SECURITIES AND EXCHANGE COMMISSION APPROVES THE NASD'S "PAPILSKY" RULES

by

Eric D. Roiter and
Benjamin M. Vandegrift *

On December 12, 1980, the Securities and Exchange Commission, by a vote of four to one, approved several rule changes proposed by the National Association of Securities Dealers, Inc. ("NASD") 1/ to restrict the grant of selling concessions, discounts, or other allowances by NASD members in fixed price underwritings of securities. 2/ The Commission's action, awaited, for some time, with great anticipation by members of the securities underwriting fraternity, 3/ climaxed a proceeding, complete with oral hearings and the submission of more than 40 comment letters, begun in mid-1978.

The NASD rules, revised in some respect to meet concerns voiced earlier by the Commission, contain three basic elements. First, the rules generally confine the grant of discounts and selling concessions to broker-dealers "actually engaged in the investment or securities business," and, even then, only in return for "services rendered in distribution" of underwritten securities. Notwithstanding this general ban on discounts to non-broker-dealers, the NASD rules would permit the furnishing of research to customers as an inducement for purchasing publicly offered securities. Second, the NASD rules generally prohibit a member taking part in a fixed price offering from placing securities with "related persons." As one result, broker-dealer affiliates of mutual

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* Messrs. Roiter and Vandegrift serve, respectively, as an Assistant General Counsel and as an Attorney Fellow in the Office of the General Counsel at the Securities and Exchange Commission. As a matter of policy, the Securities and Exchange Commission disclaims responsibility for any publications by its staff. The views expressed in this article thus do not necessarily reflect those of the Commission or of the authors' colleagues on the staff.

funds or other institutional investors cannot sell underwritten securities in fixed price offerings to those would-be purchasers. Third, the NASD rules carve out certain benchmarks to govern the practice of "swapping" — that is, the sale of underwritten securities by a broker-dealer taking part in a public offering in exchange for other securities taken in trade, rather than for cash.

Background of the NASD Rules

The impetus for these rules arose from the decision of the District Court for the Southern District of New York in Papilsky v. Berndt. 4/ In that derivative action, shareholders of a mutual fund sued the fund's investment adviser alleging, among other things, violations of a duty to "recapture" selling concessions in the purchase of underwritten securities. The fund's adviser, Lord Abbett & Co., was also principal underwriter of the fund's shares and, in that capacity, was registered as a broker-dealer. The fund's shareholders argued that Lord Abbett, as an NASD member, could have joined underwriting syndicates or selling groups, bought underwritten securities at a discount, resold them to the fund at the higher, fixed public offering price, and reduced its management fee by the difference or "spread." The district court, although awarding judgment to the shareholders, never reached the issue of whether the adviser had a fiduciary duty to "recapture" underwriting discounts for the benefit of the fund. The court did hold, however, that the adviser breached a duty by inadequately advising the fund's independent directors of at least the potential for recapture. In rejecting the defense that recapture was illegal, or at least perceived by the adviser in good faith to be illegal, the district court held that in the absence of any ruling of illegality from the NASD or the Commission, recapture of underwriting fees was available under existing federal securities laws and NASD rules.

In response to the Papilsky decision, the NASD in late 1976 took the position, in reply to an inquiry from Lord Abbett, that its existing Rules of Fair Practice did, indeed, foreclose underwriting concession recapture by investment companies through broker-dealer affiliates. 5/ In early 1977, the Commission, citing important public interest issues raised by the NASD's interpretation, directed the NASD to file its interpretation as a proposed rule change for Commission review; 6/ the NASD complied with this directive in May, 1978.

In its rule filing, the NASD, proposed to add a new Article III, Section 36 to its Rules of Fair Practice, and thereby overturn the Papilsky holding by expressly forbidding the sale of underwritten securities by an NASD member to any "related person." 7/ The NASD also proposed to expand the existing ban on direct cash discounts under Article III, Section 24 of its Rules of Fair Practice to prohibit all indirect forms of discount as well. In the most controversial part of its initial rule filing, the ban on indirect discounts would have forbid the furnishing of certain forms of research by NASD members to purchasers of underwritten securities unless separate, and full, payment was made for such research. Furthermore, the NASD proposed to exclude the provision of research as a "service in distribution" entitling a member to receive selling concessions in underwritings. The rules sought to distinguish between "bargained for" research and research given investors on a "good will" basis; the NASD rules proposal would have proscribed the former but permitted the latter. As to "swap" transactions, the NASD proposed to elaborate upon existing Article III, Section 8 of its Rules of Fair Practice, which prohibited a member participating in a fixed price offering from taking securities in trade at more than their "fair market price." 8/ The rule filing would have defined "fair market price" generally as a price not higher than the lowest independent offer to sell, but would have permitted a member to value securities taken in trade at an even higher price in exceptional circumstances. In the latter case, a member would have been required to carry the burden of demonstrating that the value given to the securities was, in fact, the fair market price.

