

ALERT

Market Surveillance Committee Disciplines Two Firms for Improper Use of SOES

The NASD's Market Surveillance Committee recently sanctioned two member firms for misusing the facilities of the NASD's Small Order Execution System (SOES). SOES is an automated system for facilitating the execution of agency orders for public customers at the best available price with specific maximum size limitations, currently 1,000 shares for NASDAQ National Market System securities and 500 shares for other NASDAQ securities.

In one of the disciplinary proceedings, the committee censured and fined a member \$15,000 and suspended it from SOES for 30 days. The committee found that the firm violated SOES operating rules by using the system to trade for its proprietary accounts and failed to properly supervise its employees' use of SOES.

In imposing sanctions, the Market Surveillance Committee said that the firm's misuse of SOES amounted to "serious misconduct" and was an "affront to the integrity of SOES and the NASDAQ System generally."

In a separate action, the committee charged another NASD firm and its president with improperly executing orders through SOES and failing to supervise the activities of employees using SOES. As a result, the committee suspended the firm as a SOES participant for six months. In

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Board Seeks Member Comment On Upgrade of Supervisory Procedures

During its meeting in January, the NASD Board of Governors approved for publication a major revision to the NASD's supervision rule. Developed by the National Business Conduct Committee (NBCC) Task Force on Supervision, the proposal would greatly expand the detail of Article III, Section 27 of the NASD's Rules of Fair Practice by specifying the minimum requirements for a member's supervisory structure. With these changes, members should be better able to properly supervise the activities of each registered representative and associated person.

In June 1987, the NASD published a notice asking for comment on proposed changes to the definitions of branch office and office of supervisory jurisdiction (OSJ). The

amendments addressed the regulatory problems associated with the absence of on-site supervision.

Although members, in general, supported the goal of improved field supervision, many found the mandated increase in principals far too burdensome.

In response, the NBCC directed the task force to identify a minimum supervisory structure flexible enough to apply to the NASD's diverse membership.

Under the current proposal, the rule changes would require members to:

- Designate at least one principal for each business in which the member engages, as noted in its Form BD.
- Treat each location that meets the revised definition as an OSJ.
- Designate a principal in each OSJ and a representative in each non-OSJ branch office to supervise the activities in those offices.
- Assign each registered representative to a specific supervisor within the structure.
- Ensure that supervisors are qualified.
- Conduct an annual interview or meeting with each registered representative to review relevant compliance matters.

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Supervision

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■ Designate a compliance principal to oversee supervision and report to senior management.

The proposals also call for more detailed written supervisory and review procedures and an annual inspection of each business in which the member engages, including a yearly examination of the activities of each OSJ. Under the proposal, an

OSJ would be any office in which the member does one or more of the following: executes orders, makes markets, structures offerings, maintains firm or customer funds or securities, accepts new accounts, approves customer orders, approves ads or sales literature, approves correspondence, or supervises persons at branch offices.

The proposal would define a branch office as any location in

which the investment banking or securities business is conducted on behalf of a member, with an exemption for locales identified solely by letterhead, business cards, or a phone book listing.

The NASD recently published *Notice to Members* 88-11 with more detailed information on the proposals. The extended comment period on these proposals will expire on April 4, 1988.

Irving Pollack Heads Quality-of-Market Study Group

NASD President Joseph R. Hardiman recently announced the creation of a special committee of the NASD's Regulatory Review Task Force to examine structural and quality-of-market issues that have emerged from the events of October.

The special committee includes:

■ Irving M. Pollack, a former SEC Commissioner, private consultant, and author of a 1986 study for the NASD on short-sale regulation that led to the establishment of short-sale reporting for NASDAQ issues in November 1986. Mr. Pollack, who also serves on the Regulatory Review Task Force, is the Chairman of this special committee.

■ James B. Cloonan, President of the American Association of Individual Investors, an organization of more than 100,000 individual investors with chapters in 38 cities, headquartered in Chicago.

■ Edward J. Mathias, Vice President and Director of Baltimore-based T. Rowe Price Associates, one

of the nation's largest mutual fund and money management organizations.

