

NASD

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NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC. 1735 K STREET, N.W. WASHINGTON, D.C. 20006

To NASD Members and Registered Representatives:

Beginning with this edition of the NASD News, a new regular section has been added concerning subjects of particular interest to the management or supervision of NASD member firms. It is hoped that by increasing member awareness of Association activities, the concept of self-regulation in the securities industry will be further enhanced.

AUTOMATION PLAN ADOPTED

At its regularly scheduled meeting in January, the NASD Board approved a comprehensive plan to develop an automated quotations system (NASDAQ) for the OTC markets.

Envisioned in the highly technical and complex project is the use of electronic data processing equipment to eventually produce a three-level system responsive to 350,000 inquiries in any given eight-hour trading period and designed to aid both customers and professional traders in the OTC markets.

A Level I service, which is aimed at the requirements of registered representatives and securities customers of retail sales firms, will supply a current representative bid and asked quotation for any security registered in the system. This current representative bid and asked would be supplied initially through the more than 25,000 interrogation display units now in use by broker/dealers throughout the country. It is expected that about 1,500 different securities will be quoted initially in the Level I program.

The second level of the NASDAQ system will be designed for use by the trading departments of retail sales firms and will supply a complete list of market makers in any given security registered in the system with their respective bid and asked prices. Information will be supplied participants in the Level II service via a cathode ray tube (CRT) similar to a small television screen or through a teletypewriter printout.

Level III of the NASDAQ system will also be for use by trading departments but will differ chiefly from Level II by providing input facilities allowing authorized market makers to enter, change or update bid and ask prices. Level III information will be dispensed through CRT equipment and may include optional sophisticated accessories for broker/dealer firms making a great many markets or handling a large number of transactions.

The Level II and III service of the NASDAQ system will eliminate the necessity of separate requests for market maker's quotations and expand a trader's knowledge of market conditions to a complete list of all market makers and their current prices.

Although the physical equipment for NASDAQ will be supplied and operated by a qualified independent firm, the NASD will administer and manage the system. The NASD Automation Committee retained in 1967 the technical expertise of management consultants Arthur D. Little, Inc. to assist in making the indepth study of the feasibility of a NASDAQ system. The complex nature of the over-the-counter market and the wide differences in the size, location and interest of broker/dealers presented unique challenges to the study team.

Phase I of the study was completed within the strict guidelines for automation previously approved by the Association's Board of Governors. These guidelines included provisions that the system would: (1) Maintain and support the negotiated character of the over-the-counter market (2) provide safeguards to protect the important functions of market makers (3) not involve any electronic crossing or matching of orders in a machine thereby actually affecting trades and removing the essential function of negotiation.

A general description of NASDAQ together with a specific request for proposals is now available to interested equipment suppliers. The next step in the Automation Committee's continuing study will entail analysis and evaluation of the respective cost, design and operation proposals received from these firms. The target date for making the NASDAQ system operational is 1970.

In addition, the Association will shortly publish an illustrated booklet entitled, NASDAQ, which will be distributed to the membership describing the automated quote system now contemplated. Members expecting to subscribe to the system will be asked to express their intended interest.

NEW PROXY RULES TO BECOME EFFECTIVE

The Board of Governors has approved a Proxy Interpretation to be included in the NASD Manual. The interpretation requires members to forward to the beneficial owner of a security, proxy material received from carrying securities in street name.

When a member is requested by an issuer to transmit material to beneficial owners of a stock held in the member's name, he must forward the material after having been properly furnished sufficient copies of the information statements or other material and having received satisfactory assurance that he will be reimbursed by the issuer for all out-of-pocket expenses including reasonable clerical expenses.

This material sent to shareholders shall include a signed proxy bearing an identifying symbol indicating the number of shares held for the beneficial owner and a letter informing the beneficial owner of the necessity for completing and forwarding the proxy form to those soliciting proxies in order that the shares may be represented at the shareholder meeting.

There is a general exemption in the NASD interpretation for exchange members who may follow the already established rules of their respective exchanges. The new proxy interpretation will go into effect early this summer after clearance by the SEC.

TRAINING GUIDE REVISED

A completely revised NASD Training Guide was recently published and is now available to members, registered representatives and interested persons. It replaces the 1965 Training Guide and represents a complete revision of the original text together with the introduction of new sections on subjects not previously discussed.

The 1968 Training Guide is designed to aid both the candidate who is preparing to enter the securities business and the individual now in the business who desires to extend his knowledge. At the end of each major division and at the end of each chapter are questions intended to help the reader test his understanding of the subject matter.

Throughout the Training Guide are references for candidates who do not have an organized training program available. The references have been coordinated with the recently published second editions of the recommended companion textbooks.

Copies of the 1968 NASD Training Guides are available at \$.40 a piece. Send orders to NASD, 888-17th Street, N.W., Washington, D.C., 20006.

**ARBITRATION CODE
APPROVED BY BOARD**

In January, the Board of Governors formally adopted an Arbitration procedure for disputed matters involving over-the-counter securities transactions. The new code is substantially different from the procedures existing for New York and American Stock Exchange member firms. One major difference is that it limits arbitration controversies to only those arising out of or related to securities transactions. It does not include such disputes that may arise as employer-employee relationships and partnership agreements.

