

Principal Transactions with Retail Customers

(a) In "over-the-counter" transactions, whether in "listed" or "unlisted" securities, if a member acting as principal buys from its customer or acting as principal sells to its customer, it shall buy or sell at a price which is fair, taking into consideration all relevant circumstances, including market conditions with respect to such security at the time of the transaction, the expense involved, and the fact that the member is entitled to a profit.

(b) the price paid or received by a retail customer in any principal transaction with a member, after any mark-up or mark-down charged by the member, shall not be considered fair unless the resulting price is reasonably related to the prevailing market price of the security.

Prevailing Market Price

(c) For purposes of determining the prevailing market price of a security, the following standards shall be applied:

NASDAQ and Exchange Securities

(1) When a member effects a principal transaction with a customer in any security for which quotation information is disseminated in the NASDAQ inter-dealer quotation system ("NASDAQ") or for which quotation information is disseminated by a national securities exchange, the lowest asked quotation in the case of a sale to a customer, or the highest bid quotation in the case of a purchase from a customer, as such quotations appear in the primary inter-dealer quotation system for the security, shall normally be considered the current market price of the security.

Non-NASDAQ and Non-Exchange Securities

(2) When a member effects a principal transaction with a customer in any security for which quotation information is not disseminated in NASDAQ or by a national securities exchange, the following guidelines shall apply:

Contemporaneous Transactions — Independent Competitive Market

(A) If there is an independent competitive market away from the member, the prices paid to the member by other brokers or dealers in contemporaneous transactions in the case of a sale to a customer, or the prices paid by the member in contemporaneous transactions in the case of a purchase from a customer shall normally be considered the current market price of the security.

Contemporaneous Transactions — No Independent Competitive Market

(B) If there is no independent competitive market away from the member, the member's cost of purchases from other brokers or dealers in contemporaneous transactions in the case of a sale to a customer, or the prices at which the member sold to other brokers or dealers in contemporaneous transactions in the case of a purchase from a customer, shall normally be considered the current market price of the security.

Quotations of Other Brokers and Dealers

(C) In the absence of contemporaneous transactions with other brokers or dealers, the lowest asked or highest bid quotations of other brokers or dealers appearing in the primary inter-dealer quotation system for the security, if such quotations accurately reflect the market for the security, shall normally be considered the current market price of the security.

Transactions by Other Brokers and Dealers

(D) In the absence of either contemporaneous transactions with other brokers or dealers or accurate inter-dealer quotations, the prices paid or received by other brokers or dealers in contemporaneous transactions shall normally be considered the current market price of the security.

"Riskless Principal" Transactions

(E) The guidelines under subparagraphs (A)-(D) shall not be applicable to any principal transaction in a security in which the member is not a market maker, if after having received an order to buy or sell the security from the customer the member purchases the security from or sells the security to another person to offset the transaction with the customer, and the current market price shall normally be considered the cost or proceeds of the offsetting transaction.

Definition

(3) For purposes of Subsection (c)(2), the term "contemporaneous transaction" shall mean any transaction or transactions which take place the day of or the day before or within a reasonable time before the transaction with the customer which determination shall be made in the context of the market for the security.

Agency Transactions with Retail Customers

(d) If a member acts as agent for its customer in any "over-the-counter" transaction, whether in

"listed" or "unlisted" securities, the member shall not charge its customer more than a fair commission or service charge, taking into consideration all relevant circumstances including market conditions with respect to such security at the time of the transaction, the expense of executing the order and the value of any service it may have rendered by reason of its experience in and knowledge of such security and the market therefore.

Amount of Mark-ups or Mark-downs and Commissions

(e) For purposes of determining whether prices to customers in principal transactions (mark-ups and mark-downs) and commissions charged customers in agency transactions are fair and reasonable, the following factors, as well as any other relevant factors and circumstances, should be taken into consideration:

(1) the percentage of mark-up or mark-down based on the current market price of the security as determined under Subsection (c) above, or the percentage commission based on the execution price of the transaction;

(2) the type of security involved since some securities customarily carry a higher mark-up or commission than other types of securities;

(3) the availability of the security in the market since, in the case of an inactive security, the effort and cost of buying or selling the security may be greater than in the case of a more actively traded security;

(4) the price of the security as the percentage mark-up or commission generally increases as the price of the security decreases because transactions in lower-priced securities may require more handling and expense;

(5) the amount of money involved in a transaction as a transaction which involves a small amount of money may require proportionately higher handling expenses compared to expenses of handling transactions involving larger amounts of money;

(6) Any disclosure to the customer, before the transaction is effected, of the amount of commission charged in an agency transaction or mark-up made in a principal transaction; provided, however, that disclosure cannot justify a commission or mark-up that is unfair or unreasonable in light of all other relevant factors covered by this subsection;

(7) the types of services and facilities that

the member makes available to its customers and the costs to the member since there are differences among members in the amount and types of services and facilities provided to customers; provided, however, a member may not justify mark-ups or commissions on the basis of costs of services and facilities which are excessive; and

(8) in principal transactions with retail customers, the degree of risk assumed by the member since sales from and purchases for an existing inventory position may, because of a willingness to take on the uncertainties of a risk position, entitle the member to a higher percentage mark-up or mark-down than would be permissible for a "risk-less" principal transaction.

(f) Mark-ups in principal transactions in outstanding securities in excess of 5 percent will generally be presumed to be unfair and unreasonable; however, a mark-up pattern of 5 percent or even less may be shown to be unfair or unreasonable depending on a consideration of all other relevant factors and under certain circumstances, a mark-up in excess of 5 percent may be justified upon a consideration of such other relevant factors.

Mark-ups in Proceeds Transactions

(g) When a customer sells securities to, or through, a member, the proceeds of which are used to pay for other securities purchased from the member at or about the same time, the mark-up shall be computed in the same way as if the customer had purchased for cash, except that in computing the mark-up, there shall be included any mark-down or commission on the securities liquidated. In such circumstances, however, a reasonable allowance may be made for the additional cost of handling the liquidating transaction.

Exemptions

(h) This section shall not apply to transactions in municipal securities or to securities which are being publicly offered.

EXPLANATION

New Section [4] will replace current Article III, Section 4 of the Rules of Fair Practice, which establishes general standards of fairness required of members in transactions with customers. The major significance of the new section is that it will also codify and replace the NASD Mark-Up Policy adopted by the Board of Governors as an

Interpretation of Article III, Section 4 and the broad ethical standards of conduct required under Article III, Section 1 of the Rules of Fair Practice. The Policy was adopted in 1943 and has been in place since then without any major revisions.

Proposed Subsections (a), (b), and (c) of new Section [4] deal with principal transactions with retail customers. Subsection (a) carries forward the existing language of Article III, Section 4 that states that prices in principal transactions must be fair. Subsection (b) incorporates the language of the Mark-Up Policy that states that a "fair price" is one that is reasonably related to the prevailing market price of the security. Subsection (c), which provides general guidelines as to the term "prevailing market price," is entirely new and has no counterpart in the current Mark-Up Policy.

A substantive change has been made in new Section [4] as originally proposed for comment that relates to the definition of "current market price" to be used in computing the level of mark-ups and mark-downs. The basic concept underlying the definition in Subsection (c) is similar to the originally proposed language circulated for comment and is intended to establish somewhat flexible standards that, in appropriate cases, will allow a member to demonstrate that the current market price should be based on a review of other factors not expressly mentioned.

The guidelines contained in Subsection (c) being submitted for vote would use both inter-dealer quotations and actual inter-dealer trades. The determination of which method would be used depends on the nature of the market in which the security is traded. Under Subsection (c)(1), the current market price of securities for which quotations are disseminated in NASDAQ or by a national securities exchange will normally be considered the best asked quotation appearing in the primary inter-dealer quotation system in the case of a principal sale to a customer. If the member purchases a security from a customer for which quotations are disseminated by NASDAQ or a national securities exchange, the current market price will normally be the best bid quotation appearing in the primary inter-dealer system. It is believed that for such securities NASDAQ or exchange quotations should be the norm, as such securities are subject to firm quotation rules and must meet minimum qualification requirements for inclusion in

NASDAQ or trading on a national securities exchange.

