Harvey
Sec/c

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

July 27, 1984

The Honorable John D. Dingell
Chairman
Committee on Energy and Commerce
United States House of Representatives
Room 2125
Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Dingell:

In response to your request, I am enclosing a memorandum setting forth the Commission's comments on H.R. 5881, a bill to clarify current law concerning the powers and regulation of financial institutions.

The enclosed memorandum sets forth the views of the Commission and does not necessarily reflect the views of the President. We are sending a copy of this letter to the Office of Management and Budget. We will inform you of any comments we receive from that office on the relation of the memorandum to the program of the Administration.

If you need any further assistance in this matter, please let me know or have your staff contact Alan Rosenblat, Assistant General Counsel, at (202) 272-2428.

Sincerely,

John S.R. Shad

Enclosure

cc: James Frey
Office of Management and Budget

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION ON H.R. 5881, A BILL TO CLARIFY EXISTING LAW CONCERNING POWERS AND REGULATION OF FINANCIAL INSTITUTIONS

July 27, 1984

This memorandum, prepared in response to a request by Chairman John D. Dingell, sets forth the views of the Commission concerning H.R. 5881.

The Commission supports the goal of clarifying the powers and regulation of financial institutions and believes that any legislation to eliminate the confusion in and reform the regulatory framework of the financial services industry should take into account four principles. These principles are:

- regulation by functional activities, rather than outmoded industry classifications;
- consolidation of overlapping and duplicative regulatory activities;
- elimination of excessive and conflicting regulation within and between regulatory agencies; and
- the safety and soundness of the banking system. */

---

*/ On March 21, 1984, the Commission testified in support of certain Administration proposals and S. 2181, bills which would expand bank securities activities.

H.R. 5881 does not do violence to these principles. Accordingly, the Commission is limiting its comments on that bill to one facet which would affect its regulatory responsibilities.

Specifically, the Commission opposes Section 210 of H.R. 5881. That section is intended to prevent inappropriate conflicts of interest by securities firms and would grant the Commission additional authority to regulate brokers and dealers.

Section 210 would amend Section 15(c) of the Securities Exchange Act of 1934 in two ways. First, it would add a new subsection 15(c)(7) to provide that no broker or dealer could underwrite its own securities, or those of an affiliate, except an affiliated investment company, unless the Commission granted an exemption after considering a list of statutorily mandated criteria. Second, it would add a new subsection 15(c)(8) that would permit the Commission to adopt rules imposing conditions on brokers and dealers that offer to sell or market any security, product, or service of any affiliate of that broker or dealer, if the affiliate was not a broker, dealer, underwriter, investment adviser, or investment company.

While Section 210 of H.R. 5881 would expand the Commission's rulemaking authority, the Commission believes that it is duplicative and unnecessary. As explained in greater detail in Attachment A, subsection 15(c)(7) could be interpreted as requiring the Commission to regulate self-underwriting directly when that activity already is regulated effectively by the combination of

the disclosure and antifraud provisions of the securities laws and by the existing rules of the self-regulatory organizations, approved by the Commission and administered under the Commission's oversight. Furthermore, although subsection 15(c)(8) would grant the Commission incremental authority to regulate brokers and dealers, the Commission believes that it already has ample authority. This also is discussed in greater detail in Attachment A.

AR/LS/119(5)/cj/ab

ATTACHMENT A

Section 210: Conflicts of Interest

Section 210 of the Financial Institutions Act of 1984 ("FIA") 1/ is intended to prevent conflicts of interest by securities firms and would grant the Commission additional authority to regulate brokers and dealers selling securities, products, or services, issued or offered by themselves or their affiliates. Section 210 would amend section 15(c) of the Securities Exchange Act of 1934 ("Exchange Act") in two significant ways. First, section 210 would add a new subsection 15(c)(7) to provide that no broker or dealer may underwrite its own securities, or those of an affiliate 2/ (so-called "self-underwriting"), unless the Commission, by rule or by order, grants an exemption to the broker or dealer, or for a type of security (or to any class of brokers, dealers, or securities). 3/ The FIA directs the Commission, in granting such exemptions, to consider, among other things: (1) the prevention of inappropriate conflicts of interest; 4/ (2) the prevention of inappropriate sales practices; (3) the need to ensure (A) that statements in a registration statement are true and that there are no omissions of material fact and (B) that the price of the security is fairly established; and (4) the need

---

1/ H.R. 5881.

