

ALERT

Levies \$500,000 in Fines

NASD Suspends And Bars for Penny-Stock Fraud

The NASD has taken disciplinary actions against Sheldon D. Kanoff, former President of F. D. Roberts Securities, Inc.; Alan Lieb, former Vice President; Frederick Galiardo, former Chairman of the Board; Robert Humphrey, former national sales manager, and Brett A. Bernstein, a former registered representative. The disciplinary action is based on an investigation into the price manipulation and fraudulent markups in sales to customers of a "penny stock," Frankel Capital Management, Inc.

F. D. Roberts Securities, Inc., was a Paramus, New Jersey-based broker-dealer that specialized in low-priced speculative securities, primarily penny stocks. On February 16, 1989, the firm ceased conducting a securities business and subsequently filed for bankruptcy.

Pursuant to their Offer of Settlement, without admitting or denying the allegations of the Complaint filed against them, these officers and employees of Roberts consented to certain findings and agreed to the following sanctions:

■ **Alan Lieb** - former Vice President, Director and shareholder of F. D. Roberts Securities: a bar from association with any NASD member in any capacity with the proviso that he may make application to become associated with an NASD member after a period of five years, a \$150,000 fine, and censure.

■ **Sheldon D. Kanoff** - former President, Director, and shareholder of F. D. Roberts Securities: a bar

from association with any NASD member in any capacity with the proviso that he may make application to become associated with an NASD member after a period of five years, a \$125,000 fine, and censure.

■ **Frederick Galiardo** - former Chairman of the Board and shareholder of F. D. Roberts Securities: a bar from association with any NASD member in any capacity with the proviso that he may make application to become associated with an NASD member after a period of five years, a \$100,000 fine, and censure.

■ **Robert Humphrey** - former national sales manager of F. D. Roberts Securities: censure, a suspension for three years from association in all capacities with any NASD member, a \$50,000 fine, and a requirement to submit proof of restitution in an amount not less than \$125,000 before becoming associated with an NASD member.

■ **Brett A. Bernstein** - former

registered representative of F. D. Roberts Securities: censure, a suspension for three years from association in all capacities with any NASD member, and a \$75,000 fine.

Lieb, Humphrey, and Bernstein consented to findings that they violated the NASD's Anti-Fraud rule, which prohibits the use of any manipulative, deceptive, or other fraudulent device in the purchase or sale of any security. Lieb also was found to have violated the NASD's markup policy.

Kanoff and Galiardo consented to findings that they failed to properly supervise, and Kanoff consented to recordkeeping violations.

F. D. Roberts Securities was the sole underwriter for the initial public offering of Frankel Capital Management, Inc., in January 1987, at a price of three cents a unit. Following the public offering, the securities of Frankel were traded in the non-NASDAQ over-the-counter market.

The NASD's investigation determined that Lieb and others, aided and abetted by Bernstein, Humphrey, and others, effected

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transactions in Frankel and induced the purchase and sale of such securities by means of manipulative, deceptive, and other fraudulent devices and contrivances. As part of such fraudulent conduct, the NASD found that these individuals through Roberts had dominated and controlled the trading in Frankel and initiated trading in Frankel by selling units to customers at 15 cents per unit, which represented an arbitrary increase of 400 percent over the public offering price.

Lieb and others also were found to have engaged in a course of conduct that operated as a fraud on purchasers of Frankel in that they charged fraudulently excessive markups in principal sales to customers.

In the 1,507 transactions in Frankel included in the NASD's disciplinary action, customers who

bought stock from Roberts' inventory were charged fraudulent markups ranging from 25 percent to 107 percent over the prevailing market price, resulting in excess profits to Roberts of at least \$500,000.

The action also contained findings that Humphrey, Bernstein, and others failed to make a bona fide public distribution of the Frankel offering by selling to restricted accounts, in contravention of NASD rules.

In addition, Kanoff failed to properly maintain required books and records relating to the Frankel underwriting and certain of these restricted accounts.

During the period of the NASD's investigation, Kanoff and Galiardo, were found to have failed to properly supervise the activities of Lieb, Humphrey, Bernstein, and others. These activities contributed to

the price manipulation of Frankel, the fraudulent markups, and other misconduct. In addition to conducting its own investigations, the NASD routinely cooperates with other self-regulatory organizations, the SEC, and governmental law enforcement agencies.

