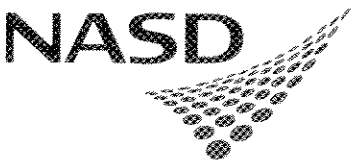
December 15, 2005



Lourdes Gonzalez
Assistant Chief Counsel
Division of Market Regulation
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

RE: File No. SR-NASD-2005-066: Proposed Rule Change Relating to NASD Rule 3011 Response to Comments

Dear Ms. Gonzalez:

NASD hereby responds to the three comment letters[1] received by the Securities and Exchange Commission (the "SEC") in response to the publication in the *Federal Register* of Notice of Filing of SR-NASD-2005-066 relating to proposed amendments to, and the adoption of interpretive material regarding, the NASD anti-money laundering program rule ("NASD Rule 3011").[2] One commenter expressed support for the proposed rule change. One commenter, the Securities Industry Association (the "SIA"), suggested that, with one minor change, NASD adopt the standard proposed by the New York Stock Exchange (the "NYSE") regarding which individuals are permitted to serve as anti-money laundering ("AML") compliance officers (an "AML Officer").[3] For the reasons described in the first section below, NASD declines to adopt the NYSE's proposed standard. Another commenter, National Regulatory Services ("NRS"), requested that NASD provide further guidance regarding which broker-dealers are permitted to conduct independent tests of their AML programs every two years (as opposed to annually). NASD's response to NRS is set forth in the second section below.

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1 Securities Industry Association (July 27, 2005) (the "SIA Letter"); Hartfield, Titus & Donnelly, LLC (July 20, 2005) (the "HTD Letter"); National Regulatory Services (June 9, 2005) (the "NRS Letter"). 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.

2 *See* Securities Exchange Act Release No. 51935 (June 29, 2005), 70 Fed. Reg. 38990 (July 6, 2005) (Notice of Filing of Proposed Rule Change Relating to Amendments to NASD Rule 3011 and the Adoption of New Related Interpretive Material) (the "Notice of Filing").

3 *See* Securities Exchange Act Release No. 51934 (June 29, 2005), 70 Fed. Reg. 38994 (July 6, 2005) (Notice of Filing of Proposed Rule Change to Amend Rule 445).

RPO, Office of General Counsel
1735 K Street, NW
Washington, DC
20006
tel 202 728 8071
fax 202 728 8264
www.nasd.com

The SIA Letter

As NASD noted in its filing, NASD engaged in extensive discussions with the NYSE to coordinate NASD's proposed rule change (the "NASD Proposal") with the NYSE's proposed rule change (the "NYSE Proposal") regarding its AML program rule. To the extent possible, NASD and the NYSE sought to develop consistent approaches. While the NASD Proposal and the NYSE Proposal approached the issue of which individuals are permitted to serve as AML Officers in a different fashion, as discussed more fully below, the outcomes are similar under both approaches. NASD is submitting this response to comments to clarify its position, and NASD believes that the clarification addresses the concerns raised in the SIA Letter.

Under the NYSE Proposal, an AML Officer must either be employed by each member or member organization for which they are designated as the AML Officer or be employed by an entity that directly or indirectly controls, is controlled by, or is under common control with the member or member organization (*i.e.*, a parent, affiliate, or subsidiary of the member or member organization). If the AML Officer is not employed by the member or member organization, the NYSE Proposal requires that (1) the designation receive the NYSE's prior written approval;[4] (2) the designee execute an attestation, acceptable to the NYSE, consenting both to the supervision of each member or member organization for which the individual is designated as the AML Officer and to the jurisdiction of the NYSE; and (3) the member or member organization execute an agreement, acceptable to the NYSE, acknowledging its responsibility to supervise, as an employee for all regulatory purposes, each such designee. The NYSE stated that it was proposing this approach to allow firms "the flexibility to integrate their AML program into the larger corporate structure to achieve a more global perspective, and thus a more comprehensive and effective AML program."

The NASD Proposal takes a different approach; however, the ultimate regulatory structure in place is similar under both approaches. Pursuant to the NASD Proposal, paragraph (d) of NASD Rule 3011 would be amended to state that the individual(s) serving as a member's AML Officer(s) "must be an associated person of the member." NASD has previously noted its view that, while the AML Officer is not "required to be a registered person as a result of serving that function . . . [w]hether or not an [AML Officer] is registered with, or an employee of, the firm, an [AML Officer] is an associated person of the firm."[5] Thus, once an individual is designated as a member's AML Officer, that individual becomes an associated person of the member with respect to the functions undertaken on behalf of the member.[6] As an associated

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4 The SIA Letter recommends that the prior approval requirement be deleted.

5 *NASD Notice to Members 02-80*, at n.5 (Dec. 2002).