2/ Section 210 would also add subsection 15(c)(9) defining, for purposes of subsections 15(c)(7) and (8), the term "affiliate," as "any person (except a natural person) who, directly or indirectly, controls, is controlled by, or is under common control with, another person (except a natural person)."

3/ The section by section analysis accompanying the FIA states, at 6, that brokers and dealers would not be subject to subsection 15(c)(7) until one year after the bill is enacted into law. It appears, however, that the language delaying the effective date of subsection 15(c)(7) was inadvertently omitted from the bill itself.

4/ Section 210 of the FIA is captioned "Preventing Conflicts of Interest by Securities Firms." Subsection 15(c)(7)(b)(1) provides, however, that the Commission shall consider, among other matters, the "prevention of inappropriate conflicts of interest." [Emphasis added.] We believe that both the caption and the subsection should provide for the prevention of "inappropriate" conflicts of interest.

to maintain financially sound brokers, dealers, and their affiliates. 5/

Second, section 210 would add subsection 15(c)(8) to the Exchange Act, permitting the Commission to regulate a broker or dealer that offers to sell or market any security, product, or service of any affiliate of that broker or dealer, if the affiliate is not a broker, dealer, underwriter, investment adviser, or investment company (or combination of such entities). 6/

While section 210 of the FIA would clarify, or expand somewhat, certain Commission rulemaking authority, the Commission believes that it would nonetheless hinder the Commission in carrying out its mandate to protect investors and the public interest by requiring the Commission to devote resources to an unnecessary program. As explained below, the Commission believes that subsection 15(c)(7) could be interpreted to require the Commission to regulate self-underwriting directly, when that activity already is regulated effectively by the combination of the disclosure and antifraud provisions of the federal securities laws and the existing rules of certain self-regulatory organizations. In addition, although subsection 15(c)(8) would grant the Commission some new authority to regulate brokers and dealers, the Commission does not believe that it needs this additional authority.

A. Self-Underwriting

Subsection 15(c)(7), in effect, seems to require the Commission to adopt regulations governing self-underwriting. To address fully Congress' concerns expressed in subsections 15(c)(7)(B)(i)-(iv), the Commission might have to adopt extensive regulations regarding pricing, sales practices, suitability, and manipulation of self-underwritten issues.

5/ Subsection 15(c)(7)(A) further provides, however, that this prohibition would not apply to a broker or dealer underwriting securities issued by an affiliate of the broker or dealer that is an investment company registered under section 8 of the Investment Company Act of 1940.

6/ Subsection 15(c)(8) should be modified to state "broker, dealer, or underwriter subject to this [Act] title or an investment adviser subject to the Investment Advisers Act of 1940 or an investment company subject to the Investment Company Act of 1940, or any combination of such entities."

Although the Commission could expend its resources developing, proposing, and adopting such regulations, this work already has been done by the National Association of Securities Dealers, Inc. ("NASD"), the self-regulatory organization which is responsible for regulation of such underwritings, under the SEC's oversight. 7/

The SEC has approved the NASD's comprehensive regulations, Schedule E, that permit self-underwriting in carefully controlled circumstances. 8/ These regulations are intended to allow brokers, dealers, and their affiliates to raise efficiently capital needed to improve their operations and strengthen their balance sheets while, at the same time, addressing any potential conflicts of interest. Schedule E provides, in essence, that a member of the NASD may not underwrite, participate as a member of the underwriting syndicate or selling group, or otherwise assist in the distribution of securities issued by the member or an affiliate 9/ unless: (1) the member (or its principals) has been actively engaged in the investment banking business or securities business for five years before the date of the proposed offering; 10/ and (2) one of the following conditions

---

7/ Section 15(b)(8) of the Exchange Act requires every registered broker or dealer to join a registered securities association unless such broker or dealer effects transactions in securities solely on a national securities exchange. The NASD is the only registered securities association.

8/ NASD By-Laws, Art. IV, Schedule E, NASD Manual (CCH) ¶ 1402 ("Schedule E").

9/ An affiliate is defined in section 2 of Schedule E as "a company which controls, is controlled by or is under common control with a member." That section then lists a number of different circumstances that are defined as constituting control. Schedule E, Section 2(a)(3), however, excludes from the definition of affiliate certain entities, such as registered investment companies, real estate investment trusts, and direct participation programs, which are regulated by other federal and state laws, or by other self-regulatory organizations' rules. See, e.g., NASD Rules of Fair Practice, Appendix F, NASD Manual (CCH) ¶ 2192 (regulation of direct participation programs).