■ William G. McGowan, Chairman of MCI Communications Corporation, a NASDAQ company headquartered in Washington, D.C.

■ Hans R. Stoll, Professor of Finance at Vanderbilt University's Owen Graduate School of Management in Nashville, Tennessee, and a consultant to various government and private agencies.

■ John L. Watson, III, President of the 5,600-member National Security Traders Association in New York.

"The unprecedented trading volume of 1987 has demonstrated the need to review the structure and operation of stock markets around the world," Mr. Hardiman said. "NASDAQ's scope — today more than 5,700 issues and an average daily trading volume of 150 million shares — was simply not contemplated when the NASDAQ System was launched in 1971.

"The special committee's recommendations will be aimed at ensuring that NASDAQ's market structure and systems meet and anticipate investor needs in an increasingly demanding market environment," he continued.

The special committee will focus on quality-of-market issues in current and future trading environments, including standards for companies and market makers, market-maker capital and obligations, market liquidity, adequacy of communication systems, and the impact of international trading. The committee hopes to present the results of its study to the NASD Board of Governors by mid-year.

The Regulatory Review Task Force was established last April to conduct a thorough examination of the NASD's regulatory policies, practices, and procedures and to make recommendations for improving them. Former SEC Commissioner, A. A. Sommer, Jr., is Chairman of the Task Force.

Member Practices in Best-Efforts Distributions Should Receive Closer Supervision

The NASD has cited several member firms for violating the escrow requirements of SEC Rule 15c2-4 which applies to all best-efforts distributions and regulates the final disposition of customer funds received during this type of securities offering. Under the rule, members participating in a

contingent offering (e.g., "all-or-none" or "minimum-maximum") must promptly deposit investors' funds received into a separate bank account, as agent or trustee for those investors, or promptly transmit these funds to a bank escrow agent, pending occurrence of the contingency.

If the contingency does not occur, the underwriting members must promptly refund all customer monies. Members subject to the \$5,000 minimum net-capital requirement may only receive, and promptly transmit to an unaffiliated bank escrow account, customer's checks made payable to the escrow agent.

However, firms subject to the \$25,000 minimum requirement may, if not affiliated with the issuer, use either a separate firm bank-escrow account or a separate bank-trustee account.

When engaged in a contingent underwriting, members must deposit funds in escrow by:

- noon of the next business day after receipt by the firm; or,
- noon of the second business day after receipt of the customer's subscription form by the issuer.

To comply with the rule, the member must grant the escrow agent authority to decide if the contingency has been satisfied before releasing any funds to the issuer or returning funds to customers. However, under no circumstances may the escrow agent forward funds to the issuer

until the contingency has been met. Such a pre-contingency payout could subject the member to sanctions under the NASD's disciplinary procedures.

In a related area involving contingency offerings, SEC Rule 10b-9 deems it a manipulative or deceptive practice to represent that a security is being sold on an "all-or-none" or "part-or-none" basis if the offering is not entirely sold in bona-fide transactions and fully paid for by the offering termination date unless prompt refunds are made to all purchasers.

Failure to comply with SEC Rule 15c2-4 and Rule 10b-9 have resulted in disciplinary actions and sanctions for the members and principals involved. All district examiners closely review member activities relative to contingent offerings

during the course of their on-site examinations.

In one district alone, the District Business Conduct Committee (DBCC) decided 17 cases in 1987 that resulted in censures and substantial monetary sanctions.

Thus, members and principals who are responsible for this area should closely review SEC Rules 15c2-4 and 10b-9 and read NASD *Notices to Members* 84-7 and 84-64, which address SEC staff interpretations of Rule 15c2-4.

For your convenience, the NASD has reproduced both of these notices in its booklet "Recordkeeping, Net Capital, and Related Requirements for Firms Specializing in Direct Participation Programs," copies of which are available from your local district office.

NASD District Business Conduct Committees Take Disciplinary Actions Against Members, Associated Persons

Throughout 1987, the NASD's 14 district offices conducted 4,672 routine and special examinations, and reviewed 5,335 customer complaints and 1,852 other special sales-practice-related situations. As a result of 826 formal disciplinary actions ordered, the NASD's District Business Conduct Committee rendered 507 disciplinary decisions and accepted 263 letters of acceptance, waiver, and consent and 5 summary complaints. These actions led to the expulsion of 17 firms, the barring of 169 individuals, and the suspension of 9 firms and 94 individuals.