In this regard, the NASD cooperated with the Office of the U.S. Attorney for the District of New Jersey in its investigation that resulted in criminal action relating to Roberts. In addition, the NASD worked with the Bureau of Securities of the State of New Jersey.

The NASD intends to continue cooperating with, and providing assistance to, federal and state securities authorities as part of its efforts to vigorously enforce the securities laws, particularly with regard to fraud and other serious sales practice abuses in penny stocks.

Levies Fines of Nearly \$250,000

NASD Expels Member for Engaging in "Deceptive, Dishonest" Practices in High-Yield Revenue Bonds

The NASD has expelled Buchanan & Co., Inc., of Jackson, Mississippi, from membership and taken disciplinary actions against two senior officers, five branch managers, and six salesmen of the firm.

In their Offers of Settlement, without admitting or denying the allegations of the NASD Complaints, the firm and the individuals consented to findings that they engaged in deceptive, dishonest, or unfair practices in connection with the underwriting and/or retail placement of high-yield, nonrated nursing home and retirement center revenue bonds.

These actions violated rules of the Municipal Securities Rulemaking Board (MSRB).

In announcing its action, the NASD acknowledged the substantial assistance of Peyton D. Prospere, Commissioner of Securities of the State of Mississippi, and the staff of the state's Securities Division.

"The development of this case

has been a fine example of the continuing cooperation between state authorities and the NASD in detecting and penalizing violations of the rules governing the securities markets," said John E. Pinto, NASD Executive Vice President for Compliance.

The NASD District 5 Business Conduct Committee found that Robert M. Buchanan, Jr., the Chairman and sole stockholder of the firm, and Robert C. Fairly, Jr., the President, were responsible for the dissemination of material misrepresentations and for omissions of facts in connection with the sale to the public of 10 municipal bond issues, with a total face amount of \$74,470,000, that were underwritten by Buchanan & Co.

Among the matters misrepresented or undisclosed were:

- The lack of occupancy and financial difficulties besetting a number of other retirement centers/nursing homes that had securities under-

written by the firm;

- The failure to obtain the necessary regulatory approval for certain of the projects;

- The failure independently to verify the financial ability of the general partners to comply with promised financial commitments; and,

- The unreliability of the financial feasibility studies.

Buchanan and Fairly also failed to disclose an adverse evaluation of one of the proposed retirement centers by a national accounting firm and proceeded with another project even though two of its developers had been indicted for fraud, and one of them had already been convicted of a similar charge. All 10 of the municipal bond issues ultimately went into default.

The NASD also found that the firm, acting through Buchanan and Fairly, orchestrated a high-pressure, misleading retail sales campaign for these bonds, as well as for other high-

yield, nonrated bonds.

These bonds were sold at complimentary breakfast, luncheon, and dinner seminars held in retirement areas such as Tucson, Arizona, and Tampa, Florida, to investors, most of whom lived on fixed incomes.

Buchanan and Fairly caused their salesmen to misrepresent the nature and risks of these nonrated bonds, and the firm's past record in these issues. Buchanan was censured, fined \$200,000, and suspended for two years in all capacities.

Furthermore, he was prohibited, with certain exceptions, from maintaining any proprietary interest in any member of the Association, and was barred from holding any securities licenses other than those governing investment company products, variable contracts, and direct participation programs.

Fairly was censured, fined \$20,000, suspended in all capacities for one year, and suspended in all principal capacities for five years. Both Buchanan and Fairly must requalify by passing the appropriate examinations before serving in any limited capacity.

Jonathan D. Ulrich, a salesman

in the Tucson, Arizona, branch office and subsequently the branch manager of the Jackson, Mississippi, office, was censured, fined \$10,000, and barred in all capacities. Russell W. Clark, a salesman in the Tucson, Arizona, branch office was censured, fined \$7,500, and barred in all capacities.

Ulrich and Clark may, within one year, apply to remove the bars, if they can demonstrate that certain arbitration awards rendered against them have been paid. Murl D. Calton, the branch manager of the Tucson, Arizona, office, was censured and suspended for one month in all principal capacities. Jeffrey D. Rhodes, the Houston, Texas, branch office manager, was censured, fined \$1,000, and suspended for two weeks in all principal capacities.

Kenneth C. Weber, a salesman in the Tucson, Arizona, branch office and at one time the Houston, Texas, branch office manager, was censured, fined \$1,000, suspended for one week in all capacities, and ordered to requalify by passing the appropriate examination. Mary S. Nelson, the manager of the Boca Raton, Florida, branch office and subsequently a

saleswoman in the Tampa, Florida, branch office, was censured, fined \$1,000, and suspended for one business day in all capacities.