10/ Schedule E, section 3(b).

is met: 11/ (A) a qualified independent underwriter 12/ sets the price of the securities and participates in preparing the registration statement and offering circular and conducts a "due diligence" review; 13/ (B) the offering consists of equity securities for which a bona fide independent market exists; 14/ or (C) the issue consists of securities rated Baa or better by Moody's rating service, or Bbb or better by Standard & Poor's rating service. 15/ These restrictions ensure that only broker-dealers with established operating histories are able to sell their securities to the public. Furthermore, these requirements reduce the opportunity for issuers to sell securities at prices

---

11/ Schedule E, section 3(c).

12/ Schedule E, section 2(k), defines a qualified independent underwriter as a member that has been actively engaged in the investment banking or securities business for several years, is not an affiliate of the issuer, and is willing to accept the liability imposed on underwriters under the Securities Act of 1933 ("Securities Act").

13/ Schedule E, section 10, further provides that any issuer relying on the intrastate exemption under section 3(a)(11) of the Securities Act shall disclose at least that information specified in Securities Act Release No. 5222 (January 3, 1972), [1971-1972] Fed. Sec. L. Rep. (CCH) ¶ 78,488. That release requires self-underwriting broker-dealers to disclose information including financial statements regarding revenues and expenses, net capital and securities receivables and payables, risk factors associated with the offering, and the firm's research, trading, and investment advisory services.

14/ Schedule E, section 2(b), in general, defines a bona fide independent market as a market for which: (1) there has been aggregate trading volume of at least 100,000 shares during the twelve months before the proposed offering; (2) at least 250,000 shares have been publicly held during the twelve months before the proposed offering; and (3), in the case of over-the-counter securities, there are at least three bona fide independent market makers during the 30 days before the proposed offering. See also Schedule E, section 2(c).

15/ Schedule E, section 3(d), provides, however, that a member need not satisfy the requirements denominated above as (2)(A), (B), and (C) if (1) the member's participation in the underwriting or selling group does not exceed ten percent of the total dollar amount of the offering; and (2) the offering is underwritten on a firm commitment basis and is managed by a qualified independent underwriter.

out of line with comparable investment opportunities 16/ or make inaccurate or incomplete disclosures in their prospectuses. 17/

In addition, Schedule E reduces the likelihood that a self-underwriting broker-dealer will sell its securities to unknowing public customers, regardless of those customers' financial needs, or attempt to manipulate the secondary market for its securities. Schedule E requires the broker-dealer not to sell its securities to a customer unless the broker-dealer has reasonable grounds to believe that the securities are suitable for that customer's investment objectives, financial situation, and other needs. 18/ The NASD also prohibits a self-underwriting member from selling its securities to a discretionary account without the prior specific written consent of its customer. 19/ Schedule E also reduces opportunities for so-called "Free-Riding," i.e., an underwriter selling a new issue of equity securities to affiliated accounts, thereby creating an artificial shortage of the security. Although Schedule E permits a self-underwriting broker-dealer to sell its securities to certain preferred accounts, 20/ Schedule E

16/ Although Schedule E does not require an independent underwriter if there is a pre-existing market for the securities of the issuer, the Commission believes that the marketplace itself provides an effective check on the offering price selected by the self-underwriting broker-dealer.

17/ Moreover, the registration requirements of the Securities Act, coupled with the antifraud prohibitions of the federal securities laws, should ensure that the issuer's disclosures in the prospectus are complete and accurate.

18/ Schedule E, section 11. Schedule E further requires a member to keep records showing the basis for its determination that the securities were suitable for that customer.

19/ Schedule E, section 12.

