

Notice To Members

National Association of Securities Dealers, Inc.

March 1990

Number 90 - 10**Suggested Routing:*** Senior Management Corporate Finance Government Securities Institutional Internal Audit Legal & Compliance Municipal Mutual Fund Operations Options Registration Research Syndicate Systems Trading Training

*These are suggested departments only. Others may be appropriate for your firm.

MAIL VOTE**Subject: Proposed Corporate Financing Rule; Last Voting Date: April 5, 1990****EXECUTIVE SUMMARY**

NASD members are invited to vote on a proposed Corporate Financing Rule (the "Rule") that, if adopted, would replace the current Interpretation of the Board of Governors — Review of Corporate Financing under Article III, Section 1 of the NASD Rules of Fair Practice (the "Interpretation"). The proposed Rule has been approved by the NASD Board of Governors and now requires membership approval. Prior to becoming effective, the Rule must be filed with, and approved by, the Securities and Exchange Commission ("SEC"). The text of the Rule follows this notice.

BACKGROUND

Article III, Section 1 of the NASD Rules of Fair Practice obligates members, in the conduct of their business, to observe high standards of commercial honor and just and equitable principles of trade. In the early 1960s, the NASD began reviewing underwriting terms and arrangements of public securities offerings in which members were participating to determine whether compensation terms and arrangements were in compliance with the broad standard of fairness in Article III, Sec-

tion 1. By 1970, the criteria for determining fairness and reasonableness had become more defined and were incorporated into the Interpretation, which made it a violation of NASD rules to participate in any public offering in which the underwriting terms and arrangements are unfair and unreasonable.

Although the language of the Interpretation has been amended from time to time, it no longer accurately reflects all current industry practices or the guidelines used by the NASD to determine the fairness and reasonableness of underwriting compensation terms and arrangements. Therefore, the Corporate Financing Rule was developed to codify and clarify existing NASD policies and procedures, to update the standards of fairness applied to public offerings, and to replace the Interpretation.

In November 1988, the NASD published *Notice to Members 88-92*, which requested comment on the proposed Rule. The Corporate Financing Committee (the "committee") received and reviewed 22 letters of comment from member firms involved in the underwriting of public offerings and from law firms representing member-firm clients.

Generally, commenters expressed strong support for the codification of existing practices and policies under the Interpretation into a Corporate Financing Rule. Specific comments were received

in three areas of the proposed Rule: definitions, filing requirements, and underwriting compensation and arrangements. The NASD Board of Governors and the committee determined that a number of the comments received raised valid concerns about the application of the Rule to members' participation in the distribution of public offerings. The Rule for which membership approval is being sought, therefore, incorporates changes responsive to those comments.

SUMMARY OF CORPORATE FINANCING RULE

A subsection-by-subsection discussion of the major provisions of the Rule appears below.

Subsection (a): Definitions

The subsection on definitions is meant to explain the meaning of terms used in the Rule. Definitions for "gross dollar amount of the offering," "net offering proceeds," and "offering proceeds" have been included to clarify the differences between the terms as used in the Rule. "Gross dollar amount of the offering" is used only in the calculation of filing fees. The term "net offering proceeds" excludes from gross proceeds all expenses of issuance and distribution. "Offering proceeds" is defined as the gross proceeds of an offering, exclusive of the proceeds of any over-allotment option, securities to be paid to underwriters and related persons, or securities underlying other securities.

The definition of "underwriter and related persons" in the Interpretation has been restated in the proposed Rule with two modifications: the addition of immediate family members of any person in the definition, and the phrase "any member participating in the public offering." Also, the concept of "participation in an offering" has been defined and is intended to specify when a member's activities in connection with a public offering will trigger the filing requirements of the Rule. The definition excludes from "participation" the rendering of an appraisal in a savings and loan conversion or bank offering, or the issuance of a fairness opinion in a going-private transaction.

Subsection (b): Filing Requirements

The Filing Requirements subsection of the Rule codifies existing requirements for the filing of public offerings contained in the Interpretation without substantial change. The filing location has

been specified in Subsection (b)(2) as the Corporate Financing Department (the "department") at the NASD's Executive Office, in recognition of the fact that the NASD's multiple offices could create confusion as to where the filing should be made. Filing with the department is required no later than one business day after filing with the SEC or other regulatory authority.

Subsection (b)(4)(B) contains a new provision stating that an offering in which a member or person associated with a member participates may not commence until the member has received an opinion from the NASD as to the fairness and reasonableness of the underwriting terms and arrangements. If the opinion provided by the NASD is that the underwriting terms and arrangements are unfair or unreasonable, the member has the opportunity to file modifications to the proposed underwriting arrangements for further review. If the proposed underwriting terms and arrangements are not modified, the Rule requires the member to inform other members intending to participate in the offering that the proposed terms and arrangements have not been modified to conform to the NASD standards of fairness and reasonableness.

A list of the specific documents to be filed, along with the number of copies of each, is included in Subsection (b)(5). Certain information necessary for the department's review and required to be filed with the documents is listed in Subsection (b)(6) of the Rule.

Subsection (b)(7) contains a list of offerings exempt from filing but still subject to compliance with the Rule. The filing exemption for offerings utilizing Form S-3 and offered pursuant to Rule 415 has been expanded to also include offerings utilizing Form F-3 and Rule 415 to provide an exemption for "world class" issuers. Subsection (b)(8) lists offerings not subject to the Rule and exempt from filing. The list of offerings required to be filed contained in Subsection (b)(9) tracks the list contained in the Interpretation. Finally, Subsection (b)(10) codifies the proper calculation of the appropriate filing fee, which was increased effective October 1, 1989.

Subsection (c): Underwriting Compensation and Arrangements

Subsection (c) addresses the amount of underwriting compensation that can be received by un-

derwriters and related persons, the items of compensation that will be deemed to be underwriting compensation, the criteria for determining whether compensation is received in connection with a public offering, and the valuation of noncash compensation received as underwriting compensation. Subsection (c) also lists presumptively unfair and unreasonable underwriting terms and arrangements, enumerates restrictions on securities received as underwriting compensation, and addresses conflicts of interest present when the proceeds of a public offering are directed to members participating in the offering.

Subsection (c)(1) states that no member or person associated with a member shall underwrite or participate in a public offering if the underwriting compensation in connection with the offering is unfair or unreasonable. Subsection (c)(2) prohibits a member from receiving an amount of underwriting compensation that is unfair or unreasonable and requires full disclosure of all underwriting compensation in that portion of the offering document dealing with underwriting or distribution arrangements. When underwriting compensation is disclosed on the cover page of the offering document, there must be a cross-reference to the section on underwriting or distribution arrangements. Subsection (c)(2)(D) discusses the factors considered by the NASD in determining the maximum amount of compensation considered fair and reasonable.