Kenneth E. Crowl, a salesman and the assistant manager of the Phoenix, Arizona, branch office, was censured, fined \$1,000, and suspended for one month in all capacities. Randall J. Whyte, a salesman in the Tucson, Arizona, branch office, was censured, fined \$2,500, and suspended for one week in all capacities. Lorin W. Surpless, a salesman in the Tucson, Arizona, branch office, was censured, fined \$1,000, and suspended for one week in all capacities.

Gerard P. Musto, a salesman in the Tampa, Florida, branch office, was censured, fined \$1,000, and suspended for one business day in all capacities.

William B. Nelson, a salesman in the Boca Raton, Florida, branch office, was censured, fined \$1,000, and suspended for one business day in all capacities.

The bars became effective June 7, 1989, and the suspensions commenced with the opening of business June 23, 1989.

NASD Suspends and Fines Three Individuals For Fraudulent Markdowns and Other Misconduct

The NASD has taken disciplinary action against Mark G. Ross, Marc J. Rothenberg, and Donna L. Morris for excess markdowns and other fraudulent conduct concerning the common stock of Business Computing International, Inc. (BCII), a low-priced security that formerly traded on NASDAQ.

The violations were committed while these individuals were associated with E. C. Farnsworth & Co., Inc., a former member of the NASD. All three are currently registered and active with other NASD members.

Pursuant to their Offers of Settlement, without admitting or denying the allegations of the Complaint, Ross and Rothenberg were censured and fined \$100,000, jointly and

severally. Ross was suspended from association with any member in any capacity for 60 calendar days.

Rothenberg was suspended from association with any member in any capacity for 30 calendar days and thereafter suspended for an additional 60 calendar days from determining (or supervising the determination of) markups or markdowns.

Morris was censured, fined \$10,000, and suspended from association with any member in certain capacities for 30 calendar days.

The NASD Market Surveillance Committee found that the three respondents violated Article III, Sections 1 and 18 of the Association's Rules of Fair Practice. Section 18 is the NASD's anti-fraud provision, which prohibits the use of any

manipulative, deceptive, or other fraudulent device in the purchase or sale of any security.

The Committee also found that Ross and Rothenberg violated Article III, Section 4 of the Rules of Fair Practice and that Ross and Morris violated Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-6, as well as Section 17(a) of the Exchange Act and Rule 17a-3(a)(9).

Ross was the President, majority shareholder, and allegedly head of over-the-counter trading at E.C. Farnsworth. Rothenberg was Executive Vice President and head of retail sales. Morris was a registered representative and allegedly served as a branch office manager.

Farnsworth was the underwriter

on a firm-commitment basis of BCII, which made its initial public offering of six million shares of common stock at 50 cents per share.

The Market Surveillance Committee found that Rothenberg and Ross caused the firm to purchase BCII from its retail customers with markdowns of 15.7 percent to 36.8 percent below the prevailing market, contrary to NASD rules, which require that markups and markdowns must be fair. The Committee stated that the vast majority of markdowns were 20 percent or more of the prevailing market price.

It observed that, by charging excessive markdowns, "Ross and Rothenberg breached their obligation of fair dealing which they owed to Farnsworth customers and undermined the integrity of the NASDAQ marketplace, particularly with respect to that segment of the marketplace relating to low-priced securities."

In addition to the fraudulent markdowns, the Committee's Complaint alleged other serious misconduct against Ross and Morris. Specifically, the Complaint alleged that, in reviewing the BCII offering, the NASD's Corporate Finance Department objected to the compensation arrangement for a certain promoter of BCII, viewing the overall compensation as excessive. The promoter allegedly contributed back to BCII about one week prior to the offering the shares the promoter had received.

The Complaint claimed that the promoter then opened up eight securities accounts at Farnsworth in the names of third parties, with the approval of Ross and the assistance of Morris. Ross and Morris knew, according to the Complaint, that the promoter was the beneficial owner of these accounts or were reckless in not knowing. The Complaint alleged that the accounts were established for the purpose of permitting the promoter to purchase shares in the initial public offering and to resell them in the immediate aftermarket.

