SECURITIES AND EXCHANGE COMMISSION
(Release No. 34-53030; File No. SR-NASD-2005-066)

December 28, 2005

Self-Regulatory Organizations; National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Change and Amendment No. 1 Thereto Relating to Amendments to NASD Rule 3011 and the Adoption of New Related Interpretive Material

I. Introduction

On May 23, 2005, the National Association of Securities Dealers, Inc. ("NASD") filed with the Securities and Exchange Commission ("SEC" or "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 relating to amendments to NASD Rule 3011 and the adoption of new related interpretive material. The Commission published the proposed rule change for comment in the Federal Register on July 6, 2005.[3] The Commission received three comments on the proposal.[4] On December 15, 2005, NASD filed a response to the comment letters,[5] as well as Amendment No. 1 to the proposed rule change.[6] This order approves the proposed rule change, as amended.

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1 15 U.S.C. 78s(b)(1).

2 17 CFR 240.19b-4.

3 See Securities Exchange Act Release No. 51935 (June 29, 2005), 70 FR 38990 (July 6, 2005) (the "Notice").

4 See letters from Marianne Czernin, Senior VP, Director, Broker/Dealer Client Services, National Regulatory Services to Jonathan G. Katz, Secretary, SEC, dated June 9, 2005 (the "NRS Letter"), from John J. Lynch, Jr., Executive Vice President, Hartfield, Titus & Donnelly, LLC, to Barbara Z. Sweeney, Senior Vice President and Corporate Secretary, NASD, dated July 20, 2005 (the "HTD Letter") and from Alan E. Sorcher, Vice President and Associate General Counsel, Securities Industry Association ("SIA"), to Jonathan B. Katz, Secretary, SEC, dated July 27, 2005 (the "SIA Letter").

5 See letter from Brant K. Brown, Counsel, NASD, to Lourdes Gonzalez, Assistant Chief Counsel, Division of Market Regulation, dated December 15, 2005 (the "NASD Response").

6 Amendment No. 1 clarified the conditions set forth in proposed IM-3011-1(c)(3). See footnote 9 and accompanying text.

II. Description of the Proposed Rule Change

Financial institutions, including broker-dealers, must develop and implement anti-money laundering ("AML") programs pursuant to the Bank Secrecy Act,[7] 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").[8] 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 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 NASD Rule 3011 currently specifies the frequency of independent testing, and members have asked NASD for guidance on this

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7 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.

8 Pub. L. No. 107-56, 115 Stat. 272 (2001).

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

NASD 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 NASD 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.[9] 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.

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[9] This exception is primarily intended to accommodate small firms that, absent the exception, could not use internal personnel to conduct an independent test of the firm's AML program. For example, assume that all the small firm's employees, even those who do not perform any AML functions, report to the firm's AML compliance officer 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 the conditions set forth in proposed IM-3011-1(c)(3) have been met. NASD conducts routine exams of member firms to test the adequacy of AML compliance programs with the objective of determining whether member firms' AML compliance programs are reasonably designed to achieve and monitor compliance with the requirements of the Bank Secrecy Act and applicable Treasury, SEC, and NASD rules. During any such exam, firms that elect to rely on the exception must be able to demonstrate that they have complied with the conditions set forth in proposed IM-3011-1(c)(3).

Consistent with SEC and NASD recordkeeping requirements, the member would need to retain a copy of the documented rationale, which could 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 NASD 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 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.[10] Quarterly reviews and updates are consistent with NYSE requirements.[11] The proposed rule change also would clarify that the AML compliance person would be an associated person of the member, but only with respect to the activities performed on behalf of the member.

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.

III. Summary of Comments Received and NASD Response

The Commission received three comment letters on the proposal and a response to the comment letters by NASD. The HTD Letter expressed support for the proposed changes to NASD Rule 3011(c), which NASD noted in its response.[12]

The SIA Letter expressed concern that NASD and NYSE proposals may set forth different standards as to who is permitted to serve as the designated AML compliance

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10 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.

11 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.

12 HTL Letter, supra note 4. NASD Response, supra note 5. The NASD Response stated "The HTD Letter is limited to support for the proposed rule changes to NASD Rule 3011(c); consequently, this response will not address the HTD Letter."

person.[13] NASD noted that the "[t]he SIA Letter objected to the proposed rule change on the grounds that by requiring the AML Officer to be an associated person of the member firm, the proposed rule change would not permit larger member firms to designate an individual as the AML Officer unless that individual was an employee of the member itself."[14] NASD clarified, however, that because NASD considers designated AML compliance persons to be associated persons for purposes of their activities on behalf of the member, the permissible structures for establishing AML programs are similar under the NASD proposal and the NYSE proposal.[15] Specifically, the NASD expressed the view that the NASD proposal "would not prohibit a member that is part of a diversified financial institution from designating an AML Officer that is employed by the member's parent company, sister company, or other affiliate; however, if such a person is designated as a member's AML Officer, NASD would consider that person to be an associated person of the member with respect to those activities performed on behalf of the member."[16]

The NRS Letter requested clarification regarding which types of broker-dealers are required to test their AML procedures annually and which are permitted to have their AML programs tested every two years.[17] The NASD Response indicated that in

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13 SIA Letter, supra note 4, at 2.

14 NASD Response, supra note 5, at 4.

15 NASD Response, supra note 5, at 2-3. In footnote 6 of the NASD Response, the NASD clarified that while the Notice states "that '[s]erving as an AML Officer, by itself, would not make a person an associated person of an NASD member,' as further discussed with the SEC staff, NASD believes that the AML Officer would be an associated person of the member, but only with respect to the activities performed on behalf of the member."

16 NASD Response, supra note 5, at 3-4.

17 NRS Letter, supra note 4, at 1-2.

"assessing how often a member must conduct independent tests, members should begin with the premise that they must test annually."[18] NASD also noted that each member "should determine whether its business activities meet the requirements set forth in the rule" for testing every two years.[19] In addition, NASD stated: "If, after assessing its status, a member finds that there is an ambiguity in the application of the express standards for testing its AML program every two years (rather than on an annual or more frequent basis) to specific factual settings, the member may either seek interpretive guidance from NASD staff or test the program on at least an annual basis."[20]

IV. Discussion and Findings

After careful review, the Commission finds that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,[21] 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. The Commission 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.

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18 NASD Response, supra note 5, at 5.

19 Id.

20 Id.

21 15 U.S.C. 78o-3(b)(6).

V. Conclusions

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,[22] that the proposed rule change, as amended (SR-NASD-2005-066), be, and it hereby is, approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[23]

Nancy M. Morris
Secretary

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22 15 U.S.C. 78s(b)(2).

23 17 CFR 200.30-3(a)(12).