Subsection (c)(3) lists the items of compensation that will be viewed as underwriting compensation in connection with an offering. Several modifications to the list in the Interpretation have been made: (1) a right of first refusal for future offerings granted to the underwriter is included as compensation with a stated compensation value of one percent of offering proceeds or the amount contractually agreed to by the issuer and the underwriter for the underwriter to waive the right of first refusal; (2) fees paid to an underwriter by an issuer for a public offering that was not completed within six months prior to the initial or amended filing of an offering by a new underwriter are included as underwriting compensation; (3) fees of a qualified independent underwriter are included as underwriting compensation; and, (4) if the NASD filing fee is paid or reimbursed by the issuer, the Rule states that such payment or reimbursement will not be viewed as underwriting compensation.

With regard to expenses or fees paid to prior underwriters in connection with an uncompleted offering, in exceptional or unusual circumstances and upon good cause shown, the NASD has discretion not to view such expenses or fees as underwriting compensation. This provides the department with the opportunity to review the facts and circumstances relating to the type and amount of compensation paid and the reasons for the offering not being completed.

Subsection (c)(4) enumerates the criteria considered by the department in determining whether any item of value is underwriting compensation received in connection with a public offering. The Interpretation currently only specifies factors that may be used to determine whether securities acquired by underwriters and related persons constitute compensation in connection with an offering. Therefore, the Rule institutes guidelines for determining whether either securities or compensation not in the form of securities is in connection with an offering and considered underwriting compensation.

Subsection (c)(4)(A) provides a presumption that items of value received within six months immediately preceding the filing of an offering will be considered to be underwriting compensation. Excepted are cash discounts or commissions received in connection with the successful distribution of the issuer's securities in a prior offering. Subsection (c)(4)(E) provides the basis for which financial consulting and advisory fees may be excluded from underwriting compensation.

Subsection (c)(5) of the Rule deals with the valuation of noncash compensation received as underwriting compensation. Subsection (c)(5)(A) prohibits underwriters and related persons from receiving as underwriting compensation a security or warrant for a security that is different from the security being offered to the public or that does not have a bona fide independent market.

An NASD notice published in 1981 permitted members to receive securities as underwriting compensation that were different from the securities offered to the public or that did not have a bona fide market. The example cited in the notice was the receipt of warrants for common stock in an underwritten debt offering where the warrants could be valued for compensation purposes on the basis of the current market value of the underlying stock, or if no market for the stock exists, on a case-

by-case basis taking into account book value and other relevant factors. However, the department has experienced much difficulty in assigning a compensation value to securities that have no market, since such securities are typically acquired at little or no cost and, in the absence of any market value to determine the economic benefit received by the underwriter and related person, any analysis of the compensation value of such securities is necessarily highly subjective.

The Rule states in Subsection (c)(5)(A)(i) that, in exceptional and unusual circumstances, upon good cause shown, the department or the committee may approve an arrangement providing for the acquisition of securities or rights to acquire securities that are either different from the securities being offered or do not have a bona fide independent market.

Subsection (c)(5)(A)(ii) originally proposed to limit underwriter's warrants received as underwriting compensation in unit offerings to warrants based only on the common stock component of the public units, exclusive of the common stock underlying any warrants in the public units. This provision would have prohibited underwriters from receiving a so-called "unit purchase option" permitting the member to receive a warrant for the purchase of the units sold to the public.

Many commenters on the Rule argued that, in unit offerings, it should be considered fair and reasonable for the underwriter to receive a unit purchase option enabling the underwriter to purchase units identical to the public's. Therefore, Subsection (c)(5)(A)(ii) was modified to state that, in unit offerings, underwriters and related persons are permitted to receive a unit purchase option provided that the underwriter's units are the same as the public's units, with the terms of the unit purchase option being no more favorable than the terms of the units received by the public; i.e., the exercise price of the unit purchase option is equal to or greater than the price paid by the public in the offering, and the exercise price of any warrants for additional securities contained within the unit purchase option similarly is greater than or equal to the exercise price of the public's warrants. In addition, the term of exercisability for any warrants contained in the unit purchase option must be identical to the term of the public's unit warrants.

Subsection (c)(5)(B) describes the valuation

of cheap stock deemed to be underwriting compensation. Subsection (c)(5)(C) of the Rule contains the warrant formula utilized by the department to determine the value of options, warrants, or convertible securities received as underwriting compensation. Both valuations are expressed as a percentage of offering proceeds. Subsection (c)(5)(D) allows securities restricted from sale, transfer, assignment, or hypothecation for a period longer than the required one year to receive a discounted compensation value to reflect the risk of an extended lock-up period.

Subsection (c)(6)(A) permits the department to deem public offering terms and arrangements unfair and unreasonable not only on the basis of application of the Rule, but also for inconsistency with other NASD rules. The list of unfair and unreasonable arrangements in Subsection (c)(6)(B) includes a prohibition on any nonaccountable expense allowance in excess of 3 percent of offering proceeds. The department has found that nonaccountable expense allowances of up to 3 percent usually are justified by members as being reflective of actual out-of-pocket offering expenses. Many commenters read this provision as outlawing any expense allowance over 3 percent, but the Rule allows expense reimbursements in excess of 3 percent of offering proceeds if they are on an accountable basis only. Accountable expenses may not include general overhead, salaries, supplies, or similar expenses incurred in the normal conduct of business.

Subsection (c)(6)(B)(iii) deems it an unreasonable arrangement for an underwriter to receive commissions or reimbursements for expenses prior to commencement of a public offering of securities, except for the reimbursement of direct out-of-pocket accountable expenses actually incurred by the underwriter and related persons in preparation for the offering. A member may receive an advance on such expenses provided that the amount of the advance bears a reasonable relationship to the actual amount of accountable expenses anticipated to be incurred during the registration period and prior to the effectiveness of the offering.

Furthermore, the Rule clarifies that the payment of any compensation by an issuer or an affiliate to a member or person associated with a member in connection with an uncompleted public offering is considered unfair and unreasonable.

The only permitted exceptions are for the reimbursement of actual accountable out-of-pocket expenses and the payment of compensation negotiated in connection with a transaction that occurs in lieu of the proposed offering.