In furtherance of the scheme for the benefit of the promoter, the Complaint charged, Ross, assisted by Morris, sold to these accounts 400,000

shares for \$200,000 and immediately thereafter repurchased the shares for \$409,000, resulting in a profit of \$209,000 for the promoter. The Complaint alleged that, by virtue of Ross' and Morris' knowledge of and participation in the scheme, they engaged in fraudulent conduct prohibited under the NASD's Rules of Fair Practice and the Exchange Act. Without admitting or denying the allegations, Ross and Morris agreed to a settlement of the charges.

The investigation of this case was carried out by the NASD's Anti-Fraud Department. The disciplinary action was taken by the NASD's Market Surveillance Committee.

Nonpayment of Arbitration Awards Leads to Severe Penalties

NASD District Business Conduct Committees recently filed several disciplinary cases involving respondents that fail to honor arbitration awards. The formal complaints alleged conduct inconsistent with just and equitable principles of trade in violation of Article III, Section 1 of the NASD Rules of Fair Practice.

In one recent instance, the NASD barred a registered principal in New York City from association with any member in any capacity. This individual did not comply with his agreement to pay an arbitration award within 90 days after the NASD accepted his Offer of Settlement.

Failure to honor an arbitration award also resulted in a \$5,000 fine for a New Jersey-based member firm and for one of the firm's registered representatives. In addition, the NASD expelled the firm and barred the individual. Another member firm in Texas was fined \$10,000 and expelled for not honoring an arbitration award.

To avoid such penalties, the NASD urges members to inform their associated persons of the importance of honoring arbitration awards

properly rendered in a valid industry arbitration procedure.

Cites Investor Protection NASD Issues Rule To Curb Abuses By Short Sellers

The NASD has issued a regulation designed to guarantee delivery of stock purchased from short sellers for the account of public investors.

The Securities and Exchange Commission has approved the new rule, which is now effective.

The rule stipulates that when broker-dealers doing business in NASDAQ securities find it necessary to "buy in" stock to obtain delivery of customers' securities that a short seller has failed to deliver to the clearing corporation, the buy-in transaction must be for guaranteed delivery.

Guaranteed Delivery

The guaranteed delivery buy-in rule aims to ensure that delivery of securities to purchasing customers is not repeatedly frustrated by additional failures to deliver on the part of short sellers with which close-out transactions were executed under standard buy-in procedures.

Short selling, a legitimate practice, is the sale of borrowed shares, followed by a subsequent purchase of the same stock.

Problems occur, however, when a short seller fails to borrow and deliver shares to the clearing corporation.

This in turn precludes the clearing corporation from delivering shares to the purchaser, which must then "buy in" the seller — now for guaranteed delivery — to make delivery to its customer.

"This rule ensures that attempts to obtain delivery of securities for public customer accounts will not be frustrated by the repeated rolling over of short positions by short sellers," says NASD President Joseph R. Hardiman. "Buy-ins for customer accounts will now be for guaranteed delivery."

NASD Takes Action Against Firm for "Swaps" In Governments

The NASD has taken disciplinary actions against Prudential-Bache Securities Inc., and two former employees, Richard Grado and Nicholas A. Petrarca, for violations involving transactions in government securities.

On May 15, 1989, the District Business Conduct Committee for NASD District 5 accepted a Letter of Acceptance, Waiver and Consent submitted by Prudential-Bache Securities Inc. Pursuant to the consent proceeding, the firm was censured and fined \$200,000.

Without admitting or denying the allegations, Prudential-Bache consented to the sanctions imposed and findings made that the firm entered into a series of "swap" transactions with a nonrelated broker-dealer between August 25, 1987, and February 29, 1988.

In the transactions, three government zero-coupon agency securities were purchased and sold at prices not reasonably related to the then-current market price of these securities.

Prudential-Bache would purchase a government zero-coupon agency security from the broker-dealer at a price that was higher than the prevailing market price and recover its loss by selling another government zero-coupon agency security to the same broker-dealer at a price also higher than the prevailing market price.

This practice, known as "adjusted trading," has been the subject of previous disciplinary actions taken against members by the NASD.

In two related disciplinary actions, the District Business Conduct Committee accepted Letters of Acceptance, Waiver and Consent submitted by former Prudential-Bache employees Grado and Petrarca. Pursuant to these consent proceedings, Grado, a government zero-coupon

agency securities trader, was suspended for 30 calendar days in all capacities and fined \$5,000.

Petrarca, a government securities institutional salesman, was suspended for 30 calendar days in all capacities and fined \$15,000. Grado and Petrarca were also required to qualify or requalify as General Securities Representatives and to be subjected to special supervisory measures.