A summary of recent cases includes:

Providing Guarantees Against Losses

District 2 charged a registered representative with violations of Sections 1 and 19(e) of Article III because he guaranteed three customers against losses in connection with their purchases of a common stock. These guarantees were in writing and notarized. The registered

representative was censured, fined \$5,000, and suspended from association with any NASD member for 30 days.

Conversion of Customer Funds To Personal Use

One registered representative was censured, fined \$173,000, and barred from association with any NASD member in any capacity. The NASD's Board of Governors imposed the sanctions following its review of a decision rendered by the District Business Conduct Committee for District 12. The sanctions were based on findings that on 26 occasions, in 14 accounts, the representative caused partial liquidations of certain mutual funds owned by various investors and deposited the proceeds, totaling \$255,643.57, to his own bank account without the knowledge or consent of his employer. At various times prior to the discovery of his misconduct, the representative restored funds to certain customers, retaining the remaining \$168,000.

A registered representative in District 7 submitted an offer of settle-

ment pursuant to which he was censured, fined \$15,000, ordered to disgorge \$158,000, and barred from association with any NASD member in any capacity. Without admitting or denying the allegations, the representative consented to the described sanctions and findings that he induced a public customer to provide him with the documents necessary for him to withdraw monies from the customer's cash management account. Thereafter, he withdrew \$175,000 from the account, falsely represented to the customer that the monies were to be used to purchase GNMA's for her securities account, and instead converted the funds to his own use.

The DBCC for District 2 fined a registered representative \$84,000 and barred him from association with any NASD member in any capacity. The sanctions were based on findings that he received checks from two customers totaling \$59,000 for the purchase of mutual fund shares and without the customers' knowledge or consent deposited these funds to his own money market account. The rep-

representative thereafter transferred the funds to another broker-dealer and used them to trade in commodities. In connection with the misappropriation of these customer funds, he prepared and provided to the customers fictitious confirmations and statements reflecting that the mutual fund shares had been purchased. The representative also received a customer's checks totaling approximately \$5,760 intended for the purchase of insurance and converted the proceeds of these checks to his own use. Further, he forged a customer's signature to a \$20,000 check, which he received from his employer and was made payable to the customer, and converted the proceeds to his own use.

In another case, a registered representative was censured, fined \$20,000, and barred from association with any NASD member in any capacity. The NASD's Board of Governors imposed the sanctions following the appeal of a decision rendered by the District Business Conduct Committee for District 5. The sanctions were based on findings that the representative misappropriated funds

totaling \$10,889.12 from five public customers. He also failed to respond to the NASD's requests for information.

Misleading Advertising

The DBCC in District 10 censured and fined a member firm \$15,000 for publishing GNMA advertisements that were misleading in that no basis was explained for the yield quoted, the term "100% safety" was used, implying that the investment was not subject to market risk, and the use of the phrase "U.S. Government Yield" was misleading because the guarantee extended only to timely payments of principal and interest.

Financial Responsibility Rules Violations

An NASD member was censured, fined \$20,000, and suspended from soliciting business for one business day, and the registered principal fined \$5,000 and suspended from association with any NASD member as a principal for one year. The NASD's Board of Governors imposed the sanctions following its review of a decision rendered by the District Business Conduct Committee for District 2. The sanctions were based on findings that the firm and registered principal failed to accurately compute the amounts required to be deposited into its Special Reserve Bank Account for the Exclusive Benefit of Customers and to thereafter make such deposits within the required time period. The firm and registered principal also failed to comply with the requirements of Reg T.

