

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
WASHINGTON, D. C .

August 28, 1967

Martin Moskowitz, Esq.
Securities and Exchange Commission
Division of Trading and Markets
500 North Capitol Street
Washington, D. C. 20549

Dear Mr. Moskowitz:
[signer crossed out "Mr. Moskowitz" and wrote "Marty"]

Enclosed are an original and fourteen copies of a new draft of the mark-up policy.

Sincerely yours,

Lloyd J. Derrickson
General Counsel

Enclosures

INTERPRETATION AND POLICY WITH RESPECT TO MARKUPS AND MARKDOWNS

(Reference: Sections 1 and 4, Article III of the Rules of Fair Practice)

I. Background of the Markup or 5% Policy

In connection with the Association's efforts to insure fair dealing with customers in the over-the-counter market^ a survey of the membership was conducted in 1943 to establish the general practice of the business on markups. This survey, conducted in 1943, showed that 47% of the transactions were made at markups of 3% or less and 71% were effected at 5% or less. Shortly thereafter the Board

of Governors adopted the Markup or 5% Policy which stated the basic requirement set forth in Article III, Section 4 of the Rules of Fair Practice that transactions with customers be at prices reasonably related to the current market; that in the enforcement of this general rule the fairness of retail prices must be based upon a consideration of all relevant factors involved in each transaction; and that while a markup in excess of 5% may sometimes be justified, a markup of 5% or even a lower percentage is not always justified.

Over the years the Policy has been reviewed by the Board of Governors in connection with numerous disciplinary actions and current market conditions. In 1960 and again in 1967, after such reexamination, changes were made in the Policy to reflect the experience gained from processing disciplinary proceedings before the Association and upon appeal to the Securities and Exchange Commission. The Board has each time reaffirmed the basic views expressed when the Policy was adopted in 1943.

II. The Interpretation

It shall be deemed conduct inconsistent with just and equitable principles of trade for a member to enter into any transaction with a customer in any security at any price not reasonably related to the current inter-dealer market price of the security or to charge a commission which is not reasonable.

III. Definitions

A. Inter-dealer Market

Inter-dealer market means the prices at which one or more members, which may be the member in question, buy or sell, or indicate their willingness to buy and sell (the bid and ask) the securities in question from or to another member or members.

Quotations furnished by one or more members to another member or members or to an inter-dealer quotation system, may be used, to ascertain the inter-dealer market.

B. Contemporaneous price

"Contemporaneous price" is the price which a member pays to or receives from another member for a security at or about the time of a retail transaction in the same security.

C. Proceeds transaction

A "proceeds transaction" means a transaction in which a customer sells securities to or through a member, the proceeds from which are utilized to pay for other securities purchased from, or through the member at or about the same time.

IV. Basis for Computation of Markups and Markdowns

A. Transactions Not Involving An Inventory Position

When a member, acting as principal without an inventory and for the purpose of completing an order in a security, buys or sells the security in approximately the same quantity, the basis for determining the amount of the markup or markdown in a retail transaction shall be the member's own contemporaneous price.

B. Transactions Involving Purchases For and Sales Out of Inventory

(1) Purchases

The markdown applied by the member shall be calculated on the basis of his contemporaneous price, or in the absence of a contemporaneous purchase, by a representative current inter-dealer bid (which may be the member's if it is in fact representative).

(2) Sales

(a) Independent markets (active and competitive)

If an active, independent and competitive market exists, the member's contemporaneous sales to other dealers would be the appropriate basis for determining the amount of the markup. In the absence of such sales a representative independent contemporaneous offer would be appropriate.

(b) Non-independent markets (inactive or non-competitive)

If the market is inactive, non-independent or non-competitive the basis for determining the markup shall be the member's contemporaneous purchase, either from another member or a customer. In the absence of such a purchase, the basis for determining the markup shall be (1) the member's bid price of made in a market making capacity, or (2) a representative contemporaneous bid of the member is not making a market.

For purposes of this subsection B(2), the amount of profit or loss to the member from market appreciation or depreciation before or after the transaction with the

customer shall not be included in determining the amount of the markup or markdown.

C. Proceeds transactions

In a proceeds transaction the markdown or commission realized by the member on the liquidated security or securities shall be added to the markup or commission, on the purchased security or securities and applied to the purchase as if the customer had purchased for cash.

V. Relevant Factors as to the Fairness of Markups or Markdowns

Some of the relevant factors which the Board believes that members and the Association's committees should take into consideration in determining the fairness of the amount of markup or markdown are outlined below:

A. The Markup Policy is a guide -- not a rule

The Board has stated and been upheld in its view that it would be impractical and unwise, if not impossible, to define specifically what constitutes a fair price on each and every transaction because the fairness of a markup or markdown can be determined only after considering all the relevant factors of which the percentage of markup is only one such factor. What might be considered fair in one transaction could be excessive in another transaction because of different circumstances.

B. The degree of activity of the market for the security

In the case of a security with an inactive market the effort and cost of buying or selling the security, or any unusual circumstances connected with its acquisition or sale, may have a bearing on the amount of markup or markdown justified.