Without admitting or denying the allegations, Grado and Petrarca consented to the sanctions imposed and findings made that they participated in a series of off-market "swaps" by executing 69 transactions in government zero-coupon agency securities at prices that were artificially established and not reasonably related to the then-current market prices.

This fraudulent practice caused the falsification of Prudential-Bache's books and records, in that Grado and Petrarca failed to reflect that the firm's purchase prices were artificially established and were conditioned upon subsequent sales by the firm at further inflated prices.

Grado and Petrarca also caused false and misleading confirmations to be mailed to the other broker-dealer.

NASD Disciplines Florida Member For Fraudulent Markups

The NASD has taken disciplinary action against Brownstone-Smith Securities Corp., based in Coral Springs, Florida, and Michael Lewis Donnelly, its President and CEO, for charging fraudulent markups in principal sales to customers of the penny stocks of Ortech Industries, Inc., New Age Industries, Inc., and Leading Edge Industries, Inc., and for other serious misconduct.

Pursuant to their Offer of Settlement, which neither admitted nor denied the allegations of the Complaint filed against them, Brownstone-

Smith was expelled from membership in the NASD; Donnelly was barred from association with any NASD member, with the right to re-apply after three years; and both were censured and fined \$15,000, jointly and severally.

The firm and Donnelly consented to findings that they violated the NASD's markup policy and anti-fraud rule by selling the three securities to customers at markups ranging from 50 percent to 140 percent above the firm's contemporaneous cost.

The firm and Donnelly also consented to NASD findings that in connection with an underwriting of the common stock of Thoroughbred Investments, Inc., on a contingency basis, the firm failed to return customers' monies as required by SEC Rule 15c2-4 when the contingency was not met. In addition, they consented to the findings that the firm contravened the SEC disclosure rule relating to contingent offerings (Rule 10b-9) and the anti-manipulation rule (Rule 10b-6).

In an action filed by the SEC, the firm and Donnelly were permanently enjoined by the United States District Court for the Southern District of Florida from violating the anti-fraud provisions of the federal securities laws and ordered to disgorge \$100,000 of the fraudulent markups charged customers. The firm and Donnelly consented to the court's action.

In addition, they agreed that the SEC may revoke the firm's registration as a broker-dealer and bar Donnelly from the securities industry, with the right to apply for re-entry after three years.

The NASD investigation that led to this action is part of a concerted effort by the Association to eliminate sales practice abuses in penny stocks on a nationwide basis.

It was conducted by the NASD District 7 office in Atlanta and coordinated with the SEC's Miami branch office, as part of the aggressive enforcement program by securities industry regulators to stop fraud in the penny-stock market.

Effective Supervision of Their Operations Is Key To Members' Successful Compliance Programs

With the recent adoption of significant changes to the NASD's supervision rule, members' responsibility for adequately supervising their associated persons has taken on even greater urgency. Members should make certain that their supervisory procedures are in line with these new rules.

Along with the NASD's rule changes, additional measures regarding insider trading have placed added emphasis on the importance of proper supervision. One of these, *The Insider Trading and Securities Fraud Enforcement Act of 1988*, is covered in greater detail below.

In addition, the SEC recently approved an NASD-sponsored change to make the Uniform Termination

Notice of Securities Industry Registration (Form U-5) more readily available to prospective employers. Some specifics on this program can be found below.

To assist members and their associated person in understanding these new supervisory procedure requirements, the NASD has reprinted, in question and answer format, certain guidelines for compliance with the new provisions.

The NASD encourages all persons involved in supervising any aspect of a member firm's securities business activity or personnel to review these guidelines thoroughly.

Members should direct any questions in this area to their appropriate District office or to the NASD Surveillance Department at (202) 728-6906.

NASD Reviews Firm Supervision Of Insider Trading

The NASD has incorporated into its examination program a review to determine member compliance with the provisions of the Insider Trading and Securities Fraud Enforcement Act of 1988 (the Act), including requirements for written supervisory procedures.

The Act expressly requires every broker-dealer to establish, maintain, and enforce written policies and procedures that are "reasonably designed" to prevent and detect insider trading abuses, including the misuse of inside information by employees.

Failure to comply with the new requirements, contained in Section 15(f) of the Securities Exchange Act of 1934, can give rise to civil penalties of \$1 million or more if insider trading results from that failure.