If a security is a non-NASDAQ and non-exchange-traded security, the market price is determined by a descending priority scale which starts at a member's transaction prices with other brokers and dealers. These securities, which comprise all non-NASDAQ and non-exchange-traded securities, should not be measured against quotations in the first instance as they are generally less actively traded securities and are not subject to firm-quotation rules. Under Subsection (c)(2)(A), the norm for determining "current market price" for these securities if there is an independent market away from the member is considered to be the member's contemporaneous sale prices to other broker-dealers, in the case of a principal sale to a customer, and its contemporaneous purchase prices from other broker-dealers, in the case of a purchase from a customer. The term "contemporaneous transaction" is defined by Subsection (c)(2)(F) to be an inter-dealer transaction by the member the day of or the day before or a reasonable time before the retail principal transaction depending on the context of the market for the security. Under Subsection (c)(2)(C), the current market price for non-NASDAQ and non-exchange-traded securities in which the member has had no inter-dealer transactions is considered to be the available quotations appearing in the inter-dealer quotation system, but only if such quotations are accurate reflections of the true market for the security. If reliable quotations are not available, the norm for determining "current market price" under Subsection (c)(2)(E) is the actual transaction prices of other brokers and dealers. Notwithstanding these standards under Subsection (c)(2)(F), any "riskless principal transaction" in any non-NASDAQ or non-exchange-traded security shall be the cost of purchasing the security to fill a customer buy order or, in the case of a customer sell order, the proceeds from the sale to satisfy a customer sell order.

The method to be used in computing "current market price" under proposed Subsection (d) of Section [4] is substantially different from that originally proposed for comment. Under the original proposal, the cost of purchasing or proceeds from the sale of the security would have been the norm, regardless of the market in which the security was traded. Several commenters

strongly objected to the original proposal because it failed to recognize bona fide quotations as a proper basis for determining "current market price," despite the existence of active trading markets in many NASDAQ and exchange-traded securities. In light of these and similar objections, the Board of Governors decided to distinguish active inter-dealer markets from less active markets and to introduce an element of certainty into members' pricing decisions. The structure currently proposed in Subsection (c) is based on whether the security is a NASDAQ security or exchange-traded security in which firm quotations are mandated or is a security where quotations appear, but is not subject to firm-quotation requirements.

A member's responsibility when executing agency transactions for customers is covered by Subsection (d), which contains substantially the same language that appears in the second half of existing Article III, Section 4 of the Rules of Fair Practice.

The language under the heading "Relevant Factors" in the Mark-Up Policy is incorporated into Subsection (e), which sets forth the factors that should be considered in determining whether the amount of a mark-up for a given transaction is fair and reasonable. It also applies to the fairness of the amount of commission in an agency transaction as does the existing Mark-Up Policy, although some of the factors appear primarily directed at principal transactions.

Subsections (e)(1)(i) and (ii) are intended to clarify that the percentage of mark-up, or commission, while a major consideration, is only one of a number of factors that should be taken into account. It also incorporates the basic concept of a "Five Percent Policy" currently appearing under the "General Considerations" section of the Mark-Up Policy. Subsections (e)(2) through (7) are simply a rewording of the existing language in rule format. Subsection (e)(8) has been added to reflect the fact that, in a principal transaction, a risk position may entitle a member to a higher mark-up than would be allowed in a "riskless" transaction.

The language of the Mark-Up Policy under the heading "Transactions to Which the Policy is Applicable" would be eliminated as unnecessary, with one exception. The exception is the unique handling of proceeds transactions, and the existing language would be carried forward and clarified.

Subsection (g) carries forward the existing language, but clarifies that the amended rule does not apply to municipal securities, which are covered by Municipal Securities Rulemaking Board rules, or to securities being publicly offered where the fairness of compensation is governed by the Corporate Financing Interpretation (and the corresponding pending rule) or by Article III, Sections 26 and 29, in the case of mutual funds and variable annuities.

CURRENT TEXT

NASD Manual, ¶ 2155, p. 2071

No Vote Required

Publication of Transactions and Quotations

Sec. 5.

No member shall publish or circulate, or cause to be published or circulated, any notice, circular, advertisement, newspaper article, investment service, or communication of any kind which purports to report any transaction as a purchase or sale of any security unless such member believes that such transaction was a bona fide purchase or sale of such security; or which purports to quote the bid price or asked price for any security, unless such member believes that such quotation represents a bona fide bid for, or offer of, such security. If nominal quotations are used or given, they shall be clearly stated or indicated to be only nominal quotations.

EXPLANATION

No change is being proposed to this section.

CURRENT TEXT

NASD Manual, ¶ 2156, p. 2075

No Vote Required

Offers at Stated Prices

Sec. 6.

No member shall make an offer to buy from or sell to any person any security at a stated price unless such member is prepared to purchase or sell, as the case may be, at such price and under such conditions as are stated at the time of such offer to buy or sell.

EXPLANATION

No change is being proposed to this section.

CURRENT TEXT

NASD Manual, ¶2157, p. 2075

**No Vote Required
Disclosure of Price in Selling Agreements
Concessions**

Sec. 7.

Selling syndicate agreements or selling group agreements shall set forth the price at which the securities are to be sold to the public or the formula by which such price can be ascertained, and shall state clearly to whom and under what circumstances concessions, if any, may be allowed.

EXPLANATION

No change is being proposed to this section.

CURRENT TEXT

NASD Manual, ¶2158, p. 2075—2075-3

**No Vote Required
Securities Taken in Trade**

Sec. 8.

(a) A member engaged in a fixed price offering, who purchases or arranges the purchase of securities taken in trade, shall purchase the securities at a fair market price at the time of purchase or shall act as agent in the sale of such securities and charge a normal commission therefore.

(b) When used in this section —

(1) the term "taken in trade" means the purchase by a member as principal, or as agent for the account of another, of a security from a customer pursuant to an agreement or understanding that the customer purchase securities from the member which are part of a fixed price offering.

(2) the term "fair market price" means a price not higher than the price at which the securities would be purchased from the customer or from a similarly situated customer in the ordinary course of business by a dealer in such securities in transactions of similar size and having similar characteristics but not involving a security taken in trade.

(3) the term "normal commission" means an amount of commission which the member would normally charge to that customer or a similarly situated customer in the ordinary course of business in transactions of similar size and having similar characteristics but not involving a security taken in trade.

(c) For purposes of this Section a member shall be:

(1) deemed, with respect to securities other than common stocks, to have taken such securities

in trade at a fair market price when the price paid is not higher than the highest independent bid for the securities at the time of purchase, if such bid quotations for the securities are readily available.

(2) presumed, with respect to common stocks, to have taken such common stocks in trade at a fair market price when the price paid is not higher than the highest independent bid for the securities at the time of purchase, if such bid quotations for the securities are readily available.

(3) presumed to have taken a security in trade at a price higher than a fair market price when the price paid is higher than the lowest independent offer for the securities at the time of purchase, if such offer quotations for the securities are readily available.

(d) A member, in connection with every transaction subject to this Section, shall with respect to:

(1) common stocks, which are traded on a national securities exchange or for which quotations are entered in an automated quotation system, obtain the necessary bid and offer quotations from the national securities exchange or from the automated quotation system; and

(2) other securities and common stocks not included in subparagraph (1) of this Subsection (d) obtain directly or with the assistance of an independent agent bid and offer quotations from two or more independent dealers relating to the securities to be taken in trade or, if such quotations are not readily available, exercise its best efforts to obtain such quotations with respect to securities having similar characteristics and of similar quality as those to be taken in trade.

(e) A member who purchases a security taken in trade shall keep or cause to be kept adequate records to demonstrate compliance with this Section and shall preserve the records for at least 24 months after the transaction. If an independent agent is used for the purpose of obtaining quotations, the member must request the agent to identify the dealers from whom the quotations were obtained and the time and date they were obtained or request the agent to keep and maintain for at least 24 months a record containing such information.

EXPLANATION

Section 8 was revised a few years ago as part of the "Papilsky" rule revisions. The Board of Governors proposes that no change be made in the current language.

CURRENT TEXT

NASD Manual, ¶2159, p. 2075-6

No Vote Required

**Use of Information Obtained in Fiduciary Capacity
Sec. 9.**

A member who, in the capacity of paying agent, transfer agent, trustee, or in any other similar capacity, has received information as to the ownership of securities, shall under no circumstances make use of such information for the purpose of soliciting purchases, sales, or exchanges, except at the request and on behalf of the issuer.

EXPLANATION

No change is being proposed to this section.

PROPOSED AMENDED TEXT

NASD Manual, ¶2160, p. 2075-6, 2075-7

Item 8 on ballot

**Influencing or Rewarding Employees of Others
Sec. 10.**

(a) No member or person associated with a member shall, directly or indirectly, give or permit to be given anything of value, including gratuities, in excess of [fifty] one hundred dollars per individual per year to any person, principal, proprietor, employee, agent, or representative of another person where such payment or gratuity is in relation to the business of the employer of the recipient of the payment or gratuity. A gift of any kind is considered a gratuity.

(b) This section shall not apply to contracts of employment with or to compensation for services rendered by persons enumerated in Subsection (a) provided that there is in existence, prior to the time of employment or before the services are rendered, a written agreement between the member and the person who is to be employed to perform such services. Such agreement shall include the nature of the proposed employment, the amount of the proposed compensation, and the written consent of such person's employer or principal.