The code provides for the appointment of a fifteen-man National Arbitration Committee to administer the procedures and to supervise the activities of a Director of Arbitration and the pool of arbitrators who will sit on the hearing panels.

The Director of Arbitration will be a permanent NASD staff member stationed in New York City. He will be responsible to the National Committee and will supervise the selection of three-to-five man panels from a pool of three or four hundred arbitrators.

The panels will be composed of three members of the public and two representatives from the securities business in disputes between the public and a member; and in the case of a member-member contest, from three to five representatives from the securities industry will serve. All cases handled under the Arbitration Code will be the result of the voluntary submission of both parties and arbitration proceedings will not preclude later NASD disciplinary actions involving the same matters.

Disputes must be submitted voluntarily by both parties within two years of the transactions. Panels will hear cases in New York or any other city where the NASD maintains a District office. It is expected that the new arbitration code will be made effective very soon and NASD members will be so notified.

**LIST AVAILABLE
FROM NASD
OF FOREIGN SECURITIES
FIRMS**

The Association's Foreign Committee has compiled a complete list of all broker/dealers approved by the Treasury Department as participating firms and custodians under the Interest Equalization Tax Extension Act of 1967. The list, which includes participating NASD member firms along with members of the New York, American and other exchanges and organizations, will be useful to all members who trade in foreign securities. The participating firms listed are those broker/dealers who have received authorization from the Internal Revenue

Service of the Treasury Department to validate foreign securities as "tax paid." A copy of this list is available, upon request, from the NASD Foreign Committee, 67 Broad Street, New York, New York, 10004.

OTC CLEARING CORP. COULD HELP WITH FAILS

In light of the high level of failures to receive and deliver, the backlog of paper work in members' offices and other problems attending the continuing heavy volume in the over-the-counter market, the NASD reminds members of the services and facilities available through the National OTC Clearing Corporation (NAT OTC). This organization was born out of the high volume days of 1960-1961 to meet the needs of all size firms in the New York City area in clearing over-the-counter securities transactions. NAT OTC is in its fifth year of operation and has processed millions of OTC transactions.

The NAT OTC offers its facilities for complete centralization of clearing operations to NASD members maintaining offices in New York City. The Clearing Corporation's services include comparison, clearance in more than 2,500 OTC securities and delivery and settlement in any over-the-counter securities. These services are aimed at reducing fails and increasing the capital leverage of Association members.

NASD members are urged to investigate NAT OTC as a possible solution to many of the problems attending today's high level of volume and subsequent fails. For further information write National OTC Clearing Corporation, 12 Albany Street, New York, New York, 10006 or telephone (212) 267-2960.

In a related area, the securities industry and member banks of the New York Clearing House Association have launched a joint, broad-scale effort aimed at solving mutual operating problems.

Five joint committees, made up of 56 representatives of the securities industry and the banks, have begun meetings on problems involving securities delivery, transfer, collateral, credit and uniform securities identification.

In a recent statement, a 7-member joint industry control group that will direct the work of the committees, said: "The substantial increase in volume in securities markets has brought home the need for more effective coordination by all organizations involved in the sale, processing, delivery and transfer of securities. Problems exist in this process and they must be solved. These committees will bring a wide range of expertise to bear in these matters of mutual concern. The result of their work will mean improved service for the investing public."

Organizations involved in the joint effort are the NASD, the New York Stock Exchange, the American Stock Exchange, the Association of Stock Exchange Firms and the ten member banks of the New York Clearing House Association.

Members of the joint control group are: R. John Cunningham, Executive Vice President of the New York Stock Exchange; Paul Kolton, Executive Vice President of the American Stock Exchange; Lee Monett, Secretary of the National Uniform Practice and Foreign Committees of the NASD; Harold A. Rousselot, Chairman of the Business and Office Procedure Committee of the ASEF; Henry J. Rohlf, Senior Vice President of Morgan Guaranty Trust Company of New York; Robert C. Shriver, Senior Vice President and Treasurer of United States Trust Company of New York; and Carl W. Desch, Senior Vice President and Cashier of First National City Bank.

NON-CONFORMING MUTUAL FUND PERFORMANCE PUBLICATIONS

The NASD Investment Companies Committee is quite concerned with the trend noted in recent months toward increased circulation among members of a number of publications specializing in reporting and analyzing short-term mutual fund performance in ways that do not conform with the Statement of Policy of the Securities and Exchange Commission. In at least one instance the publication purports to predict performance.

Members have a clear responsibility to insure that publications, and oral presentations based on these publications, that are utilized by sales personnel are fully in conformance with the Statement of Policy. The Statement of Policy, which is administered by the NASD as to its members, is designed to foster fair and complete presentations in investment company sales literature.

While the Association cannot interfere with the publication of these services, all members should be aware that their use with the public may involve serious violations of NASD rules. When members are in doubt as to the conformance of a particular publication with the Statement of Policy, it should be referred to the Investment Companies Department at the Executive Office before any use with the public.