The Act does not specify the types of policies and procedures required, but rather states that they must be "reasonably designed," taking into consideration the nature and scope of the firm's business.

The new requirements also impose "free-standing" statutory duties

on broker-dealers. In addition, the rules allow the SEC, the NASD (and other self-regulatory organizations to which the firm belongs) to examine such firms for "the adequacy of their surveillance systems."

Based on their reviews, these agencies may sanction such firms for failure to have adequate policies and procedures in place, even in the absence of insider trading.

Thus, NASD members that have not already done so must take immediate action to establish the relevant policies and procedures required by the Act.

Enhances Supervision SEC Approves Broader Access To Form U-5

The SEC recently approved an NASD proposal that expands members' access to the information on the Uniform Termination Notice of Securities Industry Regulation (Form U-5) for prospective employees.

Effective September 1, the NASD By-Law amendment requires the terminating employer that filed a Form U-5 with the NASD to provide the terminated employee with a copy

of it. Under a companion amendment to the NASD's Supervision Rule, Section 27 of the Rules of Fair Practice, a member has to obtain the Form U-5 filed by the applicant's most recent employer. In addition, prospective employers must use their best efforts to obtain the U-5 within 60 days following the prospective employee's application.

Reasons for Change

The NASD believes that the circumstances of a termination, as disclosed on the Form U-5, are relevant to the hiring decision and that this information should be available any NASD member for that purpose.

By requiring the firm to provide the persons it terminates with a copy of the Form U-5, the terminated individual has the opportunity to express any disagreement with the accuracy and completeness of the Form U-5. In addition, the NASD rule requires that members file a Form U-5 amendment if subsequent information proves any statements in the original form to be inaccurate or incomplete.

Employer members should be particularly mindful of their responsibilities under the NASD By-Laws in situations when the U-5 discloses that a person was terminated for cause, or contains affirmative

answers to questions regarding possible rule violations during the period of prior employment. Members that employ such individuals with a history of regulatory and compliance problems assume a high level of supervisory responsibility since they have been alerted to these past problems in advance of their hiring decisions.

In this same vein, employers that, after obtaining SEC or NASD approval, hire persons who are

statutorily disqualified from being associated with an NASD member, because of past regulatory findings that they committed serious securities law violations, should be particularly aware of the need for special supervision of those employees.

These supervisory procedures must be specifically designed to adequately surveil the employee's activities to prevent any reoccurrence of misconduct.

To further assist members in ful-

filling their obligation to adequately research the background of their potential employees, the NASD now gives members, with the written consent of the employee, access to the disciplinary records of prospective employees maintained by the Central Registration Depository. Members that subscribe to the Firm Access Query System (FAQS) can obtain this information electronically, while others may call NASD Information Services at (301) 590-6500.

NASD Publishes Answers to Members' Frequent Questions on Its New Supervisory Rules

The NASD's amendments to Article III, Section 27 of the Rules of Fair Practice, pertaining to supervision, took effect on April 13. The amendments prescribe specific supervisory practices and procedures for all member firms and revise the definitions of office of supervisory jurisdiction (OSJ) and branch office. To assist members in complying with these new procedures, the NASD is publishing the answers to frequent questions members have raised about these changes.

Must the supervisory system established in compliance with Article III, Section 27 cover all operations of the firm or only retail sales?

The supervisory system must cover all aspects of the firm's investment banking and securities business, including operations; corporate financing; trading activity; and market services such as Small Order Execution System (SOES), Order Confirmation Transaction (OCT), and NASDAQ National Market trade reporting, in addition to sales. The degree of detail in the plan for a given aspect of business will vary, depending on, for example, the extent to which detailed regulatory requirements apply to that aspect. Thus, the supervisory procedures for retail activity are likely to be more extensive than for other areas.

Section 27(a)(2) requires the designation, where applicable, of an ap-

propriately registered principal. This principal would have 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. Has the NASD established any specific requirements for these individuals?

No specific requirements have been established for purposes of Article III, Schedule 27. The applicable standards are contained in Part II of Schedule C, which sets forth the qualifications for functioning in the various principal capacities. Thus, for example, the principal designated as responsible for review of the firm's options business must be qualified under Schedule C to function in a principal capacity with respect to options transactions. Similarly, the principals and representatives who are assigned to carry out supervisory functions in the members' offices pursuant to Section 27(a)(4) must be qualified to function as principals or representatives for the products sold in the offices they supervise.

