

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-51935; File No. SR-NASD-2005-066)

June 29, 2005

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Notice of Filing of Proposed Rule Change Relating to Amendments to NASD Rule 3011 and the Adoption of New Related Interpretive Material

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on May 23, 2005, the National Association of Securities Dealers, Inc. (“NASD”) 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. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

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

NASD is proposing to amend NASD Rule 3011 and adopt new related interpretive material (“IM”), to (1) require each member to conduct the independent test of its anti-money laundering program on an annual basis, with the exception of certain types of firms, which would be allowed to test every two years; (2) clarify the persons not considered to be independent for purposes of Rule 3011(c), and therefore not eligible to conduct the test; and (3) require a member to review and update, if necessary, the accuracy of the member’s anti-money laundering compliance person information on a quarterly basis. The text of the proposed rule change is available on NASD’s Web site

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<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

(<http://www.nasd.com>), at NASD's Office of the Secretary, and at the Commission's Public Reference Room.

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 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 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

Financial institutions, including broker-dealers, must develop and implement anti-money laundering ("AML") programs pursuant to the Bank Secrecy Act<sup>3</sup>, as amended by Section 352 of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA PATRIOT ACT) Act of 2001 ("PATRIOT Act").<sup>4</sup> Consistent with Treasury regulation 31 C.F.R. 103.120 under the Bank Secrecy Act, NASD Rule 3011 requires that each member develop and implement a written AML program and specifies the minimum requirements for those programs.

Independent Testing

One of the AML program requirements is that firms independently test their AML programs. Testing allows a member to review and assess the adequacy of the firm's

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<sup>3</sup> Currency and Foreign Transactions Reporting Act of 1970 (commonly referred to as the Bank Secrecy Act), 12 U.S.C. §1829b, 12 U.S.C. §1951-1959, and 31 U.S.C. §5311-5330.

<sup>4</sup> Pub. L. No. 107-56, 115 Stat. 272 (2001).

AML program and the firm's degree of compliance with its written procedures. Test results alert members to any deficiencies in their AML programs, thereby allowing them to take appropriate corrective action or disciplinary action as the situation may warrant. The independent test report also is an important tool for regulators during their examinations of firms for AML compliance to, among other things, ensure that the firms are following up with corrective action when such tests discover AML program deficiencies.

#### Frequency of Testing

Neither the Bank Secrecy Act nor Rule 3011 currently specifies the frequency of independent testing, and members have asked NASD for guidance on this issue. Given the important role that testing plays in a firm ensuring that its AML program is effective in preventing money laundering activities from occurring at or through the firm and, in order to assure that member AML programs are serving their regulatory purposes, the proposed rule change would require in most instances that firms test their AML programs at least annually (on a calendar-year basis). Certain firms, however, because of their business models and activities may be able to test on a less frequent basis. Therefore, the proposed rule change would allow members that do not execute transactions for customers or otherwise hold customer accounts or act as an introducing broker with respect to customer accounts to test at least once every two years (on a calendar-year basis), rather than on an annual basis. Examples of these types of firms may include firms that engage solely in proprietary trading or that conduct business only with other broker-dealers. In either case, the proposed rule change establishes a minimum

requirement, and members should undertake more frequent testing than required if circumstances warrant.

#### Establishing Independence

Rule 3011(c) allows the independent testing of a firm's AML program to be conducted by either member personnel or by a qualified outside party. Some firms may find it more cost effective to use appropriately trained firm personnel. In this regard, members have asked for guidance on how to sufficiently maintain the independence of any internal personnel conducting the test. The proposed rule change would require the person conducting the independent test to have a working knowledge of the applicable Bank Secrecy Act requirements and related implementing regulations. The proposed rule change further clarifies that, to ensure sufficient separation of functions for independence purposes, the testing cannot be conducted by the AML compliance person(s) designated in Rule 3011, by any person who performs the AML functions being tested, or by any person who reports to any of these persons.

Recognizing that these limitations may effectively prevent a small firm from using appropriate internal personnel to conduct the tests, the proposed rule change would allow tests to be conducted by persons who report to either the AML compliance person or persons performing AML functions if (1) the member has no other qualified personnel to conduct the test; (2) the member establishes written policies and procedures to address potential conflicts that can arise from allowing the test to be conducted by a person in the reporting chain (e.g., anti-retaliation procedures); (3) to the extent possible, the results of the test are reported to someone senior to the person to whom the test conductor reports; and (4) the member documents its rationale, which must be reasonable, for determining

that it has no other alternative than to comply in this manner.<sup>5</sup> In addition, if the person does not report the results to a person senior to the AML compliance person or persons performing AML functions, the member must document a reasonable explanation for not doing so.

Consistent with SEC and NASD recordkeeping requirements, the member would need to retain a copy of the documented rationale, which would be reviewed by NASD examiners to assess whether the member's rationale reasonably supports its determination.

NASD engaged in extensive discussions with the New York Stock Exchange, Inc. ("NYSE") to coordinate this proposed rule change regarding independent testing of AML compliance programs. To the extent possible, NASD and the NYSE have tried to develop consistent approaches with variations where necessary to account for the differences in NASD and NYSE membership, namely, differences in firm size, types of businesses conducted, and overall business models.