(c) A separate record of all payments or gratuities in any amount known to the member, the employment agreement referred to in Subsection (b), and any employment compensation paid as a result thereof shall be retained by the member for the period specified by Rule 17a-4 of the General Rules and Regulations under the Securities Exchange Act of 1934.

EXPLANATION

The only amendment to Section 10 is an increase in the maximum allowable gift amount from \$50 to \$100 per individual per year.

CURRENT TEXT

NASD Manual, ¶2161, p. 2075-7

No Vote Required

**Payment Designed to Influence Market Prices,
Other Than Paid Advertising
Sec. 11.**

No member shall, directly or indirectly, give, permit to be given, or offer to give, anything of value to any person for the purpose of influencing or rewarding the action of such person in connection with the publication or circulation in any newspaper, investment service, or similar publication, of any matter which has, or is intended to have, an effect upon the market price of any security, provided that this rule shall not be construed to apply to matter which is clearly distinguishable as paid advertising.

EXPLANATION

No change is being proposed to this section.

CURRENT TEXT

NASD Manual, ¶2162, p. 2076

Item 9 on ballot

[Disclosure on Confirmations]

[Sec. 12.]

[A member at or before the completion of each transaction with a customer shall give or send to such customer written notification disclosing: (1) whether such member is acting as a broker for such customer, as a dealer for his own account, as a broker for some other person, or as a broker for both such customer and some other person; and (2) in any case in which such member is acting as a broker for such customer or for both such customer and some other person, either the name of the person from whom the security was purchased or to whom it was sold for such customer and the date and time when such transaction took place or the fact that such information will be furnished upon the request of such customer, and the source and amount of any commission or other remuneration received or to be received by such member in connection with the transaction.]

EXPLANATION

The Board of Governors recommends that Section 12 be deleted because the confirmation requirements of SEC Rule 10b-10 more than adequately cover the provisions of this section.

CURRENT TEXT

NASD Manual, ¶2163, p. 2078

Item 10 on ballot

[Disclosure of Control]

[Sec. 13.]

[A member controlled by, controlling, or under common control with the issuer of any security, shall, before entering into any contract with or for a customer for the purchase or sale of such security, disclose to such customer the existence of such control, and if such disclosure is not made in writing, it shall be supplemented by the giving or sending of written disclosure at or before the completion of the transaction.]

EXPLANATION

When originally circulated for comment, Section 13 was to remain unchanged. However, after further consideration, the Board of Governors recommends that it be deleted since it duplicates SEC Rule 15c1-5.

CURRENT TEXT

NASD Manual, ¶2164, p. 2078

Item 11 on ballot

[Disclosure of Participation or Interest in Primary or Secondary Distribution]

[Sec. 14.]

[A member who is acting as a broker for a customer or for both such customer and some other person, or a member who is acting as a dealer and who receives or has promise of receiving a fee from a customer for advising such customer with respect to securities, shall, at or before the completion of any transaction for or with such customer in any security in the primary or secondary distribution of which such member is participating or is otherwise financially interested, give such customer written notification of the existence of such participation or interest.]

EXPLANATION

When originally proposed, Section 14 would have remained unchanged. After further consideration, the Board of Governors recommends that the

section be deleted since it duplicates SEC Rule 15c1-6.

PROPOSED AMENDED TEXT

NASD Manual, ¶2165, p. 2078

Item 12 on ballot

Discretionary Accounts

Sec. 15.

Excessive transactions

(a) No member shall effect with or for any customer's account in respect to which such member or his agent or employee is vested with any discretionary power any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account.

Authorization and acceptance of account

(b) No member or [registered representative] person associated with a member shall exercise any discretionary power in a customer's account unless such customer has given prior written authorization to a stated [individual or individuals] associated person or persons, or to the member in which case such discretionary power shall be exercised by a properly authorized associated person or persons of the member, and the account has been accepted by the member, as evidenced in writing by the member or the partner, officer, or manager, duly designated by the member, in accordance with Section 27 of these rules.

Approval and review of transactions

(c) The member or the person duly designated shall approve promptly in writing each discretionary order entered and shall review all discretionary accounts at frequent intervals in order to detect and prevent transactions which are excessive in size or frequency in view of the financial resources and character of the account.

Exception

(d) This section shall not apply to discretion as to the price at which or the time when an order given by a customer for the purchase or sale of a definite amount of a specified security shall be executed.

EXPLANATION

As originally proposed, the existing requirement that limits the grant of discretion to a particular individual was left unchanged and members were asked to comment on whether a member firm should be allowed to exercise discretion. After reviewing the comments, the Board of

Governors determined that it appears appropriate to allow members to exercise discretion. However, in an effort to ensure that discretion will be properly delegated, the amendment would require that member discretion be exercised only by an authorized person or persons within the member's organization.

CURRENT TEXT

NASD Manual, ¶2166, p. 2079

Item 13 on ballot

[Offerings "At the Market"]

[Sec. 16.]

[A member who is participating or who is otherwise financially interested in the primary or secondary distribution of any security which is not admitted to trading on a national securities exchange, shall make no representation that such security is being offered to a customer "at the market" or at a price related to the market price unless such member knows or has reasonable grounds to believe that a market for such security exists other than that made, created, or controlled by such member, or by any person for whom he is acting or with whom he is associated in such distribution, or by any person controlled by, controlling, or under common control with such member.]

EXPLANATION

Although no change was proposed in Section 16 when originally circulated for comment, the Board of Governors considered comments from the SEC and others and recommends that the section be deleted since it duplicates SEC Rule 15c1-8.

CURRENT TEXT

NASD Manual, ¶ 2167, p. 2079

Item 14 on ballot

[Solicitation of Purchases on an Exchange to Facilitate a Distribution of Securities]

[Sec. 17.]

[(a) No member, participating or otherwise financially interested in the primary or secondary distribution of any security of any issuer, shall:]

[(1) pay or offer or agree to pay, directly or indirectly, to any person any compensation for soliciting another to purchase any security of the same issuer on a national securities exchange, or for purchasing any security of the same issuer on any such exchange for any account other than the account of the member who pays or is to pay such

compensation; or]

[(2) sell, offer to sell, or induce an offer to buy such security, or deliver such security after sale, if, in connection with such distribution, such member has paid, or has offered or agreed to pay, directly or indirectly, to any person, any compensation for soliciting another to purchase any security of the same issuer on any national securities exchange, or for purchasing any security of the same issuer on any such exchange for any account other than the account of the member who has paid or is to pay such compensation.]

[(b) No member, participating or otherwise financially interested in the primary or secondary distribution of any security of any issuer, shall cause a purchase or sale of any security of the same issuer on a national securities exchange by paying or offering or agreeing to pay, directly or indirectly, to any person any compensation for soliciting another to purchase such security on any such exchange, or for purchasing such security on any such exchange for any account other than the account of the member who pays or is to pay such compensation.]

[(c)] The provisions of this rule shall not apply in respect to any salary paid by a member to any person regularly employed by him whose ordinary duties include the solicitation or execution of brokerage orders on a national securities exchange, if such salary represents only ordinary compensation for the discharge by such person of such duties in the regular course of his employment, and is not paid, in whole or in part, directly or indirectly, for the inducement by such person of the purchase or sale on a national securities exchange of any security of the issuer of the security in the primary or secondary distribution of which such member is participating or otherwise financially interested.]

EXPLANATION

The Board of Governors recommends that Section 17 be deleted since it duplicates SEC Rule 10b-2.

CURRENT TEXT

NASD Manual, ¶2168, p. 2079

No Vote Required

Use of Fraudulent Devices

Sec. 18.

No member shall effect any transaction in, or induce the purchase or sale of, any security by

means of any manipulative, deceptive, or other fraudulent device or contrivance.

EXPLANATION

No change is being proposed to this section.

PROPOSED AMENDED TEXT

NASD Manual, ¶ 2169, p. 2083-2091

Item 15 on ballot

Customers' Securities or Funds

Sec. 19.

Improper use

(a) No member or person associated with a member shall make improper use of a customer's securities or funds.

General Provisions

(b) [Every member in the conduct of its business shall adhere to the provisions or Rule 15c3-3 promulgated under the Securities Exchange Act of 1934 with respect to obtaining possession and control of securities, and the maintenance of appropriate cash reserves.] For the purposes of this Section, the definitions contained in Commission Rule 15c3-3 under the Securities Exchange Act of 1934 shall apply.

Authorization to lend

(c) No member shall lend, either to himself or to others, securities carried for the account of any customer, which are eligible to be pledged or loaned unless such member shall first have obtained from the customer a written authorization permitting the lending of securities thus carried by such member.

Segregation and identification of securities

(d) No member shall hold securities carried for the account of any customer which have been fully paid for or which are excess margin securities unless such securities are segregated and identified by a method which clearly indicates the interest of such customer in those securities.