20/ In brief, this exemption is limited to employees and immediate family members of employees of the broker-dealer, or in the case of an intended merger, acquisition or other business combination with the broker-dealer, potential employees and their immediate family members. Schedule E, section 13. In addition, the exemption does not apply to the underwriting of an affiliate's securities, unless the underwriting is in connection with an intended merger, acquisition or business combination of the broker-dealer or otherwise for purposes of raising capital for the broker-dealer itself. See Schedule E, section 9.

provides that when the issue sold is an equity security for which a bona fide independent market does not exist, the purchaser must not sell or pledge the securities for at least six months. 21/

Schedule E also establishes other restrictions that must be satisfied by a self-underwriting member, including: (1) establishing an audit committee of the board of directors to review the independent auditor's report and accounting controls; 22/ (2) appointing a public director to its board who also shall be a member of the audit committee; 23/ (3) providing to its security-holders quarterly summaries of its operations and annually audited and certified financial statements; and (4) requiring a member to withdraw its offering and to return money received from investors if the member lacks adequate net capital. 24/

The Commission believes that Schedule E effectively regulates self-underwriting because it addresses those aspects of self-underwriting subject to conflicts of interest. Moreover, Schedule E is not the sole method of dealing with conflicts of interest. The disclosure requirements and antifraud provisions of the Securities Act provide a framework to ensure complete and accurate information is made available to investors in a self-underwritten offering. In addition, under the Exchange Act, the Commission has adopted rules requiring underwriters to disclose their interest in a distribution as well as their control relationships with an issuer prior to trading in that issuer's security with their customers. 25/ Therefore, the

---

21/ Schedule E, section 13. This provision is less restrictive than the NASD's Interpretation with Respect to Free-Riding and Withholding for conventional underwritings. NASD Rules of Fair Practice, Art. III, §1, NASD Manual (CCH) ¶ 2151. The reason for this difference is that a broker-dealer's employees and other related persons are much more likely to have legitimate investment purposes for buying securities issued by that broker-dealer than they are for securities issued by a different company that are merely underwritten by that broker-dealer.

22/ Schedule E, section 6.

23/ Schedule E, section 7.

24/ Schedule E, section 5. See also SEC Rule 15c3-1.

25/ See Rules 15c1-5 and 15c1-6 under the Exchange Act. Moreover, New York Stock Exchange Rule 312(g) provides that after a member completes the distribution of a self-

(footnote continued)

Commission believes that Schedule E, in combination with other NASD rules and the federal securities laws' antifraud and disclosure provisions, permits the Commission and the NASD to take effective enforcement action where appropriate. Accordingly, in light of the existing regulatory framework and the Commission's oversight of the NASD, the Commission should not be required to duplicate the effective existing program. 26/

B. Broker-Dealers' Sales of Affiliates' Securities, Products or Services

Subsection 15(c)(8), as noted above, would permit the Commission to regulate brokers and dealers offering to "sell or market" 27/ any security, product, or service of certain

---

25/ (continued footnote)

underwritten issue, it may not recommend such securities to its customers and may not effect a transaction in such securities for a customer, except on an unsolicited basis. 2 NYSE Guide (CCH) ¶ 2312. The New York Stock Exchange, however, has submitted a proposed rule change, pursuant to section 19(b)(1) of the Exchange Act, that would conform Rule 312(g) to the requirements of SEC Rule 15c1-5 and other self-regulatory organizations' rules. See Securities Exchange Act Release No. 19462, 48 Fed. Reg. 5640 (Feb. 7, 1983)(notice requesting public comment).

26/ Indeed, if it became necessary for the Commission to adopt an exemptive rule under proposed subsection 15(c)(7), presumably such a rule would either substantially parallel existing Schedule E or exempt NASD members whose self-underwritten offerings were in compliance with Schedule E. Such a result would only highlight the lack of any need for subsection 15(c)(7) because, to the extent Commission action in this regard deviated from the standards set forth in Schedule E, the Commission already has the authority, under section 19(c) of the Exhange Act, to amend Schedule E, if it determines such action is necessary or appropriate to protect investors.

27/ Section 15(c)(8) would add a new term of art to the federal securities laws. Specifically, that section states that a registered broker or dealer may not "offer to sell or

(footnote continued)

affiliates. The Exchange Act currently grants the Commission wide authority to regulate the activities of brokers and dealers in connection with the purchase and sale of securities and to protect investors. For example, the Exchange Act prohibits a wide range of fraudulent, deceptive, and manipulative activities in connection with the purchase and sale of securities, authorizes the Commission to adopt rules further defining those offenses, and permits the Commission to enforce compliance with those requirements. 28/ The Exchange Act also prohibits brokers or dealers, among other things, from inducing the purchase or sale of securities in contravention of rules adopted by the Commission to protect investors and maintain orderly markets. 29/

As noted in section 102(3) of the FIA, the financial institutions in the United States have evolved significantly in recent years. For example, a number of large broker-dealers have acquired, or have been acquired by, entities outside of the securities industry. The Commission believes that some such broker-dealers might sell services or products offered by their affiliates. The Commission, however, believes that its existing statutory authority is adequate to ensure that these developments do not adversely affect the firm's securities activities. For example, the Commission already has ample authority to regulate those activities affecting a broker-dealer's financial integrity. 30/ Moreover, the Commission sees no need for the additional authority that subsection 15(c)(8) would provide.