The Commission's Proceeding and NASD Revisions

In general, the proposal to prohibit discount recapture through sales to related persons met with little opposition (even from institutional investors) in written comments and in testimony at the Commission's hearings. In contrast, the attempt to identify, and ban, "bargained for" research engendered considerable debate among public commentators. Smaller broker-dealers who lacked in-house research capabilities perceived a competitive advantage, assertedly an unfair one, accruing to larger firms who were members of the underwriting fraternity. Smaller broker-dealers contended that the furnishing of research to institutional investors played an important part in facilitating the distribution of securities in public offerings, and that their provision of research, even if not directly related to the securities being underwritten, should entitle them to be "designated" by recipient institutions to receive selling concessions from the underwriting syndicate. Because the NASD's proposal prohibited only "bargained for" research, smaller firms contended that larger broker-dealers who belonged to underwriting syndicates and maintained in-house research capabilities could continue to furnish research on a "good will" basis and to reap the benefits, however attenuated, which accrue from providing this "free" service. 9/ Further, it was noted, the larger integrated firms had no need to rely on their research services as the basis for receiving selling concessions, since they could count as a "service in distribution" their underwriting commitments or essentially perfunctory selling efforts directed at research recipients.

In response to arguments that restrictions on research burdened competition among broker-dealers, and were unfairly discriminatory against smaller broker-dealers, 10/ the Commission, in July, 1980, 11/ asked the NASD to consider two alternatives first raised by the NASD in its testimony at the hearings. Under one alternative, the furnishing of "bona fide" research 12/ would be treated as a "service in distribution," entitling a firm, upon designation by a research recipient buying underwritten securities, to receive selling concessions. Under this approach, research would not be considered a form of indirect discount even if it were otherwise commercially available or had a readily calculable cash value. Only research provided pursuant to an express quid pro quo arrangement would fail to be deemed "good will" research. The second alternative eliminated this distinction altogether — that is, even research furnished pursuant to an express agreement obligating its recipient to compensate the broker-dealer through the purchase of underwritten securities would entitle a broker-dealer to receive selling concessions. Noting, among other things, that any attempt to distinguish between "good will" and "bargained for" research would distort economic realities, the Commission suggested that the NASD rules treat research simply as sui generis and exclude it from the prohibition against indirect discounts. Such an approach, the Commission noted, probably represented the most effective way to avoid unfair discrimination among broker-dealers, since in the long run, some form of compensation, although perhaps unstated, is expected by all firms who provide research to institutional investors. In suggesting this approach, the Commission noted the apparent consensus among all commentators that research was an important part of the distribution process, and that prevailing research practices did not appear to have undermined the underwriting system.

Apart from revising the approach toward research, the Commission also urged the NASD to revisit the parameters drawn to distinguish legitimate "swap" transactions from "overtrades." Affording a "safe harbor" for a swap taking place at a price no higher than the highest independent offer to sell, it was suggested, would be unduly expansive, since purchases by dealers generally took place at their bid, rather than offer. Indeed, reliance on highest independent offer as the determinant of fair market price seemed particularly unrealistic for swaps involving a large block of securities, since the sale of a block typically took place at a discount from the prevailing market price.

Commission Approval of NASD's Revised Rules

In response to the Commission's concerns, the NASD filed amendments to its "Papilsky" rules revising, among other things, the approach toward research and the formulation of "fair market price" for swap trades. As to research, the NASD adopted the second, broader alternative discussed by the Commission — namely, the exclusion of all bona fide research, however provided, from the ban on indirect discounts, and the inclusion of such research as a "service in distribution" entitling a broker-dealer to receive selling concessions. In revising the lines drawn to govern swap trades, the NASD retreated from its reliance on highest independent offer. For common stock taken in trade, a member would be presumed to be in compliance with the prohibition against overtrades if the price assigned to those securities did not exceed the highest independent bid at the time of purchase. 13/ For securities other than common stock, a safe harbor (that is, an irrebuttable presumption) would be available if the member paid no more than the highest independent bid at the time of purchase. 14/ It was these revised rules which the Commission approved by its December 12th vote.