A number of unfair and unreasonable arrangements have been enumerated in Subsection (c)(6)(B) of the Rule to clarify and codify policies presently applied by the department. These include a prohibition on:

- A right of first refusal with a duration of more than five years from the effective date of the offering.
- Warrants, options, or convertible securities having a duration of more than five years or exercisable below the public offering price.
- More than one demand registration right at the issuer's expense.
- A demand registration right with a duration of more than five years from the effective date of the offering.
- A piggyback registration right with a duration of more than seven years from the effective date of the offering.
- The receipt of any item of indeterminate compensation.
- An over-allotment option greater than 15 percent of the amount of securities being offered.
- The receipt of securities as underwriting compensation in an amount greater than the Stock Numerical Limitation, which limits the amount of securities that can be received as underwriting compensation to 10 percent of the securities sold to the public.

The conditions relating to the receipt of warrant solicitation fees by members and associated persons upon the exercise of warrants contained in unit offerings are enumerated in Subsection (c)(6)(B)(x). The Rule requires disclosure in the offering document of any arrangements to pay solicitation fees if the arrangements are contemplated or if any agreement exists as to such arrangements at the time of the offering. If no arrangements are contemplated or no arrangement exists at the time of the offering, the disclosure of any warrant solicitation fee must be made in the prospectus or offering circular provided to security holders at the time of exercise or conversion of warrants.

Warrant solicitation fees may be received on securities held in a discretionary account only upon the written approval of the customer. Fees

paid within one year of the effective date of an offering are included as underwriting compensation in connection with the offering.

The prohibition currently contained in the Interpretation on the receipt by a member or persons associated with a member of non-cash sales incentive items has been incorporated into Subsection (c)(6)(B)(xi) of the Rule.

Subsection (c)(6)(B)(xii) deems it an unfair and unreasonable arrangement for a member to participate with an issuer in a public distribution of a nonunderwritten issue of securities if the issuer hires persons primarily for distributing or assisting in the distribution of the issue, or for the purpose of assisting in any way in connection with the offering, except to the extent that the issuer or those persons associated with the issuer are in compliance with applicable state law and the federal exemption from registration as a broker-dealer.

Subsection (c)(7) clarifies and recodifies the lock-up restrictions on securities deemed to be underwriting compensation. Subsection (c)(7)(A)(iii) states that securities to be received by a member as underwriting compensation shall be issued only to a member participating in the offering or the bona fide officers and partners thereof.

The Venture Capital Restrictions of the Interpretation have been incorporated into Subsection (c)(7)(C) of the Rule. The language has been updated to clarify the terms of the 1 percent *de minimis* exemption from the venture capital lock-up provisions currently contained in the Interpretation.

Subsection (c)(8) concerns conflicts of interest and governs members' participation in public offerings where more than 10 percent of the net offering proceeds are intended to be paid to members participating in the distribution of the offering, or associated or affiliated persons of such members, or members of the immediate family of such persons. Such participation would be permitted only in compliance with the provisions of this paragraph, which may require the pricing opinion and due diligence of a qualified independent underwriter. In addition, all such offerings must disclose the name of the member acting as qualified independent underwriter in the offering document.

Subsection (d): Power of the Board of Governors

Subsection (d) of the proposed Rule permits the Board of Governors to adopt, alter, amend, supplement, or modify the filing requirements under

Subsection (b) without prior membership approval.

Code of Procedure

No comments were received on the Code of Procedure for Corporate Financing and Direct Participation Program Matters, which codifies the present informal procedures for requesting review of NASD determinations in connection with the review of public offerings. Only a member aggrieved by a determination of the NASD may make application for review of the staff's determination to a hearing committee of a national standing committee of the Board of Governors. The Code also specifies that an appeal of a hearing committee's determination must be requested within 15 business days following the hearing committee's written determination. Determinations of hearing committees or standing committees are advisory in nature, and a finding of a violation of any rule, interpretation, or policy shall be made only by a District Business Conduct Committee pursuant to the Code of Procedure.

Rather than being included in the Corporate Financing Rule, the Code of Procedure for Corporate Financing and Direct Participation Program Matters will be moved to the NASD's Code of Procedure. Amendments to the Code of Procedure do not require a membership vote. Nevertheless, the text of the amendment follows the text of the Rule.

REQUEST FOR VOTE

Following is the complete text of the proposed Corporate Financing Rule. The Rule, which would replace the Corporate Financing Interpretation, is important and merits members' immediate attention. Prior to becoming effective, the Rule must be approved by the NASD membership and thereafter by the SEC.

The NASD Board of Governors believes this amendment to the Rules of Fair Practice to be necessary and appropriate and recommends that members vote their approval. Please mark the attached ballot according to your convictions and return it in the enclosed, stamped envelope to The Corporation Trust Company. Ballots must be postmarked **no later than April 5, 1990**.

Questions concerning this notice may be directed to Richard J. Fortwengler, Assistant Director, NASD Corporate Financing Department, at (202) 728-8258.

THE CORPORATE FINANCING RULE

[Note: All language is new and replaces in its entirety the current Interpretation of the Board of Governors — Review of Corporate Financing, Article III, Section 1 of the Rules of Fair Practice (NASD Manual, 2151.02 at pages 2023-2036)].

Underwriting Terms and Arrangements

Sec. _____

(a) **Definitions**

For purposes of this Section, the following terms shall have the meanings stated below. The definitions in Schedule E to the By-Laws are incorporated herein by reference.

(1) **gross dollar amount of the offering** — public offering price of all securities offered to the public and securities included in any overallotment option, the registration price of securities to be paid to the underwriter and related persons, and the registration price of any securities underlying other securities;

(2) **issuer** — the issuer of the securities offered to the public, any selling security holders offering securities to the public, any affiliate of the issuer or selling security holder, and the officers or general partners, directors, employees and security holders thereof;

(3) **net offering proceeds** — offering proceeds less all expenses of issuance and distribution;

(4) **offering proceeds** — public offering price of all securities offered to the public, not including securities subject to any overallotment option, securities to be received by the underwriter and related persons, or securities underlying other securities;

(5) **participation or participating in a public offering** — participation in the preparation of the offering or other documents, participation in the distribution of the offering on an underwritten, non-underwritten, or any other basis, furnishing of customer and/or broker lists for solicitation, or participation in any advisory or consulting capacity to the issuer related to the offering, but not the preparation of an appraisal in a savings and loan conversion or a bank offering or the preparation of a fairness opinion pursuant to Rule 13e-3; and

(6) **underwriter and related persons** — includes underwriters, underwriter's counsel, financial consultants and advisors, finders, members of the selling or distribution group, any member par-

ticipating in the public offering, and any and all other persons associated with or related to and members of the immediate family of any of the aforementioned persons.

(b) Filing Requirements

(1) General

No member or person associated with a member shall participate in any manner in any public offering of securities subject to this Section, Schedule E to the By-Laws, or Article III, Section 34 of the Rules of Fair Practice unless documents and information as specified herein relating to the offering have been filed with and reviewed by the NASD.