Attachment: Schedule E

27/ (continued footnote)

market" any security, product or service of any affiliate in contravention of Commission rules. [Emphasis added]. The phrase "market" is undefined. It would be helpful if this phrase were either further defined or deleted. For example, instead of "offer to sell or market" it would be preferable to use the traditional section 15(c) language, i.e., "No registered broker or dealer shall . . . effect any transaction in, or induce or attempt to induce the purchase or sale of, any . . . . "

28/ See, e.g., subsections 15(c)(1), (2), (3), and (4). See also Rule 15c1-1 et seq.

29/ See, e.g., subsections 15(c)(5) and (6).

30/ See section 15(c) of the Exchange Act and Rule 15c3-1 thereunder.

• • • *Cross Reference*

Resolution of the Board of Governors: "Interpretations and Explanations" ..... ¶ 1503

Resolution of the Board of Governors: "Suspension of Members for Failure to Furnish Information Duly Requested" ..... ¶ 2204

Resolution of the Board of Governors: "Right of Association to Require Written Reports and to Inspect Books and Records" .... ¶ 2204

Resolution of the Board of Governors: "Requirement of Members to File Information on NASD Form Q" ..... ¶ 4196

Schedule E

Distribution of Securities of Members and Affiliates

Section 1—General

No member or person associated with a member shall participate in the distribution of a public offering of securities issued or to be issued by the member or an affiliate of the member and no member shall issue securities except in accordance with this Schedule.

Section 2—Definitions

For purposes of this Schedule, the following words shall have the stated meanings:

(a) Affiliate—

(1) a company which controls, is controlled by or is under common control with a member.

(2) For purposes of subsection 2(a)(1) hereof,

(i) a company will be presumed to control a member if the company beneficially owns 10 percent or more of the outstanding voting securities of a member which is a corporation, or beneficially owns a partnership interest in 10 percent or more of the distributable profits or losses of a member which is a partnership;

(ii) a member will be presumed to control a company if the member and persons associated with the member beneficially own 10 percent or more of the outstanding voting securities of a company which is a corporation, or beneficially own a partnership interest in 10 percent or more of the distributable profits or losses of a company which is a partnership;

(iii) a company will be presumed to be under common control with a member if:

(1) the same natural person or company controls both the member and company by beneficially owning 10 percent or more of the outstanding voting securities of a member or company which is a corporation, or by beneficially owning a partnership interest in 10 percent or more of the distributable profits or losses of a member or company which is a partnership; or

(2) a person having the power to direct or cause the direction of the management or policies of the member or the company also has the power to direct or cause the direction of the management or policies of the other entity in question.

(3) The provisions of paragraphs (1) and (2) hereof notwithstanding, none of the following shall be presumed to be an affiliate of a member for purposes of this Schedule E:

(i) an investment company registered with the Securities and Exchange Commission pursuant to the Investment Company Act of 1940, as amended;

(ii) a "separate account" as defined in Section 2(a)(37) of the Investment Company Act of 1940, as amended;

(iii) a "real estate investment trust" as defined in Section 856 of the Internal Revenue Code;

(iv) a "direct participation program" as defined in Article III, Section 34 of the Rules of Fair Practice.

(b) Bona fide independent market—a market in a security which:

(1) is registered pursuant to the provisions of Sections 12(b) or 12(g) of the Securities Exchange Act of 1934 or issued by a company subject to Section 15(d) of such Act, unless exempt from those provisions;

(2) has an aggregate trading volume for the 12 months immediately preceding the filing of the registration statement of at least 100,000 shares;

(3) has outstanding for the entire twelve-month period immediately preceding the filing of the registration statement, a minimum of 250,000 publicly held shares; and

(4) in the case of over-the-counter securities, has had at least three bona fide independent market makers for a period of at least 30 days immediately preceding the filing of the registration statement and the effective date of the offering.