Section 27(a)(6) requires members to make reasonable efforts to determine that all supervisory personnel are properly qualified. What constitutes reasonable efforts?

It would not be practical for the NASD to prescribe specific steps to be taken to determine the proper

qualification of supervisory personnel. Generally speaking, such persons should be knowledgeable with respect to both regulatory requirements and the firm's product line, experienced in the activities that take place in the office they are supervising, and capable of exercising authority over their subordinates. In addition, factors such as relevant industry experience, previous employment, and disciplinary history should be taken into account.

Section 27(a)(7) requires that each representative participate in an annual compliance interview.

(a) Is a telephone interview adequate?

Neither a telephone interview nor a video conference complies with the rule. The interview or meeting must be "in person," although, as the rule states, it may be individual or collective, and the compliance discussions may take place in conjunction with discussions or presentations on other topics. It would, however, be permissible to include the showing of a videotape prior to or as a part of the presentation.

(b) Must the interview be conducted by a principal? By an employee from the compliance department or main office?

The interview or meeting is not required to be conducted by a registered principal or by an employee from the main office or

compliance department. A qualified branch manager may conduct the interview or meeting, as may a qualified registered representative. A member may also engage a third party to conduct the interview or meeting; however, the firm cannot avoid ultimate responsibility for any inaccuracies or other problems in the contents presented or procedures employed.

(c) What should be discussed, and what type of records should the firm maintain to establish compliance?

It would be extremely difficult for the NASD to provide an exhaustive list of the topics that should be addressed at the compliance interview or meeting. Generally speaking, the purpose of the requirement is threefold: (1) to provide the member an opportunity to review the product mix and method of operation of each representative and emphasize compliance issues related thereto; (2) to provide the representative an opportunity to ask any questions he or she may have and receive authoritative guidance; and (3) to communicate regulatory developments, firm policies, and similar information to the representatives. As to evidencing compliance, members may wish to maintain records that reflect the date and location of the interview or meeting, the attendees, and the subjects discussed.

(d) Is the requirement limited to those representatives who engage in retail sales?

The rule requires that all registered representatives must attend an interview or meeting; it is not intended to be restricted to those representatives engaged in retail sales.

Section 27(a)(8) requires members to designate and "specifically identify" to the NASD one or more principals to review the member's supervisory system and take or recommend appropriate action. How should members identify such individuals to the NASD?

Members should maintain a

record of the individual(s) so designated so that it may be provided to the NASD on request. Sometime in the future, the identification will be made by means of the Form BD. The NASD will advise members of any changes in this regard.

Section 27(c) continues the existing requirement that each member review the activities of each office, including the periodic examination of customer accounts to detect and prevent irregularities or abuses. By the phrase "each office," does the NASD mean to include nonbranch offices?

This review requirement (as contrasted with the inspection requirements applicable to OSJs and branch offices) encompasses all offices of the member, regardless of whether they are OSJs or branch offices. The NASD believes that it is essential for a member to be aware, on an ongoing basis, of the individuals located in and activities of each office at which the member's business is conducted, and to be able to monitor all customer accounts, wherever they are handled, for irregularities and abuses.

May a member employ outside entities to perform the branch office inspections required by Section 27(c)?

Yes. As with the compliance interview, however, the member cannot avoid regulatory responsibility for the conduct of the inspections.

If an individual located away from an office of the firm telephones an order to the firm's clearing broker, does that person's location become an OSJ under Section 27(f)(1)(i), "order execution and/or market making"?

The individual's location would not be an OSJ because the order is executed by the clearing broker, not the introducing broker. Such a practice, however, does raise concerns about the introducing broker/employer's ability to supervise the transaction.

If, prior to April 13, 1989, a mem-

ber has contracted for a telephone directory listing that does not comply with the exception to the branch office definition, must the office be designated as a branch office until a complying listing is published?

No, provided that the listing is modified to comply in the next-published directory and that the contract was entered into prior to November 1, 1988, the date when the membership was notified of the effective date of the amendments.

The NASD has proposed amendments to Article III, Section 35, that would affect the form of business cards and letterhead. Is it possible to delay compliance with Article III, Section 27(f)(2), until those provisions go into effect?

No. The NASD has already provided a six-month phase-in period for the new branch office definition and does not believe it is appropriate to delay further the effectiveness of this key aspect of the new rules. In order to reduce the financial burden of compliance with both changes, it may be possible to affix the supervising-office identification to existing cards and letterhead until the new advertising rules take effect. As an alternative, a member may wish to prepare new business cards that comply with both rules even though the advertising rules are not yet effective.