Prohibition against guarantees

(e) No member or person associated with a member shall guarantee a customer against loss in any securities account of such customer carried by the member or in any securities transaction effected by the member with or for such customer.

Sharing in accounts; extent permissible

(f) (1)(A) Except as provided in Subsection (f)(2), no member or person associated with a member shall share directly or indirectly in the profits or losses in any account of a customer carried by the member or any other member; provided, however, that a member or person

associated with a member may share in the profits or losses in such an account if (i) such member or person associated with a member obtains prior written authorization from the member carrying the account; and (ii) the member or person associated with a member shall share in the profits or losses in any account of such customer only in direct proportion to the financial contributions made to such account by either the member or person associated with a member.

(B) Exempt from the direct proportionate share limitation of Subsection (f)(1)(A)(ii) are accounts of the immediate family of such member or person associated with a member. For purposes of this section, the term "immediate family" shall include parents, mother-in-law or father-in-law, husband or wife, children, or any relative to whose support the member or person associated with a member otherwise contributes directly or indirectly.

(2) Notwithstanding the prohibition of Subsection (f)(1), a member or person associated with a member may receive compensation based on a share in profits or gains in an account if all of the following conditions are satisfied:

(A) The member or person associated with a member seeking such compensation obtains prior written authorization from the member carrying the account.

(B) The customer has at the time the account is opened either a net worth which the member or person associated with a member reasonably believes to be not less than \$1,000,000, or the minimum amount invested in the account is not less than \$500,000.

(C) The member or person associated with a member reasonably believes the customer is able to understand the proposed method of compensation and its risks prior to entering into the arrangement;

(D) The compensation arrangement is set forth in a written agreement executed by the customer and the member;

(E) The member or person associated with a member reasonably believes, immediately prior to entering into the arrangement, that the agreement represents an arm's-length arrangement between the parties;

(F) The compensation formula takes into account both gains and losses realized or accrued in the account over a period of at least one year; and

(G) The member has disclosed to the customer all material information relating to the arrangement, including the method of compensation and potential conflicts of interest which may result from the compensation formula.

EXPLANATION

Several commenters suggested deleting this section since it partially duplicates certain provisions in SEC Rule 15c3-3. Therefore, the language in Subsection (b) that duplicates the SEC's rule is proposed to be deleted.

CURRENT TEXT

NASD Manual, ¶ 2170, p. 2095

Item 16 on ballot

[Installment or Partial Payment Sales]

[Sec. 20.]

[Prohibition]

[(a) No member shall take or carry any account or make a transaction for any customer under any arrangement which contemplates or provides for the purchase of any security for the account of the customer or for the sale of any security to the customer, where payment for the security is to be made to the member by the customer over a period of time in installments or by a series of partial payments, unless:]

[Member acts as agent]

[(1) in the event such member acts as an agent or broker in such transaction he shall immediately, in the regular course of business, make an actual purchase of the security for the account of the customer, and shall immediately, in the regular course of business, take possession or control of such security and shall maintain possession or control thereof so long as he remains under obligation to deliver the security to the customer;]

[Member acts as principal]

[(2) in the event such member acts as a principal in such transaction, he shall, at the time of such transaction, own such security and shall maintain possession or control thereof so long as he remains under obligation to deliver the security to the customer;]

[Regulation T satisfied]

[(3) the provisions of Regulation T of the Federal Reserve Board, if applicable to such member, are satisfied.]

[Hypothecation]

[(b) No member, whether acting as principal or

agent, shall, in connection with any transaction referred to in this rule, make any agreement with his customer under which such member shall be allowed to pledge or hypothecate any security involved in such transaction for any amount in excess of the indebtedness of the customer to such member.]

EXPLANATION

The provisions of Section 20 are inconsistent with Federal Reserve Board Regulation T, notwithstanding the attempted saving language in Subsection (a)(3), and are redundant with SEC Rule 15c3-3. It therefore appears appropriate to delete this section.

PROPOSED AMENDED TEXT

NASD Manual, ¶2171, p. 2095-2

Item 17 on ballot

Books and Records

Sec. 21.

Requirements

(a) Each member shall keep and preserve books, accounts, records, memoranda, and correspondence in conformity with all applicable laws, rules, regulations, and statements of policy promulgated thereunder and with the rules of this Association.

Marking of customer order tickets

(b) (i) A person associated with a member shall indicate on the memorandum for each customer order for the sale of any security whether the order is "long" or "short." An order shall be marked "long" only if (1) the customer's account is "long" the security involved or (2) the member is informed that the customer owns the security and will deliver it as soon as possible without undue inconvenience or expense.

(b) (ii) A person associated with a member shall indicate on the memorandum for each transaction in a non-NASDAQ security, as that term is defined in Schedule H to the NASD By-Laws, the name of each dealer contacted and the quotations received to determine the best inter-dealer market.

Information on accounts

(c) Each member shall maintain accounts of customers in such form and manner as to show the following information: name, address, and whether the customer is legally of age; the signature of the registered representative introducing the account and the signature of the member or the partner, of-

ficer, or manager accepting the account for the member. If the customer is associated with or employed by another member, this fact must be noted. In discretionary accounts, the member shall also record the age or approximate age and occupation of the customer [as well as the signature of each person authorized to exercise discretion in such account].

Record of written complaints

(d) Each member shall keep and preserve in each office of supervisory jurisdiction, as defined in Section 27 of these rules, either a separate file of all written complaints of customers and action taken by the member, if any, or a separate record of such complaints and a clear reference to the files containing the correspondence connected with such complaint as maintained in such office.

"Complaint" defined

(e) A "complaint" shall be deemed to mean any written statement of a customer or any person acting on behalf of a customer alleging a grievance involving the activities of those persons under the control of the member in connection with the solicitation or execution of any transaction or the disposition of securities or funds of that customer.

EXPLANATION

The Board believes the signature of the person with discretion under Subsection (c) is unnecessary on new account forms.

CURRENT TEXT

NASD Manual, ¶2172, p. 2097

Item 18 on ballot

[Disclosure of Financial Condition]

[Sec. 22.]

[(a) A member shall make available to inspection by any bona fide regular customer, upon request, the information relative to such member's financial condition as disclosed in its most recent balance sheet prepared either in accordance with such member's usual practice or as required by any state or federal securities laws, or any rule or regulation thereunder.]

[(b) As used in paragraph (a) of this rule, the term "customer" means any person who, in the regular course of such member's business, has cash or securities in the possession of such member.]

EXPLANATION

Section 22 duplicates the provisions of SEC Rule 17a-5 that require brokers and dealers to

send certain periodic financial reports to their customers. Therefore, this duplicative provision is proposed to be deleted.

CURRENT TEXT

NASD Manual, ¶2173, p. 2097

Item 19 on ballot

[Net Prices to Persons Not in Investment Banking or Securities Business]

[Sec. 23.]

[No member shall offer any security or confirm any purchase or sale of any security, from or to any person not actually engaged in the investment banking or securities business at any price which shows a concession, discount, or other allowance, but shall offer such security and confirm such purchase or sale at a net dollar or basis price.]

EXPLANATION

This provision is proposed to be deleted since the requirements of Section 23 are adequately covered by SEC Rule 10b-10.

CURRENT TEXT

NASD Manual, ¶2174, pp. 2097-2098

No Vote Required

Selling Concessions

Sec. 24.

In connection with the sale of securities which are part of a fixed price offering:

(a) A member may not grant or receive selling concessions, discounts, or other allowances except as consideration for services rendered in distribution and may not grant such concessions, discounts, or other allowances to anyone other than a broker or dealer actually engaged in the investment banking or securities business; provided, however, that nothing in this Section shall prevent any member from (1) selling any such securities to any person, or account managed by any person, to whom it has provided or will provide bona fide research, if the stated public offering price for such securities is paid by the purchaser; or (2) selling any such securities owned by him to any person at any net price which may be fixed by him unless prevented therefrom by agreement.

(b) The term "bona fide research," when used in this Section, means advice, rendered either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of

securities or purchasers or sellers of securities, or analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and performance of accounts; provided, however, that investment management or investment discretionary services are not bona fide research.

(c) A member who grants a selling concession, discount, or other allowance to another person shall obtain a written agreement from that person that he will comply with the provisions of this Section, and a member who grants such selling concession, discount, or other allowance to a non-member broker or dealer in a foreign country shall also obtain from such broker or dealer a written agreement to comply, as though such broker or dealer were a member, with the provisions of Sections 8 and 36 of this Article and to comply with Section 25 of this Article as that Section applies to a nonmember broker-dealer in a foreign country.

(d) A member who receives an order from any person designating another broker or dealer to receive credit for the sale shall, within 30 days after the end of each calendar quarter, file reports with the Association containing the following information with respect to each fixed price offering which terminated during that calendar quarter: the name of the person making the designation; the identity of the brokers or dealers designated; the identity and amount of securities for which each broker or dealer was designated; the date of the commencement and termination of the offering, and such other information as the Association shall deem pertinent.