#### AML Compliance Person – Review and Update of Contact Information

Paragraph (d) of Rule 3011 requires that each member designate and identify to NASD the member's AML compliance person(s) and notify NASD of any changes to the compliance person(s)' contact information. NASD requires this information to, among other things, facilitate the efforts of the Financial Crimes Enforcement Network, pursuant to Section 314(a) of the PATRIOT Act and its implementing regulations, in requesting

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<sup>5</sup> This exception is primarily intended to accommodate small firms. For example, assume that all of a small firm's employees, even those who do not perform any AML functions, report to the firm's AML compliance person who is also the sole compliance officer of the firm. The member could elect to use qualified internal personnel who do not perform AML functions to conduct the independent test, even though they report to the AML compliance officer, provided all of the conditions set forth in proposed IM-3011-1(c)(3) have been met.

information from financial institutions about persons suspected of engaging in money laundering or terrorist activities.

Given the important role of the AML compliance person in ensuring effective communication for purposes of identifying money-laundering and terrorist financing activities, NASD believes that members should review and update the AML compliance person information periodically to ensure its accuracy. As such, the proposed rule change would require that each member conduct a review and update, if necessary, of its AML compliance person information within 17 business days after the end of each calendar quarter.<sup>6</sup> Quarterly reviews and updates are consistent with NYSE requirements.<sup>7</sup>

The proposed rule change also would clarify that the AML compliance person must be an associated person of the member. As noted in Section 2 of this filing, NASD will announce the effective date of the proposed rule change in a Notice to Members to be published no later than 60 days following Commission approval. The effective date will be not more than 30 days following publication of the Notice to Members announcing Commission approval.

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<sup>6</sup> This proposed schedule is consistent with a member's quarterly FOCUS reporting schedule, as well as with a member's business continuity plan requirement to review and update emergency contact information on a quarterly basis (see NASD Rule 3520(b)). Similarly, the proposed schedule is consistent with the requirement to review and update a member's Executive Representative designation and contact information (see NASD Rule 1150) and to designate a person to receive notifications relating to continuing education, and the need to review and update such designation and contact information (see NASD Rule 1120(a)(7)). When members file their FOCUS reports each quarter, they are reminded of the need to review and update this information on the NASD Contact System.

<sup>7</sup> In Information Memo Number 02-41 (Aug. 30, 2002), the NYSE stated that its members should review and/or update on a quarterly basis (*i.e.*, March, June, September, and December) the information furnished on its Electronic Filing Platform, including information regarding the member's or member organization's AML compliance person.

## 2. Statutory Basis

NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act, which requires, among other things, that NASD rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. NASD believes that the proposed rule change is designed to accomplish these ends by requiring members to conduct periodic tests of their AML compliance programs, preserve the independence of their testing personnel, and ensure the accuracy of their AML compliance person information.

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

NASD does not believe that 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, as amended.

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

Written comments were neither solicited nor received.

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

Within 35 days of the date of 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 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, including whether the proposed rule change is consistent with the Act. The Commission particularly urges commenters to consider the proposed rule change in light of a similar but not identical proposed rule change by the NYSE.<sup>8</sup>

Specifically, the NASD and NYSE proposals differ in who would be permitted to serve as a firm's designated AML compliance contact person ("AML Officer"). The NYSE proposal would, subject to certain restrictions, permit the AML Officer to be an employee of a parent, affiliate, or subsidiary of a member. As discussed above, the NASD proposal, however, would require the AML Officer to be an "associated person of the member," as that term is defined in Article I(dd) of the NASD By-Laws. Serving as an AML Officer, by itself, would not make a person an associated person of an NASD member. What issues, if any, would arise from the application of both standards regarding who can serve as an AML Officer at firms that are dual members of the NASD and NYSE?

The NASD and NYSE proposals also differ in who would be permitted to perform the independent testing function for AML compliance. Primarily to accommodate smaller firms, the NASD proposal would permit an employee who reports to a person who performs the functions being tested and/or reports to the AML Officer to perform the independent testing, if, among other requirements, the member has no other

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The text of the proposed rule change is available on the NYSE's Web site ([www.NYSE.com](http://www.NYSE.com)), at the NYSE's principal office, and at the Commission's Public Reference Room.

qualified internal personnel to conduct the test and the member creates a written policy to address conflicts. The NYSE proposal, however, would not permit an employee who reports to a person who performs the functions being tested or reports to the AML Officer to perform the independent testing. How would these standards, if adopted, affect the AML program of dual members of the NASD and NYSE? Firms are invited to discuss how this would affect their specific operations.

Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NASD-2005-066 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-9303.

All submissions should refer to File Number SR-NASD-2005-066. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). 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 in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549. Copies of such filing will also be available for inspection and copying at the principal office of NASD.

All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to the File Number SR-NASD-2005-066 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.<sup>9</sup>

Margaret H. McFarland  
Deputy Secretary

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<sup>9</sup> 17 CFR 200.30-3(a)(12).