In its extensive order accompanying its approval, the Commission focused particularly on statutory standards pertaining to unfair discrimination and competitive impact. 15/ In support of its rules, the NASD had urged that a ban on discounts from fixed price offerings furthered a statutory purpose of preventing unfair discrimination against customers without much purchasing power. Although recognizing that pricing the same security differently depending on the customer would not be unfair per se, the NASD asserted that adequate prospectus disclosure simply could not be made of the various forms of indirect discounts available to institutional investors in public offerings. It was the non-disclosure of these discounts, the NASD contended, which would constitute the unfairness to smaller customers paying the full purchase price in a supposedly "fixed price" offering. The Commission did not agree that adequate disclosure of discounting practices could not be achieved, and, in fact, turned the question around to assess whether a ban on discounts unfairly discriminated against larger investors by hampering their exercise of purchasing power. Ultimately, however, the Commission was attracted to the explanation that fixed price offerings, in contrast to the fixed commission rates that had applied until 1975 in the secondary market, involved "only short-term maintenance of a price that is separately negotiated for each offering by the issuer and the underwriters." From this perspective, the Commission was unable to conclude that voluntary agreements to charge a particular price or prices were "unfair" to any class of customers.

In a further finding that the NASD rules did not run afoul of a statutory prohibition against the fixing of discounts or allowances, 16/ the Commission was required to grapple with the "PSI case," an early administrative proceeding involving similar issues. 17/ In that proceeding, the Commission set aside a sanction imposed by an NASD disciplinary panel on a member who had assertedly sold securities in a public offering in violation of pricing provisions set forth in an underwriting agreement. In so doing, the Commission explained that the NASD's enforcement of the pricing provisions was tantamount to the imposition of a schedule of allowances or discounts, and thus impermissible. 18/ Although the other statutory provisions that applied to the PSI case had undergone some alteration in 1975, 19/ the Commission declined to distinguish PSI from the NASD's proposed rules only on this basis. Rather, the Commission essentially repudiated the PSI decision by refusing to reaffirm its earlier position that NASD enforcement of privately negotiated fixed-price underwriting agreements amounted to imposition by the NASD of a fixed schedule of prices or discounts.

Completing its weighing of applicable legal criteria, the Commission concluded that the NASD rules would not impose burdens upon competition which were "not necessary or appropriate in furtherance of the purposes of [the Act]." 20/ The Commission stressed that Congress had specifically rejected a standard that the rules of securities industry self-regulatory bodies represent the least anticompetitive approach available, and had instead directed the Commission to balance perceived anti-competitive effects against the furtherance of other statutory goals. 21/ The Commission declined to rely directly upon assertions by the NASD that prevention of fraud in public offerings, fostering of public confidence in the securities markets, promotion of just and equitable principles of trade among members, or slowing a trend toward concentration in the underwriting business, tipped the scales in favor of approval of its rules. But the Commission did find that the fixed price underwriting system, while not the only method, had traditionally been an effective way to raise capital, and had received general support from broker-dealers and investors alike in the Commission's proceeding. Recognizing that underwriting techniques may continue to evolve, the Commission concluded that the NASD rules would provide "appropriate support" for the current fixed price underwriting system. Even assuming some anticompetitive impact, the Commission suggested that the exclusion of research from the ban on indirect discounts provided at least one channel through which competitive forces could continue to operate. Finally, the Commission took note of the considerable uncertainty created by the Papilsky decision concerning the duties of fiduciaries for institutional investors. The contribution to greater certainty in this area, in the Commission's view, provided another public interest basis for approval of the NASD's rules.

In his dissent from the Commission's approval, Commissioner Evans took issue with the balance struck by the other four Commissioners. In his view, the anticompetitive impact of the NASD's rules outweighed any possible regulatory benefits. While agreeing that issuers and underwriters should be free to agree upon prices in particular offerings, Commissioner Evans strongly urged that government should play no part in reinforcing private price-setting agreements by bringing disciplinary proceedings against industry members who breach their undertakings. Among other objections, Commissioner Evans disagreed with the majority's disavowal of PSI and also asserted that the NASD's rules were, in any event, not amenable to effective enforcement.