(e) A member who is designated by its customer for the sale of securities shall keep, and maintain for a period of 24 months, records in such form and manner to show the following information: name of customer making the designation; the identity and amount of securities for which the member was designated; the identity of the manager or managers of the offering, if any; the date of the commencement of the offering, and such other information as the Association shall deem pertinent.

EXPLANATION

The Board of Governors recommends that Section 24, adopted as part of the "Papilsky" rules, remain unchanged. On January 27, 1989, the SEC approved an amendment to the Interpretation of the Board of Governors — "Bona Fide Research

Exclusion" — published in *Notice to Members* 88-72 (October 1988), which amends the exclusion from bona fide research in Section 24(b) by reference to the standard established by the SEC in Securities Exchange Act Release No. 23170 (April 30, 1986).

CURRENT TEXT

NASD Manual, ¶2175, p. 2101

Item 20 on ballot

[Dealing with Non-Members]

[Sec. 25.]

[(a) No member shall deal with any non-member broker or dealer except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public.]

[(b) Without limiting the generality of the foregoing, no member shall:]

[(1) in any transaction with any non-member broker or dealer, allow or grant to such non-member broker or dealer any commission, selling concession, discount, or other allowance allowed by such member to a member of a registered securities association, and not allowed to a member of the general public;]

[(2) join with any non-member broker or dealer in any syndicate or group contemplating the distribution to the public of any issue of securities or any part thereof; or]

[(3) sell any security to or buy any security from any non-member broker or dealer except at the same price at which at the time of such transaction such member would buy or sell such security, as the case may be, from or to a person who is a member of the general public not engaged in the investment banking or securities business.]

[Transactions with foreign non-members]

[(c) The provisions of paragraphs (a) and (b) of this rule shall not apply to any non-member broker or dealer in a foreign country who is not eligible for membership in a registered securities association, but in any transaction with any such foreign non-member broker or dealer, where a selling concession, discount, or other allowance is allowed, a member shall as a condition of such transaction secure from such foreign broker or dealer an agreement that, in making any sales to purchasers within the United States of securities acquired as a result of such transactions, he will conform to the

provisions of paragraphs (a) and (b) of this rule to the same extent as though he were a member of the Corporation.]

["Non-member broker or dealer"]

[(d) For the purpose of this rule, the term "non-member broker or dealer" shall include any broker or dealer who makes use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security, otherwise than on a national securities exchange, who is not a member of any securities association, registered with the Commission pursuant to Section 15A of the Act, except a broker or dealer who deals exclusively in commercial paper, bankers' acceptances, or commercial bills.]

[(e) Nothing in this rule shall be so construed or applied as to prevent any member of the Corporation from granting to any other member of any registered securities association any dealer's discount, allowance, commission, or special terms.]

PROPOSED NEW TEXT

Dealing with Non-Members

Sec. 25.

Prohibition

(a) No member shall deal with any non-member broker or dealer except at the same prices, for the same commissions or fees, and on the same terms and conditions as are by such member accorded to the general public.

(b) Without limiting the generality of the foregoing, no member shall:

(1) in any transaction with any non-member broker or dealer, allow or grant to such non-member broker or dealer any commission, selling concession, discount, or other allowance allowed by such member to a member of a registered securities association, and not allowed to a member of the general public, or in the case of transactions in municipal securities, allowed by such member to a municipal securities dealer which is a bank or department or division of a bank, and not allowed to a member of the general public;

(2) join with any non-member broker or dealer in any syndicate or group contemplating the public or private sale of any issue of securities or any part thereof if the member, directly or indirectly, allows or grants any commission, selling concession, discount, or other allowance to such non-member broker or dealer; or

(3) sell any security to or buy any security from any non-member broker or dealer except at the same price at which at the time of such transaction such member would buy or sell such security, as the case may be, from or to a person who is a member of the general public not engaged in the investment banking or securities business.

Transactions with foreign non-members

(c) The provisions of Subsections (a) and (b) of this rule shall not apply to any non-member broker or dealer in a foreign country who is not eligible for membership in a registered securities association because it is not a registered broker or dealer; but in any transaction with any such foreign non-member broker or dealer, where a selling concession, discount, or other allowance is allowed, a member shall, as a condition of such transaction, obtain from such foreign broker or dealer an agreement that, in making any sales to purchasers within the United States of securities acquired as a result of such transactions, it will conform to Subsections (a) and (b) hereof to the same extent as though it were a member of the Corporation.

"Non-member broker or dealer"

(d) For the purpose of this Section, the term "non-member broker or dealer" shall mean any broker or dealer, if registered or required to be registered with the Commission, or municipal securities broker or dealer (other than a bank or a department or division of a bank) who makes use of the mails or of any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security, otherwise than on a national securities exchange, who is not a member of any securities association registered with the Commission pursuant to Sections 15A and 19(a) of the Act, except a broker or dealer who deals exclusively in commercial paper, bankers' acceptances, and commercial bills. The term shall also include a broker or dealer whose registration has been and is revoked or suspended by the Commission, who has been and is expelled or suspended from membership in the Corporation, or whose registration or membership has been and is canceled by the Commission or the Corporation.

Payments to members of other registered securities associations and to bank municipal securities dealers

(e) Nothing in this Section shall be so construed or applied to prevent any member of the Corporation from granting to a member of any other registered securities association any dealer's dis-

count, allowance, commission, or special terms, nor shall this Section be construed or applied to prevent any member from granting to any municipal securities dealer, which is a bank or a division or department of a bank, any dealer's discount, allowance, commission, or special terms in connection with the purchase or sale of municipal securities.

Receipt of payments from non-member brokers or dealers or from bank municipal securities dealers

(f) Nothing in this Section shall be so construed or applied to prevent a member's receipt of commissions, concessions, discounts, or other allowances from non-member brokers or dealers, nor shall this rule be construed or applied to prevent a member's receipt of commissions, concessions, discounts, or other allowances from municipal securities dealers which are banks or departments or divisions of banks in connection with transactions in municipal securities.

EXPLANATION

The proposed changes are primarily designed to conform Section 25 to statutory amendments and SEC interpretations.

Section 15A(e) of the Securities Exchange Act of 1934 (Exchange Act) expressly authorizes the NASD to adopt a rule such as Section 25 that requires members to treat brokers and dealers that are non-members on terms and conditions no more favorable than are accorded the general public. Section 25 has existed since the NASD's inception, and the statutory language is almost identical to Subsection (a) of Section 25. The only change in the statutory language was made by the Securities Acts Amendments of 1975, which expressly authorized the NASD to apply the Section 25 restrictions to members' dealings with non-member brokers and dealers other than banks in the area of municipal securities. The remaining sections of the NASD's Rules of Fair Practice do not address members' municipal securities transactions since rulemaking authority in this area was granted to the Municipal Securities Rulemaking Board (MSRB), with the NASD having responsibility for enforcing MSRB rules.

The language added to Subsection (b)(1) of Section 25 is intended to clarify that the restrictions also apply to municipal securities. It is intended to make clear that, although a member may grant a municipal securities concession to a bank,

it is prohibited from paying the same concession to non-member brokers and dealers.

The proposed changes to Subsection (b)(2) have two purposes. In Aetna proceeding, the SEC issued an order partially abrogating Section 25 and, in particular, Subsection (b)(2). (See 44 S.E.C. 896 (1972).) The SEC found that the statutory provision authorizing Section 25 did not allow the NASD to construe it to prevent member dealers in a public offering from receiving selling concessions from a non-member underwriter. The SEC also held that the NASD could not apply Section 25 to prevent a member and non-member broker or dealer from participating in a "parallel distribution" if the issuer makes separate commission payments to a member and a non-member. (Plaza Securities, 45 S.E.C. 449 (1974).) The added language at the end of the subsection is intended to codify this construction. The other language changes are intended to eliminate any misunderstanding that Section 25 does not apply to private placements.

The changes in Subsection (c) are designed to conform the provision to the current statutory requirements with respect to eligibility for membership and to eliminate an anomaly created by a construction of the NASD By-Laws that has not been followed for many years. The 1975 Securities Acts Amendments amended Section 15A(b)(3) of the Exchange Act to provide that, unless there is a bar or other statutory disqualification or failure to satisfy examination or other qualification requirements, the NASD must admit to membership any broker or dealer that is registered with the SEC. The statutory language thus eliminates an older provision authorizing the NASD to restrict membership on a geographic basis.

The new language of Subsection (c) simply codifies the statutory provisions. It also clarifies that if a registered foreign broker or dealer is ineligible for reasons apart from registration (for example, a failure to pass qualification examinations), the broker-dealer shall be treated the same way as a non-member United States broker-dealer must be treated.