(c) Bona fide independent market maker—a market maker which:

(1) continually maintains net capital as determined by Rule 15c 3-1 of the General Rules and Regulations under the Securities Exchange Act of 1934 of $50,000 or $5,000 for each security in which it makes a market, whichever is less;

(2) regularly publishes bona fide competitive bid and offer quotations in a recognized interdealer quotation system;

(3) furnishes bona fide competitive bid and offer quotations to other brokers and dealers on request; and

(4) stands ready, willing and able to effect transactions in reasonable amounts, and at his quoted prices, with other brokers and dealers.

(d) Company—a corporation, a partnership, an association, a joint stock company, a trust, a fund, or any organized group of persons whether incorporated or not; or any receiver, trustee in bankruptcy or similar official or any liquidating agent for any of the foregoing, in his capacity as such.

(e) Effective date—the date on which an issue of securities first becomes legally eligible for distribution to the public.

(f) Immediate family—parents, mother-in-law, father-in-law, husband or wife, brother or sister, brother-in-law or sister-in-law, children, or any relative to whom financial support is contributed directly or indirectly by an employee of, or person associated with, a member.

(g) Parent—any entity affiliated with a member from which member the entity derives 50 percent or more of its gross revenues or in which it employs 50 percent or more of its assets.

(h) Person—any natural person, partnership, corporation, association, or other legal entity.

(i) Public director—a person elected from the general public to the board of directors of a member or its parent which has made a public distribution of an issue of its own securities. Such person shall not beneficially own five percent or more of the outstanding voting securities of the member or its parent and shall not be engaged in the investment banking or securities business or be an officer or employee of the member or its parent, or be a member of the immediate family of an employee occupying a managerial position with a member or its parent.

(j) Public offering—any primary or secondary distribution of securities made pursuant to a registration statement or offering circular including exchange offers, rights offerings, offerings made pursuant to a merger or acquisition, straight debt offerings and all other securities distributions of any kind whatsoever except any offering made pursuant to an exemption under Section 4(1) or 4(2) of the Securities Act of 1933.

(k) Qualified independent underwriter*—a member which:

(1) is actively engaged in the investment banking or securities business and which has been so engaged, in its present form or through predecessor broker/dealer entities, for at least five years immediately preceding the filing of the registration statement;

(2) in at least three of the five years immediately preceding the filing of the registration statement has had net income from operations of the broker/dealer entity or from the pro forma combined operations of predecessor broker/dealer entities, exclusive of extraordinary items, as computed in accordance with generally accepted accounting principles;

(3) as of the date of the filing of the registration statement and as of the effective date of the offering:

a. if a corporation, a majority of its board of directors or, if a partnership, a majority of its general partners, are persons who have been actively engaged in the investment banking or securities business for the five-year period immediately preceding the filing of the registration statement;

b. if a sole proprietorship, the proprietor has been actively engaged in the investment banking or securities business for the five-year period immediately preceding the filing of the registration statement;

* In the opinion of the National Association of Securities Dealers, Inc. and the Securities and Exchange Commission the full responsibilities and liabilities of an underwriter under the Securities Act of 1933 attach to a "qualified independent underwriter" performing the functions called for by the provisions of Section 3 hereof.

(4) has actively engaged in the underwriting of public offerings of securities for at least the five-year period immediately preceding the filing of the registration statement;

(5) is not an affiliate of the entity issuing securities pursuant to Section 3 of this Schedule; and

(6) has agreed in acting as a qualified independent underwriter to undertake the legal responsibilities and liabilities of an underwriter under the Securities Act of 1933, specifically including those inherent in Section 11 thereof.

(l) Registration statement—a registration statement as defined by Section 2(8) of the Securities Act of 1933; notification on Form 1A filed with the Securities and Exchange Commission pursuant to the provisions of Rule 255 of the General Rules and Regulations under the Securities Act of 1933; or any other document, by whatever name known, initiating a registration or similar process for an issue of securities which is required to be filed by the laws or regulations of any federal or state agency.

(m) Settlement—the distribution of the net proceeds from an offering to the issuer or selling stockholders.

Section 3—Participation in Distribution of Securities of Member or Affiliate

(a) No member shall underwrite, participate as a member of the underwriting syndicate or selling group, or otherwise assist in the distribution of a public offering of an issue of debt or equity securities issued or to be issued by the member or an affiliate of the member unless the member is in compliance with subsection 3(b) and either subsection 3(c) or 3(d) below, depending on the nature of the member's participation.