In District 12, a registered principal submitted a letter of acceptance, waiver, and consent pursuant to which he was censured, fined \$7,500 jointly and severally with his employer, suspended from association with any NASD member in any registered capacity for six months, and suspended as a general securities principal and in any managerial or supervisory capacity for two years. Without admitting or denying the allegations, the principal consented to the described sanctions and findings that he permitted his firm to engage

in a securities business at times when it failed to maintain minimum required net capital, failed to comply with certain provisions of SEC Rule 15c3-3, failed to prepare certain books and records, and failed to accurately reflect firm liabilities on the firm's records. The principal also failed to comply with certain terms of a restriction agreement with the NASD to limit the dollar amount of its inventory.

Unauthorized Transactions

A registered representative in District 5 was censured, fined \$25,000, and suspended from association with any NASD member in any capacity for 90 days. The sanctions were based on findings that he exercised discretion in the account of a customer and executed or caused to be executed certain securities purchase and sale transactions without written discretionary authorization from the customer and without written acceptance of the account as discretionary by his employer. The representative also executed seven securities purchase and sale transactions for his own exclusive benefit in the account of a customer and thereby shared directly or indirectly in the profits or losses of the subject account without the authorization of his employer.

A registered representative submitted to District 3 an offer of settlement pursuant to which he was censured, fined \$15,000, required to disgorge \$1,046.82, and suspended from association with any NASD member in any capacity for two years. Without admitting or denying the allegations, the representative consented to the described sanctions and findings that he caused the execution of 40 unauthorized securities transactions in the accounts of nine customers and recommended to certain customers that they change their addresses to reflect residency in Florida rather than Michigan to circumvent Michigan laws. (Referrals were made to the relevant state securities officials.) The representative also failed to respond to the

SEC Convenes Sales-Practice Roundtable in Washington, D.C.

Indicative of the current level of interest in member sales practices and supervisory standards, the SEC sponsored a Roundtable on Broker/Dealer Sales Practices on January 6.

Along with all five SEC Commissioners, the NASD and other major self-regulatory organizations, as well as representatives from several securities firms, NASAA, and the private sector attended the meeting. Among the subjects discussed were training of sales personnel, customer suitability, the fiduciary responsibilities of integrated firms, regulatory oversight of sales practices, arbitration, and supervision.

NASD's requests for information.

In District 5, a registered representative submitted an offer of settlement pursuant to which he was censured, fined more than \$12,600, and suspended from association with any NASD member in any capacity for three weeks. Without admitting or denying the allegations, the representative consented to the described sanctions and findings that he recommended and executed or caused to be executed unsuitable and excessive securities purchase and sale transactions in the account of a public customer. These transactions resulted in total losses of \$26,349.04. The representative also exercised discretion in this account during a five-month period without prior authorization from the customer and without prior written acceptance of the account as discretionary by his employer.

The DBCC in District 2 censured and fined a registered representative \$10,000 based on findings that he caused the unauthorized purchase of securities in a customer's account. The representative also purchased, for a California resident, securities that had not been registered or qualified in accordance with applicable provisions of the securities laws of that state or exempted from such registration or qualification. To facilitate the sale, he initiated a plan to circumvent California requirements by effecting an address change for the customer from California to an address in Nevada and received statements and other correspondence directed to the customer at that Nevada address. The securities officials of these states have been notified as well.

Failure to Provide Information As Requested

The Market Surveillance Committee accepted an offer of settlement submitted by a registered principal pursuant to which he was censured, fined \$2,500 and suspended from association with any NASD member in any supervisory capacity for 30 business days. Without admitting or denying the allegations, he consented to the described sanctions and find-

ings that he failed to provide information to the NASD pursuant to three written requests for the production of documents and information in connection with an NASD inquiry into the trading of a non-NASDAQ security.

A registered representative in District 8 submitted a letter of acceptance, waiver, and consent pursuant to which he was censured, fined \$5,000, and barred from association with any NASD member in any capacity. Without admitting or denying the allegations, the representative consented to the described sanctions and findings that he prepared and filed a Form U-4 application for registration with the NASD that contained false and misleading information regarding his educational background.

Escrow Account Violations

A member in District 2 and its principal officers were charged with the sale of limited partnership interests for which they received funds from investors without promptly forwarding those funds to the issuer, in contravention of SEC Rule 15c2-4. The member and its officers were charged by the DBC with failure to maintain minimum net capital for a three-month period and with permitting an officer of the member to act in a principal capacity without being registered as a principal with the NASD. The member and its officers were censured and fined \$2,500, jointly and severally.