(2) Means of Filing

Documents or information required by this rule to be filed with the NASD shall be considered to be filed only upon receipt by its Corporate Financing Department at the Executive Office located at 1735 K Street, N.W., Washington, D.C. 20006.

(3) Confidential Treatment

The NASD shall accord confidential treatment to all documents and information filed pursuant to this Section and shall utilize such documents and information solely for the purpose of review to determine compliance with the provisions of applicable NASD rules and regulations or for other regulatory purposes deemed appropriate by the NASD.

(4) Requirement for Filing

(A) Unless filed by the issuer, the managing underwriter, or another member, a member that anticipates participating in a public offering of securities subject to this Section shall file with the NASD the documents and information with respect to the offering specified in paragraphs (5) and (6) below no later than one business day after the filing of any of such documents: (i) with the Securities and Exchange Commission; (ii) with the state securities commission; (iii) with any other regulatory authority; or (iv) if not filed with any regulatory authority, at least fifteen (15) business days prior to the anticipated offering date.

(B) No offering of securities subject to this Section shall commence unless:

(i) the documents and information specified in paragraphs (5) and (6) below have been filed with and reviewed by the NASD, and the NASD has provided an

opinion that it has no objections to the proposed underwriting and other terms and arrangements. If the NASD's opinion states that the proposed underwriting and other terms and arrangements are unfair and unreasonable, the member may file modifications to the proposed underwriting and other terms and arrangements for further review.

(C) Any member acting as a managing underwriter or a similar capacity that has been informed of an opinion by the NASD, or a determination by the appropriate standing committee of the Board of Governors, that the proposed underwriting terms and arrangements of a proposed offering are unfair or unreasonable, and the proposed terms and arrangements have not been modified to conform to the standards of fairness and reasonableness, shall notify all other members proposing to participate in the offering of that opinion or determination at a time sufficiently prior to the effective date of the offering or the commencement of sales so the other members will have an opportunity as a result of specific notice to comply with their obligation not to participate in any way in the distribution of a public offering containing arrangements, terms and conditions which are unfair or unreasonable.

(5) Documents to be Filed

The following documents relating to all proposed public offerings of securities shall be filed for review:

(A) Five (5) copies of the registration statement, offering circular, offering memorandum, notification of filing, notice of intention, application for conversion and/or any other document used to offer securities to the public;

(B) Three (3) copies of any proposed underwriting agreement, agreement among underwriters, selected dealers agreement, agency agreement, purchase agreement, letter of intent, consulting agreement, partnership agreement, underwriter's warrant agreement, escrow agreement, and any other document which describes the underwriting or other arrangements in connection with or related to the distribution, and the terms and conditions relating thereto; and any other

information or documents which may be material to or part of the said arrangements, terms and conditions and which may have a bearing on the NASD's review;

(C) Five (5) copies of each pre- and post-effective amendment to the registration statement or other offering document, one copy marked to show changes; and three (3) copies of any other amended document previously filed pursuant to subparagraphs (A) and (B) above, one copy marked to show changes; and

(D) Three (3) copies of the final registration statement declared effective by the Securities and Exchange Commission or equivalent final offering document and a list of the members of the underwriting syndicate, if not indicated therein, and one (1) copy of the executed form of the final underwriting documents and any other document submitted to the NASD for review.

(6) Information Required to be Filed

Any person filing documents pursuant to paragraph (4) above shall provide the following information with respect to the offering:

(A) an estimate of the maximum public offering price;

(B) an estimate of the maximum underwriting discount or commission; maximum reimbursement of underwriter's expenses, and underwriter's counsel's fees (except for reimbursement of "blue sky" fees); maximum financial consulting and/or advisory fees to the underwriter and related persons; maximum finder's fees; and a statement of any other type and amount of compensation which may accrue to the underwriter and related persons;

(C) a statement of the association or affiliation with any member of any officer, director or securityholder of the issuer in an initial public offering of equity securities, and with respect to any other offering provide such information with respect to any officer, director or securityholder of 5% or more of any class of the issuer's securities, to include:

- (i) the identity of the person,
- (ii) the identity of the member and whether such member is participating in any capacity in the public offering, and

(iii) the number of equity securities or the face value of debt securities owned by such person, the date such securities were acquired, and the price paid for such securities;

(D) a statement addressing the factors in subparagraphs (c)(4)(C) and (D), where applicable;

(E) a detailed explanation of any other arrangement entered into during the 12-month period immediately preceding the filing of the offering, which arrangement provides for the receipt of any item of value and/or the transfer of any warrants, options, or other securities from the issuer to the underwriter and related persons; and

(F) any person filing documents pursuant to paragraph (5) above shall file with the NASD written notice that the offering has been declared effective or approved by the Securities and Exchange Commission or other agency no later than one business day following such declaration or approval or that the offering has been withdrawn or abandoned within three business days following the withdrawal or decision to abandon the offering.

(7) Offerings Exempt From Filing

Notwithstanding the provisions of paragraph (1) above, documents and information related to the following public offerings need not be filed with the NASD for review, unless subject to the provisions of Schedule E to the By-Laws. However, it shall be deemed a violation of this Section or Article III, Section 34 of these Rules of Fair Practice, for a member to participate in any way in such public offerings if the underwriting or other arrangements in connection with the offering are not in compliance with this Section or Section 34, as applicable:

(A) securities offered by a corporate, foreign government or foreign government agency issuer which has unsecured non-convertible debt with a term of issue of at least four (4) years, or unsecured non-convertible preferred securities, rated by a nationally recognized statistical rating organization in one of its four (4) highest generic rating categories, except that the initial public offering of the equity of an issuer is required to be filed;

(B) non-convertible debt securities and non-convertible preferred securities rated by a nationally recognized statistical rating organization in one of its four (4) highest generic rating categories;

(C) securities registered with the Securities and Exchange Commission on registration statement Form S-3 or F-3 and offered pursuant to Rule 415 adopted under the Securities Act of 1933, as amended;

(D) securities offered pursuant to a redemption standby "firm commitment" underwriting arrangement registered with the Securities and Exchange Commission on Form S-3; and

(E) financing instrument-backed securities which are rated by a nationally recognized statistical rating organization in one of its four (4) highest generic rating categories.