As originally proposed, Section 25 would have deleted existing language requiring that, in making sales to a foreign broker-dealer that is a non-member, a member must obtain an agreement that such foreign non-member broker-dealer, in

making resales to purchasers in the United States, will agree to comply with Subsections (a) and (b) as if it were a member. The Board of Governors decided to retain this requirement in Section 25 to prevent evasion if a member should allow a concession to a foreign broker or dealer that, in turn, could re-allow such concession to a non-member registered broker or dealer.

The added language at the beginning of Subsection (d) that defines the term "non-member broker or dealer" is intended to clarify that it has been construed to cover unregistered firms which are ". . . required to be registered . . ." and are, therefore, conducting an unlawful broker-dealer business. In December 1983, amendments to the Exchange Act became effective that rescinded the SECO program regulating registered non-member brokers and dealers. Thereafter, all registered brokers and dealers were required to become NASD members, except certain exchange members with gross annual income from over-the-counter transactions of under \$1,000. Therefore, it appears that the primary effect of the first sentence of Subsection (d) should be with respect to dealings with unregistered brokers and dealers. The existence of brokers and dealers that should be registered does not appear to be an isolated problem. The NASD staff is aware of situations — such as investment advisers receiving transaction-related compensation, purchaser representatives whose fees appear to be based on the amount purchased by an investor rather than being related to the evaluative effort, finders who receive fees from issuers for referring investors, and real estate and other syndicators who continuously engage in sales of limited partnerships — sometimes acquiring a sales force for this sole purpose.

A new sentence has been added to expressly state that a revoked or suspended member is a non-member broker or dealer during the period of the revocation or suspension penalty. This position is currently stated in the Board of Governors' Interpretation following Section 25.

The added language at the end of Subsection (e) and a part of the language added at the beginning of Subsection (d) is intended to conform to Section 15A(e)(3)(B) of the Exchange Act, added by the 1975 Securities Acts Amendments, prohibiting the NASD from applying Section 25 to prevent members from granting discounts, allowances, or special terms to municipal securities

dealers that are banks, or divisions or departments of banks, in connection with transactions in municipal securities.

Subsection (f) is entirely new and codifies the SEC's partial abolition of Section 25 in the Aetna proceeding. The new language also codifies Section 15A(e)(3)(B) of the Exchange Act, which prohibits the NASD from applying Section 25 to prevent members from receiving discounts, allowances, or special terms from municipal securities dealers, which are banks, or divisions or departments of banks, in connection with transactions in municipal securities.

PROPOSED AMENDED TEXT

NASD Manual, ¶2176, pp. 2105-3 — 2106

Item 21 on ballot

Investment Companies

Sec. 26.

Application

(a) This section shall apply exclusively to the activities of members in connection with the securities of companies registered under the Investment Company Act of 1940; provided, however, that Section 29 of this Article shall apply, in lieu of this Section, to members' activities in connection with "variable contracts" as defined therein.

Definitions

(b) (1) The terms "underwriter," "principal underwriter," "redeemable security," "periodic payment plan," "open-end management investment company," and "unit investment trust" shall have the same definitions used in the Investment Company Act of 1940.

(2) "Public offering price" shall mean a public offering price as set forth in the prospectus of the issuing company.

(3) "Rights of accumulation," as used in Subsection (d) of this Section, shall mean a scale of reducing sales charges in which the sales charge applicable to the securities being purchased is based upon the aggregate quantity of securities previously purchased or acquired and then owned plus the securities being purchased. The quantity of securities owned shall be based upon:

(A) The current value of such securities (measured by either net asset value or maximum offering price); or

(B) Total purchases of such securities at actual offering prices; or

(C) The higher of the current value or

the total purchases of such securities. The quantity of securities owned may also include redeemable securities of other registered investment companies having the same principal underwriter.

(4) "Any person" shall mean "any person" as defined in Subsection (a), or "purchaser" as defined in Subsection (b), of Rule 22d-1 under the Investment Company Act of 1940.

(5) "Covered account," as used in subsection (k) of this Section, shall mean (A) any other investment company or other account managed by the investment adviser of such investment company, or (B) any other account from which brokerage commissions are received or expected as a result of the request or direction of any principal underwriter of such investment company or of any affiliated person (as defined in the Investment Company Act of 1940) of such investment company or of such underwriter, or of any affiliated person of such investment company.

(6) "Brokerage commissions," as used in Subsection (k) of this Section, shall not be limited to commissions on agency transactions but shall include underwriting discounts or concessions and fees paid to members in connection with tender offers.

(7) "Associated person of an underwriter," as used in Subsection (1) of this Section, shall include an issuer for which an underwriter is the sponsor or a principal underwriter, any investment adviser to such issuer, or any affiliated person (as defined in Section 2(a)(3) of the Investment Company Act of 1940) of such underwriter, issuer, or investment adviser.

Conditions for discounts to dealers

(c) No member who is an underwriter of the securities of an investment company shall sell any such security to any dealer or broker at any price other than a public offering price unless such sale is in conformance with Section 25 of this Article and, if the security is issued by an open-end management company or by a unit investment trust which invests primarily in securities issued by other investment companies, unless a sales agreement is in effect between the parties as of the date of the transaction, which agreement shall set forth the concessions to be received by the dealer or broker.

Sales charge

(d) No member shall offer or sell the shares of any open-end investment company or any "single

payment" investment plan issued by a unit investment trust registered under the Investment Company Act of 1940 if the public offering price includes a sales charge which is excessive, taking into consideration all relevant circumstances. Sales charges shall be deemed excessive if they do not conform to the following provisions:

(1) The maximum sales charge on any transaction shall not exceed 8.5% of offering price.

(2)(A) Dividend reinvestment shall be made available at net asset value per share to "any person" who requests such reinvestment at least 10 days prior to the record date, subject only to the right to limit the availability of dividend reinvestment to holders of securities of a stated minimum value, not greater than \$1,200.

(B) If dividend reinvestment is not made available on terms at least as favorable as those specified in subparagraph (2)(A), the maximum sales charge on any transaction shall not exceed 7.25% of offering price.

(3) (A) Rights of accumulation (cumulative quantity discounts) shall be made available to "any person" for a period of not less than 10 years from the date of first purchase in accordance with one of the alternative quantity discount schedules provided in subparagraph (4)(A) below, as in effect on the date the right is exercised.

(B) If rights of accumulation are not made available on terms at least as favorable as those specified in subparagraph (3)(A), the maximum sales charge on any transaction shall not exceed:

- (i) 8.0% of offering price if the provisions of subparagraph (2)(A) are met; or
- (ii) 6.75% of offering price if the provisions of subparagraph (2)(A) are not met.

(4)(A) Quantity discounts shall be made available on single purchases by "any person" in accordance with one of the following two alternatives:

- (i) A maximum sales charge of 7.75% on purchases of \$10,000 or more and a maximum sales charge of 6.25% on purchases of \$25,000 or more; or
- (ii) A maximum sales charge of 7.50% on purchases of \$15,000 or more and a maximum sales charge of 6.25% on purchases of \$25,000 or more.

(B) If quantity discounts are not made available on terms at least as favorable as those specified in subparagraph (4)(A), the maximum

sales charge on any transaction shall not exceed:

- (i) 7.75% of offering price if the provisions of subparagraph (2)(A) and (3)(A) are met;
- (ii) 7.25% of offering price if the provisions of subparagraph (2)(A) are met but the provisions of subparagraph (3)(A) are not met;
- (iii) 6.50% of offering price if the provisions of subparagraph (3)(A) are met but the provisions of subparagraph (2)(A) are not met;
- (iv) 6.25% of offering price if the provisions of subparagraph (2)(A) and (3)(A) are not met.

Selling dividends

(e) No member shall, in recommending the purchase of investment company securities, state or imply that the purchase of such securities shortly before an ex-dividend date is advantageous to the purchaser, unless there are specific, clearly described tax or other advantages to the purchaser, and no member shall represent that distributions of long-term capital gains by an investment company are or should be viewed as part of the income yield from an investment in such company's securities.

Withhold orders

(f) No member shall withhold placing customers' orders for any investment company security so as to profit himself as a result of such withholding.

Purchase For Existing Orders

(g) No member shall purchase from an underwriter the securities of any open-end investment company, and no member who is an underwriter of such securities shall purchase such securities from the issuer, except (1) for the purpose of covering purchase orders previously received or (2) for its own investment. Nothing herein shall be deemed to prohibit any member from purchasing securities of any investment company specifically designed for short-term investment (e.g., money market fund).