(b) In the case of a member which is a corporation, the majority of the board of directors, or in the case of a member which is a partnership, a majority of the general partners or, in the case of a member which is a sole proprietorship, the proprietor as of the date of the filing of the registration statement and as of the effective date of the offering shall have been actively engaged in the investment banking or securities business for the five year period immediately preceding the filing of the registration statement.

(c) If a member proposes to underwrite, participate as a member of the underwriting syndicate or selling group, or otherwise assist in the distribution of a public offering of debt or equity securities subject to this Section without limitation as to the amount of securities to be distributed by the member, one or more of the following three criteria shall be met:

(1) the price at which an equity issue or the yield at which a debt issue is to be distributed to the public is established at a price no higher or yield no lower than that recommended by a qualified independent underwriter which shall also participate in the preparation of the registration statement and the prospectus, offering circular, or similar document and which shall exercise the usual standards of "due diligence" in respect thereto; provided, however, that an offering of securities by a member which has not been actively engaged in the investment banking or securities business, in its present form or as a predecessor broker/dealer, for at least the five years immediate-

ly preceding the filing of the registration statement shall be managed by a qualified independent underwriter; or

(2) the offering is of a class of equity securities for which a bona fide independent market exists as of the date of the filing of the registration statement and as of the effective date thereof; or

(3) the offering is of a class of securities rated Baa or better by Moody's rating service or Bbb or better by Standard & Poor's rating service or rated in a comparable category by another rating service acceptable to the Association.

(d) A member may participate as a member of the underwriting syndicate or selling group in the distribution of a public offering of debt or equity securities subject to this Section without regard to the requirements of subsection (c), if the member restricts its participation to an amount not exceeding ten percent of the total dollar amount of the offering and the offering is underwirtten on a firm commitment basis and managed by a qualified independent underwriter.

Section 4—Escrow of Proceeds

(a) All proceeds from an offering by a member of its securities shall be placed in a duly established escrow account and shall not be released therefrom or used by a member in any manner until the member has complied with Section 5 hereof.

(b) Any member offering its securities pursuant to this schedule shall disclose in the registration statement, offering circular, or similar document a date by which the offering is reasonably expected to be completed and the terms upon which the proceeds will be released from the escrow account described in subsection (a) hereof.

Section 5—Net Capital Computation

Any member offering its securities pursuant to this Schedule shall immediately notify the Corporation when the offering has been terminated and settlement effected and it shall file with the Corporation a computation of its net capital computed pursuant to the provisions of Rule 15c3-1 of the General Rules and Regulations under the Securities Exchange Act of 1934 (the net capital rule) as of the settlement date. If at such time its net capital ratio as so computed is more than 10:1 or, net capital fails to equal 120 percent of the minimum dollar amount required by Rule 15c 3-1 or, in the event the provisions of Rule 15c3-1(f) are utilized in making such computation, the net capital is less than seven percent of aggregate debit items as computed in accordance with Rule 15c3-3a, all monies received from sales of securities of the offering must be returned in full to the purchasers thereof and the offering withdrawn, unless the member has obtained from the Securities and Exchange Commission a specific exemption from the net capital rule. Proceeds from the sales of securities in the offering may be taken into consideration in computing net capital ratio for purposes of this section.

Section 6—Audit Committees

Any member or parent of a member which makes a public offering of an issue of its securities shall be required to establish within twelve months of the effective date of said offering an audit committee composed of members of the board of directors (except that it shall not include the chief

accounting or chief financial officer of the member or its parent) and the functions of the audit committee shall include the following:

(a) to review the scope of the audit;

(b) to review with the independent auditors the corporate accounting practices and policies and recommend to whom reports should be submitted within the company;

(c) to review with the independent auditors their final report;

(d) to review with internal and independent auditors overall accounting and financial controls; and

(e) to be available to the independent auditors during the year for consultation purposes.

Section 7—Public Director

Any member or parent of a member which makes a public offering of an issue of its securities shall cause to be elected to its board of directors within twelve months of the effective date of said offering a public director who shall serve as a member of the audit committee.

Section 8—Periodic Reports

Any member which makes a distribution to the public of an issue of its securities pursuant to this schedule, shall send to each of its shareholders or, in the case of debt offerings, to each of its investors:

(1) quarterly, a summary statement of its operations; and

(2) annually, independently audited and certified financial statements.