MUTUAL FUND SWITCHING POLICY CLARIFIED

The Association has always believed that mutual fund shares are inherently an investment vehicle for the long term, and that members' encouragement of trading activity in such shares raises serious questions under NASD rules. Particularly in view of increasing pressure to switch arising out of the popularity of the so-called "performance" or "maximum capital gains" fund, the Board of Governors, at its January 1968 meeting directed that members be made aware of its views as to certain considerations which should be taken into account by members and registered representatives who, under certain circumstances, recommend that a customer switch out of one mutual fund into a fund under another management.

This view of the Association flows from consider-

ations of investor interest including the following:

- A mutual fund investment is inherently an investment for the long term, designed to achieve specific customer objectives commensurate with the customer's ability to take investment risk.
- Switching from one fund to one or more other funds may constitute a taxable transaction with resulting shrinkage in the amount of the investor's capital at work.
- Switching may further diminish an investor's capital through the imposition of additional sales charges.

A number of questions have been raised as to the propriety of members' recommending that customers switch from a mutual fund to another mutual fund itself rather than as a result of changes in the customers' needs or circumstances.

Recommendations to switch might be regarded as inconsistent with just and equitable principles of trade unless member responsibilities, including but not limited to the following, have been observed:

1. The member should make an independent, thorough appraisal of the factors on which he based his conclusion that the customer should switch.
2. The member should be certain that the customer is aware of the member's reason for recommending the switch. Such information should include at least the following:
 - (a) All material facts on which the member bases his recommendation that the investment held by the customer should be liquidated.
 - (b) All material facts on which the member bases his recommendation favoring the fund into which the switch is to be made.
 - (c) A clear statement of the amount and percentage of additional sales charge, if any, to be paid by the customer if the member's recommendation is adopted.
 - (d) If applicable, a clear statement of any variation in risk and investment objective between funds involved.

- (e) A clear statement of the likelihood of diminution of the investor's capital if the recommended switch would represent a taxable transaction.
- (f) Naturally, in covering these points members must observe in every respect the requirements of the Statement of Policy of the Securities and Exchange Commission.

Many members feel that a recommendation to switch is of such importance as to make it desirable for the member to have, in its files, written evidence that all of the foregoing points have been satisfied even though such evidence has never been considered as conclusive evidence of the propriety of the transaction concerned.

USING OPTIONS OR WARRANTS IN UNDERWRITING ARRANGEMENTS

The Association is concerned with the increasing number of underwriters who are receiving additional compensation in the form of warrants and options or stock acquired at or near the public offering price.

In some instances, the warrants and options so received are immediately exercisable and are registered as a part of the offering, subject to a post effective amendment. In some cases where they are immediately exercisable, the underlying shares are considered a part of the overall distribution for purposes of the Association's "Free-Riding" Interpretation. The same would, of course, be true of stock received directly.

Accordingly, the NASD recommends that underwriters give careful consideration to this area of their arrangements so as to insure compliance with all Association rules. One possible method of correcting the situation would be to incorporate a provision prohibiting the exercise of the warrants or options until the expiration of a reasonable period of time after the public offering, preferably one year, or in the case of stock received directly, to prevent its sale for a like period.

NEW INTERPRETATION ON EXECUTION OF CUSTOMER ORDERS

The Board of Governors has adopted an Interpretation concerning the execution of retail transactions in the over-the-counter market. The Interpretation, which has been incorporated into the NASD Manual

(Rules of Fair Practice, Article III, Section 1) will become effective on May 1, 1968. The Interpretation provides that:

A. In any transaction for or with a customer, a member shall use reasonable diligence to ascertain the best inter-dealer market for the subject security and buy or sell in that market so that the resultant price to the customer is as favorable as possible under prevailing market conditions. Among the factors that should be considered in determining "reasonable diligence" in this area are the character of the market for the security (price, volatility, relative liquidity, pressure on available communications, etc.), the size and type of the transaction, number of primary markets available, and the member's accessibility to primary markets and quotations sources.

B. No member shall interject a third party between the member and the best available market when executing a retail OTC order for or with a customer except in cases where the member can demonstrate that to his knowledge at the time of the transaction, the total cost or proceeds of the transaction, as confirmed to the member acting for or with the customer, was better than the prevailing inter-dealer market.

The Board of Governors realizes that there are occasions when a member cannot execute directly with a market maker, but must employ a broker's broker or some other means in order to insure an execution advantageous to the customer. In such situations, the burden of showing the circumstances is on the retail firm.

This interpretation would not prohibit the channeling of customers' orders through a broker's broker or other third party pursuant to established correspondent relationships under which executions are confirmed directly to the member acting as agent for the customer, such as where the third party gives up the name of the retail firm, so long as the cost of the service is not borne by the customer.

Both paragraphs above describe the obligations of members acting as agents for their customers and as principals for retail transactions which are contemporaneously offset. These obligations are distinct from and do not relate to the reasonableness of commission rates, markups or markdowns as explained in other sections of the Rules of Fair Practice.