(8) Exempt Offerings

Notwithstanding the provisions of paragraph (1) above, the following offerings are exempt from this Section, Schedule E to the By-Laws, and Article III, Section 34 of the Rules of Fair Practice. Documents and information relating to the following offerings need not be filed for review:

(A) securities exempt from registration with the Securities and Exchange Commission pursuant to the provisions of Sections 4(1), 4(2) or 4(6) of the Securities Act of 1933, as amended, or pursuant to Rule 504 (unless considered a public offering in the states where offered), Rule 505 or Rule 506 adopted under the Securities Act of 1933, as amended;

(B) securities which are defined as "exempt securities" in Section 3(a)(12) of the Securities Exchange Act of 1934, as amended;

(C) securities of investment companies registered under the Investment Company Act of 1940, as amended, except securities of a management company defined as "closed-end company" in Section 5(a)(2) of that Act;

(D) variable contracts as defined in Article III, Section 29(b)(1) of the Rules of Fair Practice;

(E) offerings of municipal securities as defined in Section 3(a)(29) of the Securities Exchange Act of 1934, as amended;

(F) tender offers made pursuant to Regulation 14D adopted under the Securities Exchange Act of 1934, as amended; and

(G) securities issued pursuant to a competitively bid underwriting arrangement meeting the requirements of the Public Utility Holding Company Act of 1935, as amended.

(9) Offerings Required to be Filed

Documents and information relating to all other public offerings including, but not limited to, the following must be filed with the NASD for review:

(A) direct participation programs as defined in Article III, Section 34(d)(2) of the Rules of Fair Practice;

(B) mortgage and real estate investment trusts;

(C) rights offerings;

(D) securities exempt from registration with the Securities and Exchange Commission pursuant to Section 3(a)(11) of the Securities Act of 1933, as amended, which is considered a public offering in the state where offered;

(E) securities exempt from registration with the Securities and Exchange Commission pursuant to Rule 504 adopted under the Securities Act of 1933, as amended, which is considered a public offering in the states where offered;

(F) securities offered by a bank, savings and loan association, church or other charitable institution, or common carrier even though such offering may be exempt from registration with the Securities and Exchange Commission;

(G) securities offered pursuant to Regulation A or Regulation B adopted under the Securities Act of 1933, as amended; and

(H) any offerings of a similar nature that are not exempt under paragraphs (7) or (8) of this Subsection.

(10) Filing Fees

(A) The initial documents relating to any offering filed with the NASD pursuant to this Section shall be accompanied by a filing fee equal to \$500 plus .01% of the gross dollar amount of the offering, not to exceed a fee of \$30,500. The amount of filing fee may be rounded to the nearest dollar.

(B) Amendments to the initially filed documents which increase the number of

securities being offered shall be accompanied by an additional amount of filing fee equal to .01% of the increase in the amended gross dollar amount of the offering, not to exceed \$30,500 when aggregated with all fees previously paid.

(C) Filing fees shall be paid only in the form of check or money order payable to the National Association of Securities Dealers, Inc.

(D) The provisions of Rule 457 adopted under the Securities Act of 1933, as amended, shall govern the computation of filing fees for all offerings filed pursuant to this Section, including intrastate offerings, to the extent the terms of Rule 457 are not inconsistent with subparagraphs (10)(A), (B) or (C) above.

(c) Underwriting Compensation and Arrangements

(1) General

No member or person associated with a member shall participate in any manner in any public offering of securities in which the underwriting or other terms or arrangements in connection with or relating to the distribution of the securities, or the terms and conditions related thereto, are unfair or unreasonable.

(2) Amount of Underwriting Compensation

(A) No member or person associated with a member shall receive an amount of underwriting compensation in connection with a public offering which is unfair or unreasonable and no member or person associated with a member shall underwrite or participate in a public offering of securities if the underwriting compensation in connection with the public offering is unfair or unreasonable.

(B) For purposes of determining the amount of underwriting compensation, all items of value received or to be received from any source by the underwriter and related persons which are deemed to be in connection with or related to the distribution of the public offering as determined pursuant to paragraphs (c)(3) and (c)(4) below shall be included.

(C) All items of underwriting compensation shall be disclosed in the section on underwriting or distribution arrangements in the prospectus or similar document and, if the

underwriting compensation includes items of compensation in addition to the commission or discount disclosed on the cover page of the prospectus or similar document, a footnote to the offering proceeds table on the cover page of the prospectus or similar document shall include a cross-reference to the section on underwriting or distribution arrangements.

(D) For purposes of determining the currently effective guideline on the maximum amount of underwriting compensation considered fair and reasonable, the following factors, as well as any other relevant factors and circumstances, shall be taken into consideration:

- (i) the offering proceeds;
- (ii) the amount of risk assumed by the underwriter and related persons, which is determined by (a) whether the offering is being underwritten on a "firm commitment" or "best efforts" basis and (b) whether the offering is an initial or secondary offering; and
- (iii) the type of securities being offered.

(E) The maximum amount of compensation (stated as a percentage of the dollar amount of the offering proceeds) which is considered fair and reasonable generally will vary directly with the amount of risk to be assumed by the underwriter and related persons and inversely with the dollar amount of the offering proceeds.

(3) Items of Compensation

(A) For purposes of determining the amount of underwriting compensation received or to be received by the underwriter and related persons pursuant to paragraph (c)(2) above, the following items and all other items of value received or to be received by the underwriter and related persons in connection with or related to the distribution of the offering, as determined pursuant to paragraph (c)(4) below shall be included:

- (i) discount or commission;
- (ii) reimbursement of expenses to or on behalf of the underwriter and related persons;
- (iii) fees and expenses of underwriter's counsel (except for reimbursement of "blue sky" fees);

- (iv) finder's fees;
 - (v) wholesaler's fees;
 - (vi) financial consulting and advisory fees, whether in the form of cash, securities, or any other item of value;
 - (vii) stock, options, warrants, and other securities, including securities received as underwriting compensation, for example:
 - (a) in connection with a private placement of securities for the issuer;
 - (b) for providing or arranging bridge financing for the issuer;
 - (c) as a finder's fee;
 - (d) for consulting services to the issuer; and
 - (e) securities purchased in a private placement made by the issuer;
 - (viii) special sales incentive items in compliance with subparagraph (c)(6)(B)(xi);
 - (ix) any right of first refusal provided to the underwriter and related persons to underwrite or participate in future offerings by the issuer, which will have a compensation value of 1% of the offering proceeds or that dollar amount contractually agreed to by the issuer and underwriter to waive the right of first refusal;
 - (x) compensation to be received by the underwriter and related persons or by any person nominated by the underwriter as an advisor to the issuer's board of directors in excess of that received by other members of the board of directors;
 - (xi) commissions, expense reimbursements, or other compensation to be received by the underwriter and related persons as a result of the exercise or conversion within twelve (12) months following the effective date of the offering of warrants, options, convertible securities, or similar securities distributed as part of the offering;
 - (xii) fees of a qualified independent underwriter; and
 - (xiii) compensation, including expense reimbursements, paid in the six (6) months prior to the initial or amended filing of the prospectus or similar documents to any member or person associated with a member for a public offering that was not completed.
- (B) Expenses customarily borne by an issuer, such as printing costs; SEC, "blue sky"

and other registration fees; NASD filing fees; and accountant's fees, shall be excluded from underwriter's compensation whether or not paid through an underwriter.