Under Section 27(f)(2), would the branch office definition include:

(a) An exhibit booth in a shopping mall?

If an "exhibit booth" is permanent or regularly used, it would be covered by the definition.

(b) An office listed on a building lobby directory?

On reconsideration, the NASD has determined that such an office would not be subject to the definition. Although it is technically being identified to the general public as an office of the member, the NASD has concluded that a lobby listing will not cause a location to be a branch office.

(c) An office identified by a sign on the door?

An exterior door sign visible to the general public would cause the location to be a branch office. A sign that appears only on an interior door just for purposes of identification (e.g., due to state requirements) and is not placed in an area of general public access would not cause the location to be a branch office.

(d) A sign at a desk in a savings and loan office?

If the member does business at that location, it must be designated as a branch office; however, a sign that merely advertises the member's business and directs interested parties to a telephone number or an office of the firm would not give rise to the branch office designation.

(e) An office for which only the local telephone number (not an address) is printed in a newspaper advertisement?

A nonbranch location may not advertise. If a newspaper advertisement lists a local telephone number, the location at which that telephone is answered would be a branch office regardless of whether the address is given. Such an advertisement identifies that location as a place where the public, via telephone, can do business with the member.

(f) A location to which individuals are referred when they respond to a newspaper or magazine advertisement listing the main office telephone number?

The identification of a location otherwise excepted from the definition of a branch office under such circumstances is unlikely to cause that location to become a branch office. It is the main office that is being identified to the public; the local office is identified only after the prospective customer has initiated the contact.

Must a "white pages" listing also contain the address and telephone number of the supervising office in light of the exclusion of a routine listing from the definition of adver-

tisement in Section 35(a)(1) of the Rules of Fair Practice?

Yes, a "white pages" or routine listing must contain the address and telephone number of the supervising office if the member wishes to avail itself of the exception from the definition of branch office. The definition of advertisement does not affect this requirement.

NASD Continues Its Focus on Penny-Stock Sales Abuses

The NASD is continuing its regulatory and enforcement efforts to eliminate fraud in the penny-stock market. Working alone and with other enforcement agencies, the NASD is focusing on certain NASD members and associated persons who use high-pressure tactics and other fraudulent and deceptive practices to sell penny stocks to the public.

NASD disciplinary actions for such misconduct already have resulted in significant sanctions against the offenders and more than 150 cases are pending nationwide that could result in similar disciplinary actions.

Many cases involve a member's solicitation, promotion, and hard-sell tactics in recommending certain low-priced, high-risk, speculative non-NASDAQ over-the-counter (NNOTC) securities. Usually, unseasoned companies with limited management experience and financial resources issue these securities.

Often, the companies have benefited from a "blank check" offering that gives management sole discretion in using the funds derived from the offering.

When selling these securities to investors in secondary market transactions, the member's sales campaign frequently contains outright misrepresentations and misleading statements about the company's financial condition, operations, and prospects. Fraudulently excessive markups

often accompany these sales to investors.

To help address these regulatory concerns, the NASD adopted new Schedule H to its By-Laws that, during Phase I, requires reporting of price and volume for NNOTC securities cleared through the National Securities Clearing Corporation (NSCC).

NNOTC Phase II

Phase II, effective on August 1, 1989, requires that all NNOTC equity securities be subject to the daily reporting requirements of Schedule H (see *Notices to Members 88-54* and *89-54*). In addition, the NASD has increased the number of special branch and main office examinations which concentrate on abusive sales practices.

The NASD also has participated with the SEC and state securities administrators in selected joint investigations of such matters and is a major participant in an inter-agency task force on penny-stock fraud, which includes the Federal Bureau of Investigation, various U.S. Attorney's offices and state prosecutors.

Several of these cooperative efforts have resulted in criminal charges relating to securities fraud. The NASD will continue cooperating with federal and state law enforcement agencies as part of its efforts to vigorously enforce the securities law particularly with regard to fraud and other serious sales practice abuses.

Proposed Rule

As part of the intensified effort to combat "penny stock fraud," the SEC proposed Rule 15c2-6 in February 1989.

This proposal requires a broker-dealer, when recommending certain NNOTC securities whose issuers do not meet certain minimum financial standards, to obtain a written agreement from the customer for the transaction and to document the required suitability determination for that customer.

The SEC is now considering the comments it received on the rule proposal.