In District 2, a company and two of its registered principals submitted an offer of settlement pursuant to which they were each censured and fined \$15,000. Without admitting or denying the allegations, the firm and both principals consented to the described sanctions and findings that they failed to deposit investor funds received in connection with 21 contingent offerings of limited partnership interests to escrow accounts, instead depositing and commingling these funds in one of two separate bank accounts under the apparent control of either or both of the respondents.

Issuing Checks With Insufficient Funds

An associated person was censured, fined \$5,000, and barred from association with any NASD member in any capacity. The NASD's Board of Governors imposed the sanctions following its review of a decision rendered by the DBCC for District 6. The sanctions were based on findings that the associated person paid her employer over \$35,000 for personal securities transactions with four checks that were returned for insufficient funds and were never made good by the representative. The associated person also failed to respond to NASD requests for information.

A registered representative in District 2 was charged with the execution of options purchase transactions

NASD Proposes Closer Scrutiny of Business Activities

Employees of NASD members would be obligated to notify their employers prior to engaging in outside business activities under a new NASD proposal.

The rule would require all persons associated with a member firm — including principals, registered representatives, and other employees — to provide advance written notice to the firm before being employed by or accepting compensation from any other person for any outside business activities including business activities that are outside the scope of an associated person's relationship with the employer firm.

To fulfill their supervisory obligations, members have to know the nature and extent of an associated person's outside activities. Recent disciplinary cases demonstrated that prior notice of outside business arrangements could have prevented legal as well as regulatory problems for some members.

in his own account for which he failed to pay. The representative provided his employer with four checks drawn on his personal bank account when he knew that his account had insufficient funds to honor the checks. Additionally, the representative failed to provide the NASD with information about his termination by the member firm for the above described activities. In this case, the representative was censured, fined \$5,000, and barred from the NASD in any capacity.

Free-Riding and Withholding Violations

A registered representative was fined \$15,000, ordered to disgorge more than \$72,000, and suspended from association with any NASD member in any capacity for five business days. The NASD's Board of Governors imposed the sanctions following the appeal of a decision rendered by the DBCC for District 12. The sanctions were based on findings that the representative made a purchase of 89,000 shares of a new-issue security that traded at an immediate premium in the secondary market for the account of his daughter and later caused the shares to be transferred to his account, thereafter selling them at a profit.

SOES

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In addition, the committee censured both and imposed a total fine of \$10,000.

According to the complaint, the firm's president divided a 7,500-share customer order into four smaller trades and partially executed it through SOES to circumvent the system's size limitations, a practice known as "order splitting." The committee noted that the SOES operating rules clearly prohibit order splitting.

The committee further alleged that the president executed several SOES transactions for the firm's proprietary trading account, a practice also prohibited by SOES rules.

Because the system is for the execution of customer orders only, brokers and dealers may not use SOES to execute their own proprietary trades.

Finally, the firm was charged with failing to establish, maintain, and enforce written procedures for supervising employees' use of SOES.

Treasury Announces Magnetic Tape Filing Program for Currency Reports

The Department of the Treasury has made permanent a pilot program in which participating financial institutions use magnetic tape filing to report currency transactions, as required by the Bank Secrecy Act. Previously, the only form of reporting was paper filing on the Currency Transaction Report (Form 4789).

NASD members now have the option to report currency transactions by magnetic tape, if they successfully complete an acceptance test administered by the Internal Revenue Service.

However, filing by magnetic tape is voluntary, and members may continue to file the paper Currency

Transaction Report.

Members can obtain additional information on this program by contacting Phyllis A. Goldsworthy, CTR Magnetic Filing Coordinator, (313) 226-3293, or writing to her at the Internal Revenue Service Data Center, 1300 John C. Lodge Drive, Detroit, MI 48226.

The magnetic tape filing will only affect the form in which members file currency transaction reports; all the information currently required on the paper reports will also be required for magnetic tape filings. Moreover, members should note that all Bank Secrecy Act regulations will continue to apply, whether or not members participate in this program.