Implications for the Future

Notwithstanding the intense interest generated by these proposals, the NASD's "Papilsky" rules may, in retrospect, prove to be of considerably less significance than either supporters or detractors attach to them today. It should be borne in mind that the NASD rules do not mandate fixed price offerings. Issuers and their underwriters have been, and remain, free to choose any other method, such as the "Dutch" or "English" auction or sealed bidding, to distribute their securities in public offerings, so long as adequate disclosure is made. 22/ Thus, only where those involved agree upon a fixed price offering do the NASD rules, as a supplement to private contract law, impose certain duties upon NASD members taking part in the offering. In contrast to the fixed commission rate system, institutional investors need not resort to a variety of byzantine measures to exercise their purchasing power in the public offering market; instead, they may simply choose to buy underwritten securities only when distributed by a method other than the fixed price offering. Thus, if the current alignment of competitive forces shifts in favor of institutional investors and away from broker-dealers, one may expect that different methods of underwriting will, of necessity, come into greater use.

Perhaps more importantly for the near future, it should be noted that the NASD rules, even where fixed price offerings are used, do not require a single fixed price. Instead, the rules recognize that a hierarchy of prices may be prescribed for any particular offering. 23/ Thus, institutional investors who buy underwritten securities "in size" (and who are not content to receive "free" research) may insist that issuers and underwriters adopt, and disclose in their prospectuses, a range of fixed prices to provide discounts for large volume purchases of underwritten securities.

FOOTNOTES

1. Section 19(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78s(b), generally empowers the Commission to approve or disapprove proposed rule changes of all securities industry "self-regulatory organizations," a category which includes national securities associations (of which the NASD is the only one) and national securities exchanges. Section 19(b)(2) directs the Commission to "approve a proposed rule change of a self-regulatory organization if it finds that such proposed rule change is consistent with the requirements of [the Act] and the rules and regulations thereunder applicable to such organization [, but to] disapprove a proposed rule change of a self-regulatory organization if it does not make such a finding." See generally, Belenke v. Securities and Exchange Commission, 606 F.2d 193 (7th Cir. 1979); Drayer v. Krasner, 572 F.2d 352, 357 (2d Cir. 1978).

2. See Securities Exchange Act Release No. 17371 (Dec. 12, 1980). Voting for approval were Chairman Williams and Commissioners Loomis, Friedman and Thomas. Commissioner Evans dissented.

3. Although the rules impose duties only upon those broker-dealers who are NASD members, as a practical matter, all broker-dealers in the underwriting business are NASD members. This result is achieved through an "incentive" to membership in the NASD provided under Section 15A(e)(1) of the Securities Exchange Act of 1934, 15 U.S.C. 78o-3(e)(1). That provision empowers the NASD to provide by rule that "no member * * * shall deal with any nonmember professional * * * except at the same prices, for the same commission and fees, and on the same terms and conditions as are by such member accorded to the general public.

4. [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,627 (S.D.N.Y. 1976).

5. The NASD's Rules of Fair Practice made no express reference to recapture through broker-dealer affiliates. The NASD inferred a prohibition against recapture from the terms of Article III, Section 24 of the Rules of Fair Practice which permitted the grant of discounts or allowances only to brokers or dealers who provided "services in distribution" and were "actually engaged in the securities business."

6. The Commission's review authority under Section 19(b) of the Securities Exchange Act extends not only to "rules" designated as such, but also to "such of the stated policies, practices, and interpretations of [a self-regulatory organization] as the Commission, by rule, may determine to be necessary or appropriate in the public interest or for the protection of investors to be deemed to be rules of [such self-regulatory organization]." Section 3(a)(27) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(27). See also Securities Exchange Act Rule 19b-4, 17 C.F.R. 240.19b-4.

7. The NASD rule generally defined a "related person" as a person owning, owned by, or under common ownership with an NASD member. Among other things, the rule would thus reach broker-dealer subsidiaries of investment companies.

8. By over-valuing securities taken in trade, a broker-dealer, in effect, gives his customers a discount from the fixed offering price of underwritten securities. Assume, for example, that the offering price for XYZ Corp. securities is $20 per share. A broker-dealer taking part in the offering places 1,000 shares of XYZ with a customer and takes back, as payment, 1,000 shares of ABC Corp. If the fair market value of ABC shares is, say, no higher than $19 per share, the broker-dealer has given his customer an indirect discount of at least $1 per share from the "fixed" offering price for XYZ shares, or a total discount of $1,000.