(4) Determination of Whether Compensation Is Received in Connection With the Offering

(A) All items of value received or to be received by the underwriter and related persons during the twelve (12) month period immediately preceding the filing of the registration statement or similar document, and at the time of and subsequent to the public offering, will be examined to determine whether such items of value are underwriting compensation in connection with the offering and, if received during the six (6) month period immediately preceding the filing of the registration statement or similar document, will be presumed to be underwriting compensation received in connection with the offering, provided, however, that such presumption may be rebutted on the basis of information satisfactory to the NASD to support a finding that the receipt of an item is not in connection with the offering and shall not include cash discounts or commissions received in connection with a prior distribution of the issuer's securities.

(B) Items of value received by an underwriter and related person more than twelve (12) months immediately preceding the date of filing of the registration statement or similar document will be presumed not to be underwriting compensation. However, items received prior to such twelve (12) month period may be included as underwriting compensation on the basis of information to support a finding that receipt of the item is in connection with the offering.

(C) For purposes of determining whether any item of value received or to be received by the underwriter and related persons is in connection with or related to the distribution of the public offering, the following factors, as well as any other relevant factors and circumstances, shall be considered:

- (i) the length of time between the date of filing of the registration statement or similar document and (a) the date of the receipt of the item of value, (b) the date of any contractual agreement for services

for which the item of value was or is to be received, and (c) the date the performance of the service commenced, with a shorter period of time tending to indicate that the item is received in connection with the offering;

(ii) the details of the services provided or to be provided for which the item of value was or is to be received;

(iii) the relationship between the services provided or to be provided for which the item of value was or is to be received and

(a) the nature of the item of value, (b) the compensation value of the item, and (c) the proposed public offering;

(iv) the presence or absence of arm's-length bargaining or the existence of any affiliate relationship between the issuer and the recipient of the item of value, with the absence of arm's-length bargaining or the presence of any affiliation tending to indicate that the item of value is received in connection with the offering.

(D) For purposes of determining whether securities received or to be received by the underwriter and related persons are in connection with or related to the distribution of the public offering, the factors in subparagraph (C) above and the following factors shall be considered:

(i) any disparity between the price paid and the offering price or the market price, if a bona fide independent market exists at the time of acquisition, with a greater disparity tending to indicate that the securities constitute compensation;

(ii) the amount of risk assumed by the recipient of the securities, as determined by (a) the restrictions on exercise and resale; (b) the nature of the securities (e.g., warrant, stock, or debt); and (c) the amount of securities, with a larger amount of readily marketable securities without

restrictions on resale or a warrant for securities tending to indicate that the securities constitute compensation; and

(iii) the relationship of the receipt of the securities to purchases by unrelated purchasers on similar terms at approximately the same time with an absence of similar purchases tending to indicate that the

securities constitute compensation.

(E) Notwithstanding the provisions of subparagraph (3)(A)(vi) above, financial consulting and advisory fees may be excluded from underwriting compensation upon a finding by the NASD, on the basis of information satisfactory to it, that an ongoing relationship between the issuer and the underwriter and related person has been established at least twelve (12) months prior to the filing of the registration statement or similar document or that the relationship, if established subsequent to that time, was not entered into in connection with the offering, and that actual services have been or will be rendered which were not or will not be in connection with or related to the offering.

(5) Valuation of Non-Cash Compensation

For purposes of determining the value to be assigned to securities received as underwriting compensation, the following criteria and procedures shall be applied:

(A) No underwriter and related person may receive a security or a warrant for a security as compensation in connection with the distribution of a public offering that is different than the security to be offered to the public unless the security received as compensation has a bona fide independent market, provided, however, that

(i) in exceptional and unusual circumstances, upon good cause shown, such arrangement may be permitted by the NASD; and

(ii) in an offering of units, the underwriter and related persons may only receive a warrant for the unit offered to the public where the unit is the same as the public unit and the terms are no more favorable than the terms of the public unit.

(B) securities that are not options, warrants or convertible securities shall be valued on the basis of:

(i) the difference between the per security cost and either the market price per security on the date of acquisition, where a bona fide independent market exists for the security, or the proposed (and actual) public offering price per security;

(ii) multiplied by the number of securities received or to be received as underwriting

compensation;

(iii) divided by the offering proceeds; and

(iv) multiplied by one hundred (100).

(C) options, warrants or convertible securities, shall be valued on the basis of the following formula:

(i) the proposed (and actual) public offering price per security multiplied by .65 (65%);

(ii) minus the difference between the conversion price per security and either the market price per security on the date of acquisition, where a bona fide independent market exists for the security, or the proposed (and actual) public offering price per security;

(iii) divided by two (2);

(iv) multiplied by the number of convertible securities received or to be received as underwriting compensation;

(v) less the total price paid for the securities;

(vi) divided by the offering proceeds; and

(vii) multiplied by one hundred (100).
 (D) a lower value equal to 80% and 60% of the value calculation shall be assigned if securities and, where relevant, underlying securities, are or will be restricted from sale, transfer, assignment or other disposition for a period of one and two years, respectively, beyond the one-year period of restriction required by subparagraph (c)(7)(A)(i).

(6) Unreasonable Terms and Arrangements

(A) No member or person associated with a member shall participate in any manner in a public offering of securities after any arrangement proposed in connection with the public offering, or the terms and conditions relating thereto, has been determined to be unfair or unreasonable pursuant to this Section or inconsistent with any By-Law or any Rule of Fair Practice, or other rule or regulation, of the NASD.

