and available for inspection at the location conducting said market-making activity. This should not result in any record keeping burden to industry.

The drafters of this proposal should be commended for their foresight in crafting rules flexible enough to accommodate both electronic as well as paper retention of records. Many broker-dealers have made great strides in capturing and analyzing trading and client information and incorporating it into their compliance programs. Immediate production of electronic records retrievable over a computer terminal is essential to the thorough completion of an examination. For those records maintained at storage locations outside a particular state, it is imperative that these records be furnished in a timely fashion.

## Conclusion

Adoption of the proposed rules contained in the Release will result in a significant benefit to the securities industry while recognizing and preserving the states' commitment to protecting their citizens through regular branch office examination programs. As several states currently impose branch books and records requirements that are more comprehensive than those contained in the Release, the rule as proposed would relax current industry branch record keeping requirements. NASAA believes the proposed revisions to the books and records rule represents a balanced approach to satisfying the needs of the states, the SEC, and SROs by removing existing burdens on industry.

It should be noted that this delicate balance was identified by the Honorable Senator Christopher J. Dodd (D - Connecticut) in the October 1, 1996 Congressional Record as follows:

The conference report also contains a requirement for the establishment of uniform State laws on books and records for broker-dealers. While this uniformity has long been sought by State regulators, the SEC and industry, I remain concerned that some States will have to adjust their laws regarding books and records kept at branch offices. *It is the intent of the conferees that the SEC work closely with the States to determine what records should be maintained at the branch offices and to establish a mechanism so that States could require such records be kept in the branch office, rather than at a back office halfway across the Nation.* [Emphasis added]

As technology advances, NASAA remains committed to working with the SEC and industry in this and other areas of mutual concern. Desiring to avoid duplicative examinations of broker-dealers, many states have decided that emphasis be placed towards investor protection by conducting sales practice examinations of branch offices located within their borders. State books and records requirements were thus imposed to insure that books and records were available locally which help facilitate the review of sales conduct of those firms with operating locations within or from a particular state. These records are an integral component of states' regular branch office examination programs and the enactment of these proposed rules will continue to promote protection of the investing public and the effective enforcement of federal and state laws.

Sincerely yours,

Mark J. Griffin  
NASAA President