6 NASD's By-Laws define an "associated person," in relevant part, as a "natural person engaged in the investment banking or securities business who is directly or indirectly controlling or controlled by a member, whether or not any such person is registered or exempt from registration with NASD." *See* NASD By-Laws, Art. I, Sec. (dd). Because

[Footnote continued on next page]

person, the AML Officer would be subject to all applicable NASD conduct rules, and NASD would have jurisdiction over the AML Officer if circumstances arose warranting disciplinary action against that person.[7] However, as NASD has previously stated, an individual would not be required to register with NASD as a representative or principal solely because the individual serves as the AML Officer.[8]

Because NASD considers AML Officers to be associated persons for purposes of their activities on behalf of the member, the permissible structures firms can choose to implement in establishing their AML programs are similar under the NASD Proposal and the NYSE Proposal. If an AML Officer performs AML functions for multiple entities, some of which are not NASD members, his or her AML-related duties for the non-broker-dealer entities (*e.g.*, banks or other financial institutions subject to AML requirements) would not be subject to NASD rules or jurisdiction.[9] Consequently, the NASD Proposal would not prohibit a member that is part of a

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the AML Officer is responsible for monitoring the day-to-day operations and internal controls of a member program required by NASD conduct rules, and his or her function is established pursuant to the rules, NASD considers the AML Officer to be engaged in the member's securities business for purposes of the definition. In addition, a member is ultimately responsible for its compliance with NASD rules, regardless of whether the member directly performs all of its compliance functions or contracts with outside entities to support the performance of some of its compliance responsibilities. *See, e.g.*, *NASD Notice to Members 05-48*, at 4 (July 2005). Thus, a member must maintain some degree of control over its AML Officer to comply with NASD rules. Accordingly, an AML Officer is an associated person of the member with respect to those functions undertaken for the member. While the SEC's Notice of Filing 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. NASD is proposing the rule change, in part, to clarify its views on the AML Officer's associated person status.

7 *See* NASD Rule 0115(a) (providing that NASD conduct rules "apply to all members and persons associated with a member" and that "[p]ersons associated with a member shall have the same duties and obligations as a member" under NASD rules). The NYSE Proposal reaches this same result; however, the NYSE Proposal achieves the result through the use of a consent form signed by the AML Officer and an acknowledgment signed by the member firm. *See* SR-NYSE-2005-36, available at http://www.nyse.com/pdfs/2005-36fil.pdf.

8 *See NASD Notice to Members 02-80*, at n.5 (Dec. 2002).

9 This statement assumes, consistent with the type of scenario presented by the SIA Letter, that the AML Officer's services for both the NASD member and non-broker-dealer

[Footnote continued on next page]

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.[10]

The SIA Letter objected to the NASD Proposal on the grounds that by requiring the AML Officer to be an associated person of the member firm, the NASD Proposal would not permit larger member firms to designate an individual as the AML Officer unless that individual was an employee of the member itself. As detailed above, however, the designation of an individual as the AML Officer for a member makes that individual an associated person of the member for those duties undertaken on behalf of the member. Thus, the structure outlined in the SIA Letter would be permitted under the NASD Proposal.

The NRS Letter

The NRS Letter focuses solely on the frequency of the independent test required by NASD Rule 3011(c). Currently, NASD Rule 3011(c) requires that members provide for independent testing of their AML programs; however, the rule does not specify how frequently members must perform the independent test. In the proposed rule change, NASD proposes to require that most members test their AML programs at least annually (on a calendar-year basis). Certain firms, however, would be required to test their AML programs at least every two years (on a calendar-year basis). Specifically, the proposed rule would amend paragraph (c) to clarify that members must test their AML programs annually "unless the member does not execute transactions for customers or otherwise hold customer accounts or act as an introducing broker with respect to customer accounts (e.g., engages solely in proprietary trading or conducts business only with other broker-dealers), in which case such 'independent testing' is required every two years (on a calendar-year basis)."

NRS has requested that NASD clarify which types of broker-dealers are required to test their AML procedures annually and which are permitted to have their AML programs tested

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entities are limited to the types of AML-related duties and activities contemplated by Rule 3011. For example, this statement does not address circumstances where an AML Officer, in addition to his or her AML-related activities, may also be engaged in other securities activities on behalf of both entities.

[10] Indeed, the NASD Proposal is broader in this regard than the NYSE Proposal. Unlike the NYSE Proposal, the NASD Proposal does not limit a member's ability to designate an AML Officer to employees of the member or affiliated entities.

every two years.[11] At the outset, we note that NASD does not—and cannot—draft rules or provide guidance that purports to address each and every potential set of specific factual circumstances. NASD has a large and varied membership, and NASD rules must be sufficiently broad to address multiple circumstances. NASD is aware that, at times, this may raise interpretive issues under NASD rules; as a result, NASD staff responds to written requests for interpretations as to how NASD rules apply to specific factual circumstances.

NASD believes that the language contained in the proposed rule change sufficiently lays out the requirements a member must meet in order to be permitted to test its AML program every two years. First, when assessing how often a member must conduct independent tests, members should begin with the premise that they must test annually. Second, the member should determine whether its business activities meet the requirements set forth in the rule. For a member to be permitted to test every two years, the member must meet three requirements: (1) the member does not execute transactions for customers; (2) the member does not hold customer accounts; and (3) the member does not act as an introducing broker with respect to customer accounts. While the proposed rule change includes two examples of the types of firms the rule is intended to reach (firms engaged solely in proprietary trading and firms that conduct business only with other broker-dealers), the examples do not alter the analysis a member must perform. 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.

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NASD believes that the foregoing fully responds to the issues raised by the commenters to the rule filing. Please feel free to call me at (202) 728-6927 if you wish to discuss this further.

Sincerely,

Brant K. Brown

Brant K. Brown
Counsel

cc: Haime Workie, Division of Market Regulation

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[11] It is worth emphasizing that, as set forth in proposed IM-3011-1(a), all members are required to undertake more frequent testing than required if circumstances warrant. Thus, Rule 3011(c) establishes only minimum requirements for independent testing.