Section 9—Offerings Resulting in Affiliation or Public Ownership of Member

If an issuer proposes to direct all or part of the proceeds from a public offering to a member or exchange securities by means of a public offering for an interest in a member, and the member is, or as a result of the proposed transaction would be, an affiliate of the issuer, or if an issuer proposes to engage in any offering which results in the public ownership of a member, the offering shall be subject to the provisions of this Schedule E to the same extent as if the offering were of securities issued by the member.

Section 10—Registration Statements for Intrastate Offerings

Any member offering its securities pursuant to an exemption under Section 3(a)(11) of the Securities Act of 1933 shall disclose in the registration statement at a minimum that information suggested by the Securities and Exchange Commission in Securities Act Release No. 5222 (January 3, 1972).

Section 11—Suitability

Every member underwriting an issue of its securities, or securities of an affiliate, pursuant to the provisions of Section 3 hereof, who recommends to a customer the purchase of a security of such an issue shall have reasonable grounds to believe that the recommendation is suitable for such customer on the basis of information furnished by such customer concerning the customer's investment objectives, financial situation, and needs, and any other information known by such member. In connection

with all such determinations, the member must maintain in its files the basis for its determination.

Section 12—Discretionary Accounts

Notwithstanding the provisions of Article III, Section 15 of the Corporation's Rules of Fair Practice, or any other provisions of law, a transaction in securities issued by a member or an affiliate of a member shall not be executed by any member in a discretionary account without the prior specific written approval of the customer.

Section 13—Sales to Employees—No Limitations

Notwithstanding the provisions of the Board of Governors' Interpretation With Respect To "Free-Riding and Withholding," a member may sell securities issued by a member or an affiliate of a member which is subject to Section 9 hereof to the member's employees; potential employees resulting from an intended merger, acquisitions, or other business combination of members resulting in one public successor corporation; persons associated with the member; and the immediate family of such employees or associated persons without limitation as to amount and regardless of whether such persons have an investment history with the member as required by that Interpretation; provided, however, that in the case of an offering of equity securities for which a bona fide independent market does not exist, such securities shall not be sold, transferred, assigned, pledged, or hypothecated for a period of six months following the effective date of the offering.

[The next page is 1101-11.]

Section 14—Filing Requirements; Coordination with Corporate Financing Interpretation

(a) Notwithstanding the provisions of the "Interpretation of the Board of Governors—Review Of Corporate Financing" relating to factors to be taken into consideration in determining underwriter's compensation, the value of securities of a new corporate member succeeding to a previously established partnership or sole proprietorship member acquired by such member or person associated therewith, or created as a result of such reorganization, shall not be taken into consideration in determining such compensation.

(b) All offerings of securities included within the scope of this Schedule shall be subject to the provisions of the "Interpretation of the Board of Governors—Review Of Corporate Financing", and documents and filing fees relating to such offerings shall be filed with the Corporation pursuant to the provisions of that Interpretation. The responsibility for filing the required documents and fees shall be that of the member issuing securities, or, in the case of an issue of an affiliate, the managing underwriter or, if there is none, the member affiliated with the issuer.

Section 15—Predominance of Schedule E

If the provisions of this Schedule E are inconsistent with any other provisions of the Corporation's By-Laws, Rules of Fair Practice or Uniform Practice Code, or of any interpretation thereof or resolution of the Board of Governors, the provisions of this Schedule shall prevail.

Section 16—Requests for Exemption from Schedule E

The Corporate Financing Committee of the Board of Governors, upon written request, may in exceptional and unusual circumstances, taking into consideration all relevant factors, exempt a member unconditionally or on specified terms from any or all of the provisions of Schedule E which it deems appropriate. Unless waived by the party requesting an exemption, a hearing shall be held upon a request before the Corporate Financing Committee, or a Subcommittee thereof designated for that purpose.

Section 17—Violation of Schedule E

A violation of the provisions of this Schedule shall constitute conduct inconsistent with high standards of commercial honor and just and equitable principles of trade and a violation of Article III, Section 1 of the Corporation's Rules of Fair Practice and possibly other Sections, especially Sections 2 and 18, as the circumstances of the case may indicate.

[Sec. 1 amended effective September 1, 1972 and May 19, 1977. Section 2 amended effective February 8, 1971, December 29, 1971, March 21, 1972, April 1, 1974 and May 19, 1977. Sections 3 through 11 amended effective May 19, 1977. Sections 1 through 15 amended effective June 2, 1983; Section 13 amended effective February 22, 1984.]

• • • *Interpretation of the Board of Governors*

Review of Corporate Financing	¶ 2151.02