Refund of sales charge

(h) If any security issued by an open-end management investment company is repurchased by the issuer, or by the underwriter for the account of the issuer, or is tendered for redemption within seven business days after the date of the transaction: (1) the dealer or broker shall forthwith refund to the underwriter the full concession allowed to the dealer or broker on the original sale and (2) the underwriter shall forthwith pay to the issuer the underwriter's share of the sales charge on the

original sale by the underwriter and shall also pay to the issuer the refund which he receives under clause (1) when he receives it. The dealer or broker shall be notified by the underwriter of such repurchase or redemption within 10 days of the date on which the certificate or written request for redemption is delivered to the underwriter or issuer. If the original sale was made directly to the investor by the principal underwriter, the entire sales charge shall be paid to the issuer by the principal underwriter.

Purchases as principal

(i) No member who is a party to a sales agreement referred to in Subsection (c) shall, as principal, purchase any security issued by an open-end management investment company or unit investment trust from a record holder at a price lower than the bid price next quoted by or for the issuer.

Repurchase from dealer

(j) No member who is a principal underwriter of a security issued by an open-end management investment company shall repurchase such security, either as principal or as agent for the issuer, from a dealer acting as principal who is not a party to a sales agreement with a principal underwriter, nor from any investor, unless such dealer or investor is the record owner of the security so tendered for repurchase. No member who is a principal underwriter shall participate in the offering or in the sale of any such security if the issuer voluntarily redeems or repurchases its securities from a dealer acting as principal who is not a party to such a sales agreement nor from any investor, unless such dealer or investor is the record owner of the security so tendered for repurchase. Nothing in this subsection shall relate to compulsory redemption of any security upon presentation to the issuer pursuant to the terms of the security. Nothing in this subsection shall prevent any member, whether or not a party to a sales agreement, from selling any such security for the account of a record owner to the underwriter or issuer at the bid price next quoted by or for the issuer and charging the investor a reasonable charge for handling the transaction, provided that such member discloses to such record owner that direct redemption of the security can be accomplished by the record owner without incurring such charges.

Execution of investment company portfolio transactions

(k) (1) No member shall, directly or indirectly,

favor or disfavor the sale or distribution of shares of any particular investment company or group of investment companies on the basis of brokerage commissions received or expected by such member from any source, including such investment company, or any covered account.

(2) No member shall, directly or indirectly, demand or require brokerage commissions or solicit a promise of such commissions from any source as a condition to the sale or distribution of shares of an investment company.

(3) No member shall, directly or indirectly, offer or promise to another member, brokerage commissions from any source as a condition to the sale or distribution of shares of an investment company, and no member shall request or arrange for the direction to any member of a specific amount or percentage of brokerage commissions conditioned upon that member's sales or promise of sales of shares of an investment company.

(4) No member shall circulate any information regarding the amount or level of brokerage commissions received by the member from any investment company or covered account to other than management personnel who are required, in the overall management of the member's business, to have access to such information.

(5) No member shall, with respect to such member's activities as an underwriter of investment company shares, suggest, encourage, or sponsor any incentive campaign or special sales effort of another member with respect to the shares of any investment company which incentive or sales effort is, to the knowledge or understanding of such underwriter-member, to be based upon, or financed by, brokerage commissions directed or arranged by the underwriter-member.

(6) No member shall, with respect to such member's retail sales or distribution of investment company shares:

(A) provide to salesmen, branch managers, or other sales personnel any incentive or additional compensation for the sale of shares of specific investment companies based on the amount of brokerage commissions received or expected from any source, including such investment companies or any covered account. Included in this prohibition are bonuses, preferred compensation lists, sales incentive campaigns or contests, or any other method of compensation which provides an incentive to sales personnel to favor or disfavor any investment

company or group of investment companies based on brokerage commissions;

(B) recommend specific investment companies to sales personnel, or establish "recommended," "selected," or "preferred" lists of investment companies, regardless of the existence of any special compensation or incentives to favor or disfavor the shares of such company or companies in sales efforts, if such companies are recommended or selected on the basis of brokerage commissions received or expected from any source;

(C) grant to salesmen, branch managers, or other sales personnel any participation in brokerage commissions received by such member from portfolio transactions of an investment company whose shares are sold by such member, or from any covered account, if such commissions are directed by, or identified with, such investment company or any covered account; or

(D) use sales of shares of any investment company as a factor in negotiating the price of, or the amount of brokerage commissions to be paid on, a portfolio transaction of an investment company or of any covered account, whether such transaction is executed in the over-the-counter market or elsewhere.

(7) Provided that the member does not violate any of the specific provisions of this Subsection (k), nothing herein shall be deemed to prohibit:

(A) the execution of portfolio transactions of any investment company or covered account by members who also sell shares of the investment company;

(B) a member from selling shares of, or acting as underwriter for, an investment company which follows a policy, disclosed in its prospectus, of considering sales of shares of the investment company as a factor in the selection of broker-dealers to execute portfolio transactions, subject to the requirements of best execution;

(C) a member from compensating its salesmen and managers based on total sales of investment company shares attributable to such salesmen or managers, whether by use or overrides, accounting credits, or other compensation methods, provided that such compensation is not designed to favor or disfavor sales of shares of particular investment companies on a basis prohibited by this Subsection (k).

Dealer concessions

(1) (1) No underwriter or associated person of an underwriter shall offer, pay, or arrange for the offer or payment to any other member, in connection with retail sales or distribution of investment company securities, any discount, concession, fee, or commission (hereinafter referred to as "concession") which:

(A) is in the form of securities of any kind, including stock, warrants, or options;

(B) is in a form other than cash (e.g., merchandise or trips), unless the member earning the concession may elect to receive cash at the equivalent of no less than the underwriter's cost of providing the non-cash concession; or

(C) is not disclosed in the prospectus of the investment company. If the concessions are not uniformly paid to all dealers purchasing the same dollar amounts of securities from the underwriter, the disclosure shall include a description of the circumstances of any general variations from the standard schedule of concessions. If special compensation arrangements have been made with individual dealers, which arrangements are not generally available to all dealers, the details of the arrangements, and the identities of the dealers, shall also be disclosed.

(2) No underwriter or associated person of an underwriter shall offer or pay any concession to an associated person of another member, but shall make such payment only to the member.

(3) (A) In connection with retail sales or distribution of investment company shares, no underwriter or associated person of an underwriter shall offer or pay to any member or associated person, anything of material value, and no member or associated person shall solicit or accept anything of material value, in addition to the concessions disclosed in the prospectus.

(B) For purposes of this paragraph (1)(3), items of material value shall include but not be limited to:

(i) gifts amounting in value to more than [\$50] \$100 per person per year.

(ii) gifts or payments of any kind which are conditioned on the sale of investment company securities.

(iii) loans made or guaranteed to a non-controlled member or person associated with a member.

(iv) wholesale overrides (commissions)

granted to a member on its own retail sales unless the arrangement, as well as the identity of the member, is set forth in the prospectus of the investment company.

(v) payment or reimbursement of travel expenses, including overnight lodging, in excess of [\$50] \$100 per person per year unless such payment or reimbursement is in connection with a business meeting, conference or seminar held by an underwriter for informational purposes relative to the fund or funds of its sponsorship and is not conditioned on sales of shares of an investment company. A meeting, conference, or seminar shall not be deemed to be of a business nature unless: the person to whom payment or reimbursement is made is personally present at, or is en route to or from such meeting in each of the days for which payment or reimbursement is made; the person on whose behalf payment or reimbursement is made is engaged in the securities business; and the location and facilities provided are appropriate to the purpose, which would ordinarily mean the sponsor's office.

(C) For purposes of this paragraph (1)(3), items of material value shall not include:

(i) an occasional dinner, a ticket to a sporting event or the theatre, or comparable entertainment of one or more registered representatives which is not conditioned on sales of shares of an investment company and is neither so frequent nor so extensive as to raise any question of propriety.

(ii) a breakfast, luncheon, dinner, reception, or cocktail party given for a group of registered representatives in conjunction with a bona fide business or sales meeting, whether at the headquarters of a fund or its underwriter or in some other city.

(iii) an unconditioned gift of a typical item of reminder advertising, such as a ballpoint pen with the name of the advertiser inscribed, a calendar pad, or other gifts amounting in value to not more than [\$50] \$100 per person per year.

(4) The provisions of this Subsection (1) shall not apply to:

(A) Contracts between principal underwriters of the same security.

(B) Contracts between the principal underwriter of a security and the sponsor of a unit investment trust which utilizes such security as its underlying investment.

(C) Compensation arrangements of an under-

writer or sponsor with its own sales personnel.

Prompt Payment for Investment Company Shares

(m)(1) Members (including underwriters) that engage in direct retail transactions for investment company shares shall transmit payments received from customers for such shares, which such members have sold to customers, to payees (i.e., underwriters, investment companies, or their designated agents) by (1) the end of the fifth business day following receipt of a customer's order to purchase such shares or by (2) the end of one business day following receipt of a customer's payment for such shares, whichever is the later date.

(2) Members that are underwriters and that engage in wholesale transactions for investment company shares shall transmit payments for investment company shares, which such members have received from other members, to investment company issuers or their designated agents by the end of two business days following receipt of such payments.