C. Additional expenses in certain transactions

In the case of transactions involving a small amount of money, or in those cases where the completion of an order involves multiple transactions, including proceeds transactions, a higher percentage of markup may be justified to cover the expenses of handling.

D. Pattern of markups and markdowns

While each transaction must meet the test of fairness, the pattern of a member's markups or markdowns will be a factor considered in determining the fairness or unfairness of the member's pricing policy.

E. Expenses and services

A member may not justify excessive markups or markdowns on the basis of its expenses. However, the Board is aware of the different services and facilities which may be needed by customers of members, and the cost of providing such services and facilities, when they are of a continuing nature, may properly be considered in determining the fairness of the amount of a member's markups.

F. Disclosure

Disclosure to a customer does not, in and of itself, justify a commission markup or markdown which is unfair or excessive in the light of other relevant circumstances.

G. Contemporaneous inter-dealer sales and offers

On retail sales of securities with inactive, non-independent or non-competitive markets, markups, as computed under IV.B.(2)(b), must be fair and reasonable. In addition, the price charged the customer must be reasonably related (i.e., should not exceed by an amount which would be acceptable in a non-inventory transaction) to either (a) the price at which the member has made a substantially contemporaneous sale to another member or (b) the price at which a contemporaneous Independent wholesale offering of the security is being made.

VI. Applicability of the Policy

The Policy applies to all transactions in securities, including oil royalties, handled in the over-the-counter market, whether as principal or agent, except in the sale of securities where a prospectus or offering circular is required to be delivered and the securities are sold at the specified public offering price.

General Comments on Section IV.B.(2)(b)

Transactions in securities for which there is no competitive inter-dealer market, particularly where the security sells in a low price range, have been the cause of a considerable number of complaints in connection with the Markup Policy. Transactions in securities where there exists a competitive inter-dealer market may involve a substantial overall percentage spread in the case of low-priced securities because it includes the integrated dealer's spread as a market maker. In these transactions, however, the retail markup can be measured due to the existence of an active and competitive inter-dealer market and whatever profit

the dealer makes as market maker is-determined and limited by competitive conditions.

Decisions of the Board of Governors, the Securities and Exchange Commission and the courts have provided guidelines for determining the existence of an active, competitive and independent market or lack of one. In general, among the factors to be considered are the percentage spread between bid and ask; the number of two-way markets quoted; the activity in the security at the inter-dealer level; and the volume of the subject dealer's business compared to the total volume. Where a dealer's inter-dealer or retail business represents a major portion of the total business in the security, the market would ordinarily not be deemed to be competitive or independent.

Markups computed under IV.B.(2)(b) will tend to be higher than those computed under IV.A. or IV.B.(2)(a) because they include compensation both for the risk assumed in taking a position and for the cost and effort of retailing. The Board of Governors recognizes that a member is entitled to compensation for the risk he assumes in taking a position and that it would be inappropriate, when the member is entitled to such consideration, to apply the 5% guideline which relates primarily to compensation for retailing.

In the absence of any independent basis for measuring the retail spread in a transaction, the markup computed from a contemporaneous purchase or bid must be fair and reasonable and the consideration to be given for taking a position is one of reasonableness for which no definitive answer can be provided. The Board does believe, however, that prevailing inter-dealer spreads for securities of comparable price which enjoy a competitive and independent market provide a basis for judging this reasonableness. In this connection a study was made of the markets published by the National Quotation Bureau on [blank in original], using only those securities for which there were five, or more two-way markets quoted, and eliminating the quartiles with the highest and lowest spreads. It was found that the average inter-dealer spread was: •

[blank in original]% for stocks with representative bids of \$1 to \$4.99 per share

[blank in original]% for stocks with representative bids of \$5 to \$9.99 per share

[blank in original]% for stocks with representative bids of \$10 to \$19.99 per share

The Board, of Governors is aware that many of the Association's members serve a vital function in acting as sponsors and market makers for numerous securities as to which there is no competitive or independent market and it is not the purpose of this Interpretation to discourage this activity in any way. However, it is this type of security which is most frequently involved when a member attempts

to secure a profit in excess of that which is normally considered to be acceptable. The following background considerations are representative of those which should be taken into account, in addition to the relevant-factors set forth in V above, in determining the fairness of markups calculated under IV.B.(2)(b):

(1) The extent to which the member performs the function of a market maker; e.g.; the continuity and size of the member's inter-dealer market;

(2) The degree to which the member acts as a sponsor of the market in the security; e.g., the extent of the member's dissemination, to other members and to the public, of current information about the affairs of the issuer of the security and the depth and continuity of the member's effort to secure and to validate such information;

(3) The nature of the member's distribution; e.g., whether it is accomplished in large measure (a) by written or verbal presentation preceded or accompanied by adequate written information or (b) by telephone or personal solicitation with little or no supporting written material. In addition, it may be significant, if the security is of a speculative nature, whether it is offered generally to a broad range of the member's customers or only to certain types of customers.

The general comments above and the relevant factors set forth in section V are intended by the Board of Governors to assist the members and their duly elected, representatives or the District Committees in arriving at decisions based on the business man's judgment which constitutes the keystone of self-regulation.