(B) Without limiting the foregoing, the following terms and arrangements, when proposed in connection with the distribution of a public offering of securities, shall be unfair and unreasonable:

(i) any accountable expense allowance granted by an issuer to the underwriter and related persons which includes pay-

ment for general overhead, salaries, supplies, or similar expenses of the underwriter incurred in the normal conduct of business;

(ii) any non-accountable expense allowance in excess of three (3) percent;

(iii) any payment of commissions or reimbursement of expenses directly or indirectly to the underwriter and related persons prior to commencement of the public sale of the securities being offered, except a reasonable advance against out-of-pocket accountable expenses actually anticipated to be incurred by the underwriter and related persons, which advance is reimbursed to the issuer to the extent not actually incurred;

(iv) the payment of any compensation by an issuer to a member or person associated with a member in connection with an offering of securities which is not completed according to the terms of agreement between the issuer and underwriter, except those negotiated and paid in connection with a transaction that occurs in lieu of the proposed offering as a result of the efforts of the underwriter and related persons and provided, however, that the reimbursement of out-of-pocket accountable expenses actually incurred by the member or person associated with a member shall not be presumed to be unfair or unreasonable under normal circumstances;

(v) any right of first refusal regarding future public offerings, private placements or other financings which has a duration of more than five (5) years from the effective date of the offering;

(vi) the receipt by the underwriter and related persons of underwriting compensation consisting of any option, warrant or convertible security which:

(1) is exercisable or convertible more than five (5) years from the effective date of the offering;

(2) is exercisable or convertible at a price below either the public offering price of the underlying security or, if a bona fide independent market exists for the security or the underlying security,

- the market price at the time of receipt;
- (3) is not in compliance with subparagraph (c)(5)(A) above;
- (4) has more than one demand registration right at the issuer's expense;
- (5) has a demand registration right with a duration of more than five (5) years from the effective date of the offering;
- (6) has a piggyback registration right with a duration of more than seven (7) years from the effective date of the offering; or
- (7) is convertible or exercisable or otherwise is on terms more favorable than the terms of the securities being offered to the public;
- (vii) the receipt by the underwriter and related persons of any item of compensation for which a value cannot be determined at the time of the offering;
- (viii) when proposed in connection with the distribution of a public offering of securities on a "firm commitment" basis, any overallotment option providing for the overallotment of more than fifteen (15) percent of the amount of securities being offered, computed excluding any securities offered pursuant to the overallotment option;
- (ix) Stock Numerical Limitation — the receipt by the underwriter and related persons of securities which constitute underwriting compensation in an aggregate amount greater than 10% of the number or dollar amount of securities being offered to the public, which is calculated to exclude:
 - (1) any securities deemed to constitute underwriting compensation;
 - (2) any securities issued or to be issued pursuant to an overallotment option;
 - (3) in the case of a "best efforts" offering, any securities not actually sold; and
 - (4) any securities underlying warrants, options, or convertible securities which are part of the proposed offering, except where acquired as part of a unit;
- (x) the receipt by a member or person associated with a member, pursuant to an agreement entered into at any time before or after the effective date of a public offer-

ing of warrants, options, convertible securities or units containing such securities, of any compensation or expense reimbursement in connection with the exercise or conversion of any such warrant, option, or convertible security in any of the following circumstances:

- (1) the market price of the security into which the warrant, option, or convertible security is exercisable or convertible is lower than the exercise or conversion price;
- (2) the warrant, option, or convertible security is held in a discretionary account at the time of exercise or conversion, except where prior specific written approval for exercise or conversion is received from the customer;
- (3) the arrangements whereby compensation is to be paid are not disclosed (a) in the prospectus or offering circular by which the warrants, options, or convertible securities are offered to the public, if such arrangements are contemplated or any agreement exists as to such arrangements at that time, and (b) in the prospectus or offering circular provided to securityholders at the time of exercise or conversion; or
- (4) the exercise or conversion of the warrants, options or convertible securities is not solicited by the underwriter or related person, provided however, that any request for exercise or conversion will be presumed to be unsolicited unless the customer states in writing that the transaction was solicited and designates in writing the broker/dealer to receive compensation for the exercise or conversion;
- (xi) for a member or person associated with a member to accept, directly or indirectly, any non-cash sales incentive item including, but not limited to, travel bonuses, prizes and awards, from an issuer or an affiliate thereof in excess of \$50 per person per issuer annually. Notwithstanding the foregoing, a member may provide non-cash sales incentive items to its associated persons provided that no issuer, or an affiliate thereof,

including specifically an affiliate of the member, directly or indirectly participates in or contributes to providing such non-cash sales incentive; or (xii) for a member to participate with an issuer in the public distribution of a non-underwritten issue of securities if the issuer hires persons primarily for the purpose of distributing or assisting in the distribution of the issue, or for the purpose of assisting in any way in connection with the underwriting, except to the extent in compliance with 17 C.F.R.

240.3a4-1 and applicable state law.

(C) In the event that the underwriter and related persons receive securities deemed to be underwriting compensation in an amount constituting unfair and unreasonable compensation pursuant to the Stock Numerical Limitation in subparagraph (B)(ix) above, the recipient shall return any excess securities to the issuer or the source from which received at cost and without recourse, except in exceptional and unusual circumstances, upon good cause shown, a different arrangement may be permitted.

(7) Restrictions on Securities

(A) No member or person associated with a member shall participate in any public offering which does not comply with the following requirements:

(i) securities deemed to be underwriting compensation shall not be sold, transferred, assigned, pledged or hypothecated by any person, except as provided in subparagraph (B) below, for a period of one year following the effective date of the offering for which the securities were received. However, securities deemed to be underwriting compensation may be transferred to any member participating in the offering and the bona fide officers or partners thereof and securities which are convertible into other types of securities or which may be exercised for the purchase of other securities may be so transferred, converted or exercised if all securities so transferred or received remain subject to the restrictions specified herein for the remainder of the initially applicable time period;

(ii) certificates or similar instruments representing securities restricted pursuant to subparagraph (A)(i) above shall bear an appropriate legend describing the restriction and stating the time period for which the restriction is operative; and (iii) securities to be received by a member as underwriting compensation shall only be issued to a member participating in the offering and the bona fide officers or partners thereof.

(B) The provisions of subparagraph (A) notwithstanding, the transfer of any security by operation of law or by reason of reorganization of the issuer shall not be prohibited.

(C) **Venture Capital Restrictions** — When a member participates in the initial public offering of an issuer's securities, such member or any officer, director, general partner, controlling shareholder or subsidiary of the member or subsidiary of such controlling shareholder or a member of the immediate family of such persons, who beneficially owns any securities of said issuer at the time of filing of the offering, shall not sell such securities during the offering or sell, transfer, assign or hypothecate such securities for ninety (90) days following the effective date of the offering unless:

(i) the price at which the issue is to be distributed to the public is established at a price no higher than that recommended by a qualified independent underwriter who does not beneficially own 5% or more of the outstanding voting securities of the issuer, who shall also participate in the preparation of the registration statement and the prospectus, offering circular, or similar document and who shall exercise the usual standards of "due diligence" in respect thereto; or (ii) the aggregate amount of such securities held by such member and its related persons enumerated above would not exceed 1% of the securities being offered.

(8) Conflicts of Interest

(A) **Proceeds Directed to a Member** — No member shall participate in a public offering of an issuer's securities where more than ten

(10) percent of the net offering proceeds, not including underwriting compensation, are intended to be paid to members participating in the distribution of the offering or associated or affiliated persons of such members, or members of the immediate family of such persons, unless the price at which an equity issue or the yield at which a debt issue is to be distributed to the public is established pursuant to Subsection 3(c) of Schedule E to the By-Laws.