EXPLANATION

No comments were received on Section 26 as originally proposed. The Board of Governors recommends that the section be approved without change, except to raise the minimum permissible gift amounts from \$50 to \$100 in Subsection (1).

Subsequent to the time the proposed amendments herein were circulated for comment, a new Subsection (m) was approved by the SEC with respect to prompt payment for investment company shares.

CURRENT TEXT

NASD Manual, ¶2177, pp. 2107-2108

No Vote Required

Supervision

Sec. 27.

Supervisory System

(a) Each member shall establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the rules of this Association. Final responsibility for proper supervision shall rest with the member. A member's supervisory system shall provide, at a minimum, for the following:

(1) The establishment and maintenance of written procedures as required by paragraphs (b)

and (c) of this Section.

(2) The designation, where applicable, of an appropriately registered principal(s) with authority to carry out the supervisory responsibilities of the member for each type of business in which it engages for which registration as a broker-dealer is required.

(3) The designation as an office of supervisory jurisdiction (OSJ) of each location that meets the definition contained in paragraph (f) of this Section. Each member shall also designate such other OSJs as it determines to be necessary in order to supervise its registered representatives and associated persons in accordance with the standards set forth in this Section, taking into consideration the following factors:

(i) whether registered persons at the location engage in retail sales or other activities involving regular contact with public customers;

(ii) whether a substantial number of registered persons conduct securities activities at, or are otherwise supervised from, such location;

(iii) whether the location is geographically distant from another OSJ of the firm;

(iv) whether the member's registered persons are geographically dispersed; and

(v) whether the securities activities at such location are diverse and/or complex.

(4) The designation of one or more appropriately registered principals in each OSJ, including the main office, and one or more appropriately registered representatives or principals in each non-OSJ branch office with authority to carry out the supervisory responsibilities assigned to that office by the member.

(5) The assignment of each registered person to an appropriately registered representative(s) and/or principal(s) who shall be responsible for supervising that person's activities.

(6) Reasonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities.

(7) The participation of each registered representative, either individually or collectively, no less than annually, in an interview or meeting conducted by persons designated by the member at which compliance matters relevant to the activities of the representative(s) are discussed. Such interview or meeting may occur in conjunction with

the discussion of other matters and may be conducted at a central or regional location or at the representative's (') place of business.

(8) Each member shall designate and specifically identify to the Association one or more principals who shall review the supervisory system, procedures, and inspections implemented by the member as required by this Section and who shall take or recommend to senior management appropriate action reasonably designed to achieve the member's compliance with applicable securities laws and regulations, and with the rules of this Association.

Written procedures

(b)(1) Each member shall establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives and associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable rules of this Association.

(2) The member's written supervisory procedures shall set forth the supervisory system established by the member pursuant to Section 27(a) above, and shall include the titles, registration status, and locations of the required supervisory personnel and the responsibilities of each supervisory person as these relate to the types of business engaged in, applicable securities laws and regulations, and the rules of this Association. The member shall maintain on an internal record the names of all persons who are designated as supervisory personnel and the dates for which such designation is or was effective. Such record shall be preserved by the member for a period of not less than three years, the first two years in an easily accessible place.

(3) A copy of a member's written supervisory procedures, or the relevant portions thereof, shall be kept and maintained in each OSJ and at each location where supervisory activities are conducted on behalf of the member. Each member shall amend its written supervisory procedures as appropriate within a reasonable time after changes occur in applicable securities laws and regulations, including the rules of this Association, and as changes occur in its supervisory system, and each member shall be responsible for communicating amendments through its organization.

Internal inspections

(c) Each member shall conduct a review, at least annually, of the business in which it engages, which review shall be reasonably designed to assist in detecting and preventing violations of and achieving compliance with applicable securities laws and regulations, and with the rules of this Association. Each member shall review the activities of each office, which shall include the periodic examination of customer accounts to detect and prevent irregularities or abuses and at least an annual inspection of each office of supervisory jurisdiction. Each branch office of the member shall be inspected according to a cycle which shall be set forth in the firm's written supervisory and inspection procedures. In establishing such cycle, the firm shall give consideration to the nature and complexity of the securities activities for which the location is responsible, the volume of business done, and the number of associated persons assigned to the location. Each member shall retain a written record of the dates upon which each review and inspection is conducted.

Written approval

(d) Each member shall establish procedures for the review and endorsement by a registered principal in writing, on an internal record, of all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction.

Qualifications investigated

(e) Each member shall have the responsibility and duty to ascertain by investigation the good character, business repute, qualifications, and experience of any person prior to making such a certification in the application of such person for registration with this Association.

Definitions

(f)(1) "Office of Supervisory Jurisdiction" means any office of a member at which any one or more of the following functions take place:

- (i) order execution and/or market making;
- (ii) structuring of public offerings or private placements;
- (iii) maintaining custody of customers' funds and/or securities;
- (iv) final acceptance (approval) of new accounts on behalf of the member;
- (v) review and endorsement of customer orders, pursuant to paragraph (d) above;

(vi) final approval of advertising or sales literature for use by persons associated with the member, pursuant to Article III, Section 35 (b)(1) of the Rules of Fair Practice; or

(vii) responsibility for supervising the activities of persons associated with the member at one or more other branch offices of the member.

(f)(2) "Branch Office" means any location identified by any means to the public or customers as a location at which the member conducts an investment banking or securities business, excluding any location identified solely in a telephone directory listing or on a business card or letterhead, which listing, card, or letterhead also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch location are directly supervised.

EXPLANATION

No change is being proposed to this section.

PROPOSED AMENDED TEXT

NASD Manual, ¶2178, pp. 2110-2111

Item 22 on ballot

**Transactions For Personnel of Another Member
Sec. 28.**

[Determine adverse interest]

[(a) A member ("executing member") who knowingly executes a transaction for the purchase or sale of a security for the account of a person associated with another member ("employer member"), or for any account over which such associated person has discretionary authority, shall use reasonable diligence to determine that the execution of such transaction will not adversely affect the interests of the employer member.]

Obligations of executing member

[(b)](a) Where [an] a member ("executing member") knows that a person associated with [an] another member ("employer member") has or will have a financial interest in, or discretionary authority over, any existing or proposed account carried by the executing member, the executing member shall:

(1) notify the employer member in writing, prior to the execution of a transaction for such account, of the executing member's intention to open or maintain such an account;

(2) [upon written request by the employer member,] transmit duplicate copies of confirmations,

statements, or other information with respect to such account; and

(3) notify the person associated with the employer member of the executing member's intention to transmit the information required by paragraphs (1) and (2) of this Subsection [(b)] (a).
Obligations of associated persons concerning an account with a member

[(c)](b) A person associated with a member who opens an account or places an order for the purchase or sale of securities with another member, shall notify the executing member of his or her association with the employer member, provided, however, that if the account was established prior to the association of the person with the employer member, the associated person shall notify the executing member promptly after becoming so associated.

Obligations of associated persons concerning an account with an investment adviser, bank, or other financial institution

[(d)](c) A person associated with a member who opens a securities account or places an order for the purchase or sale of securities with a domestic or foreign investment adviser, bank, or other financial institution, except a member, shall:

(1) notify his or her employer member in writing, prior to the execution of any initial transactions, of the intention to open the account or place the order; and

(2) upon written request by the employer member, request in writing and assure that the investment adviser, bank, or other financial institution provides the employer member with duplicate copies of confirmations, statements, or other information concerning the account or order; provided, however, that if an account subject to this Subsection [(d)] (c) was established prior to a person's association with a member, the person shall comply with this subsection promptly after becoming so associated.

[(e)](d) Subsections [(c)] (b) and [(d)](c) of this section shall apply only to an account or order in which an associated person has a financial interest or with respect to which such person has discretionary authority.
Exemption for transactions in investment company shares and unit investment trusts

[(f)](e) The provisions of this Section shall not be applicable to transactions in unit investment trusts and variable contracts or redeemable securities of companies registered under the Investment Company Act of 1940, as amended, or to accounts which are limited to transactions in such securities.

EXPLANATION

Subsequent to the time the proposed amendments were circulated for comment, Section 28 was amended to include certain changes that already are effective and reflected in the language of the section published in the NASD Manual and reproduced above. The proposed amendments would further change Section 28 to eliminate Subsection (a). The Board of Governors believes that the current requirement that an executing member affirmatively determine whether a particular trans-

action may adversely affect the interests of the employer member is unnecessary. The employer member's interests appear adequately protected by the requirements of existing Subsection (b) that state the employer member be notified by the executing member. The Board believes that the protection given the employer member should be strengthened by amending existing Subsection (b)(2) to require that copies of all confirmations be sent to the employer member, regardless of whether they are requested by the employer member.