9. Complementing the criticism of smaller broker-dealers who lacked in-house research capabilities were the objections of other small broker-dealers, so-called "research boutiques," who could not afford to furnish research on a "good will" basis.

10. Effects on competition and unfair discrimination are among the statutory standards considered by the Commission under Section 15A(b) of the Securities Exchange Act in passing upon proposed rule changes of the NASD. <u>See</u> Section 15A(b)(6) of the Securities Exchange Act of 1934, 15 U.S.C. 78<u>o</u>-3(b)(6) (rules of a national securities association must be designed "to remove impediments to and perfect the mechanism of a free and open market * * *" and must not be designed "to permit unfair discrimination between customers, issuers, brokers, or dealers * * *"); and Section 15A(b)(9) of the Act, 15 U.S.C. 78<u>o</u>-3(b)(9) (rules of a national securities association must "not impose any burden on competition not necessary or appropriate in furtherance of the purposes of this [Act])." Commission evaluation of rules proposed by national securities exchanges are governed by essentially similar standards. <u>See</u> Section 6(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78f(b), especially Sections 6(b)(5) (free and open market; unfair discrimination) and 6(b)(8) (inappropriate burdens on competition).

11. Securities Exchange Act Release No. 16956 (July 3, 1980), 45 F.R. 46951 (July 11, 1980).

12. "Bona fide" research, the Commission explained, would cover essentially the types of research for which institutions are permitted to "pay up" pursuant to the safe harbor under Section 28(e) of the Securities Exchange Act, 15 U.S.C. 78bb(e). <u>See</u> generally Securities Exchange Act Release No. 12251 (May 24, 1976), 41 F.R. 13678 (March 31, 1976).

13. Under the revised rules, however, the NASD, in a disciplinary proceeding against a member, could attempt to rebut this presumption.

14. For purchases of any security at a price <u>higher</u> than lowest independent offer, the revised rules create a presumption that a member has <u>violated</u> the ban on overtrading. For purchases between highest independent bid and lowest independent offer, no presumption applies in either direction.

15. See note 10, supra.

16. See Section 15A(b)(6) of the Securities Exchange Act (requiring that rules of a national securities association not be designed "to fix minimum profits, to impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by its members").

17. In re National Association of Securities Dealers, Inc., 19 S.E.C. 424 (1945) (the "PSI case").

18. While finding the NASD disabled under the securities laws from enforcing privately negotiated pricing agreements, the Commission did opine that the agreements themselves were probably not unlawful under the antitrust laws. 19 S.E.C. at 462. The Commission's analysis contributed to the holding of the district court in United States v. Morgan, 118 F. Supp. 621 (S.D.N.Y. 1953) in which certain fixed price underwriting agreements survived antitrust challenge under a "rule of reason" analysis.

19. See note 20, infra.

20. The requirement of Section 15A(b)(9) that NASD rules not impose "inappropriate" burdens on competition was added as part of the Securities Acts Amendments of 1975, Pub. L. No. 94-29 (June 4, 1975). On the basis of this amendment, the Commission distinguished the reasoning of PSI in which the Commission appeared to apply a standard that any burden on competition imposed by the NASD's enforcement of fixed price underwriting agreements was per se violative of the Securities Exchange Act.

21. See Report of the Senate Comm. on Banking Housing and Urban Affairs to Accompany S. 249, S. Rep. No. 94-75, 94th Cong., 1st Sess. at 13 (1975); Conference Report to Accompany S. 249, H. Rep. No. 94-229, 94th Cong., 1st Sess. 94-95 (1975). Compare Section 15 of the Commodity Exchange Act, as amended, 7 U.S.C. 19 (requiring the Commodity Futures Trading Commission, in adopting its own rules or approving rules of boards of trade, "to take into consideration the public interest to be protected by the antitrust laws and endeavor to take the least anticompetitive means of achieving the objectives of the [Commodity Exchange] Act * * *").

22. See Item 16 of Schedule A under the Securities Act of 1933, which requires a prospectus to disclose —

> "the price at which it is proposed that the security shall be offered to the public or the method by which such price is computed and any variation therefrom at which any portion of such security is proposed to be offered to any persons or classes of persons, other than the underwriters, naming them or specifying the class. A variation in price may be proposed prior to the date of the public offering of the security, but the Commission shall immediately be notified of such variation."

23. The NASD rules define the term "fixed price offering" in relevant part as "the offering of securities at a stated public offering price <u>or prices</u> * * *" (emphasis supplied).