(i) All offerings included within the scope of this paragraph (8) shall disclose in the underwriting or plan of distribution section of the registration statement, offering circular or other similar document that the offering is being made pursuant to the provisions of this paragraph and, where applicable, the name of the member acting as qualified independent underwriter, and that such member is assuming the responsibilities of acting as a qualified independent underwriter in pricing the offering and conducting due diligence.

(ii) The provisions of this paragraph (8) shall not apply to:

(1) an offering otherwise subject to the provisions of Schedule E to the By-Laws;

(2) an offering of securities exempt from registration with the Securities and Exchange Commission under Section 3(a)(4) of the Securities Act of 1933;

(3) an offering of a real estate investment trust as defined in Section 856 of the Internal Revenue Code; or

(4) an offering of securities subject to Article III, Section 34 of the Rules of Fair Practice, unless the net offering proceeds are intended to be paid to the above persons for the purpose of repaying loans, advances or other types of financing utilized to acquire an interest in a pre-existing company.

(d) Power of the Board of Governors

The Board of Governors shall have the power to alter, amend, supplement or modify the provisions of Subsection (b) of this Section from time to time without recourse to the membership for approval as would otherwise be required by

Article III of the By-Laws.

**CODE OF PROCEDURE FOR
CORPORATE FINANCING AND DIRECT
PARTICIPATION PROGRAM MATTERS**

(Note: The following provisions are not subject to member vote.)

(1) Purpose

The purpose of this Code of Procedure is to provide a procedure for review of determinations by the NASD's staff regarding compliance with NASD rules relating to corporate financing and direct participation program matters by which any member is aggrieved.

(2) Application by Aggrieved Member

Any member aggrieved by a determination rendered pursuant to any rule or regulation of the NASD relating to underwriting terms or arrangements may make application for review of such determination. In exceptional or unusual circumstances, a member may request conditionally or unconditionally an exemption from such rules or regulations. Applications for review will be accepted only with respect to offerings for which a registration statement or similar document has been filed with the appropriate federal or state regulatory agency; provided, however, that a hearing committee may waive the requirement for filing prior to review upon a finding that such review is appropriate under the circumstances.

(3) Application for Review

Any member making application for review pursuant to paragraph (2) above (hereinafter referred to as "applicant") shall request such review in writing and shall specify in reasonable detail the source and nature of the aggrievement and the relief requested. The applicant shall state whether a hearing is requested and shall sign the written application.

(4) Notice of Hearing

Any applicant shall have a right to a hearing before a hearing committee constituted as provided in paragraph (5) below. The hearing committee may request a hearing on its own motion. A hearing shall be scheduled as soon as practicable, at a location determined by the hearing committee. Written notice of the hearing shall be sent to the applicant stating the date, time, and location of the hearing.

(5) Hearing Committee and Procedure

(A) Any hearing shall be before an individual or individuals designated by the NASD, who shall be current or past members of the appropriate standing committee of the Board of Governors, i.e., the "hearing committee." Any applicant shall be entitled to appear at, and participate in, the hearing, to be represented by counsel, and to submit any relevant testimony or evidence.

Representatives of the NASD shall be entitled to appear at, and participate in, the hearing, to be represented by counsel, and to submit any relevant testimony or evidence. Upon agreement of the applicant, representatives of the NASD, and the hearing committee, a hearing may be conducted by means of a telephonic or other linkage which permits all parties to participate simultaneously in the proceeding.

(B) In the event that the applicant waives a hearing before the appropriate hearing committee, the hearing committee shall review the matter on the record before it. Any applicant and the NASD shall be entitled to submit any relevant written testimony or evidence to the hearing committee.

(6) Requirement for Written Determination

The hearing committee shall render a determination as to all issues which the committee finds to be relevant as soon as practicable following conclusion of the hearing or, in cases in which a hearing is not requested, completion of the committee's review of the record. The hearing committee may determine whether the proposed underwriting or other terms and arrangements in connection with or relating to the distribution of the securities, or the terms and conditions related thereto, taking into consideration all elements of compensation and all of the relevant surrounding factors and circumstances, are fair and reasonable and in compliance with applicable rules and regulations. The determination of the hearing committee shall be issued in writing, and a copy shall be sent to each applicant.

(7) Review by Committee of Board

(A) Any member aggrieved by a determination of a hearing committee shall have a right to have that determination reviewed by the appropriate standing committee of the Board of Governors.

(B) Any member seeking a review of a determination of a hearing committee shall submit a written request for such review to the NASD within fifteen (15) business days following issuance of the hearing committee's written determination. Any such member shall submit with the written request for review a written statement specifying the portion of the hearing committee's determination for which review is requested and the relief sought. Any such member may submit written testimony or evidence for consideration by the committee. Representatives of the NASD may also submit written testimony or evidence to the committee.

(C) Pursuant to a request duly made, the appropriate standing committee of the Board of Governors will review the determination of a hearing committee, giving consideration to all parts of the record which the Board committee finds relevant. The Board committee shall render a determination as to all issues which the committee finds to be relevant. The determination of the Board committee shall be issued in writing, and a copy of the determination shall be sent to each member requesting review.

(8) Nature of Determination

Any determination by a hearing committee or standing committee shall constitute the opinion of that committee as to compliance with applicable NASD rules, interpretations or policies and shall be advisory in nature only. Such determination shall not be subject to review by the Board of Governors. No such determination shall constitute a finding of a violation of any rule, interpretation or policy. A finding of a violation shall be made only by a District Business Conduct Committee.

Notice To Members

National Association of Securities Dealers, Inc.

March 1990

Number 90 - 11

Suggested Routing:*

- | | | | |
|---|--|--|---|
| <input checked="" type="checkbox"/> Senior Management | <input type="checkbox"/> Internal Audit | <input checked="" type="checkbox"/> Operations | <input type="checkbox"/> Syndicate |
| <input type="checkbox"/> Corporate Finance | <input checked="" type="checkbox"/> Legal & Compliance | <input type="checkbox"/> Options | <input type="checkbox"/> Systems |
| <input type="checkbox"/> Government Securities | <input type="checkbox"/> Municipal | <input type="checkbox"/> Registration | <input checked="" type="checkbox"/> Trading |
| <input checked="" type="checkbox"/> Institutional | <input type="checkbox"/> Mutual Fund | <input type="checkbox"/> Research | <input type="checkbox"/> Training |

*These are suggested departments only. Others may be appropriate for your firm.

MAIL VOTE

Subject: Proposed Amendment Re: Disclosure of Payment for Order Flow Practices on Customer Confirmations; Last Voting Date: April 5, 1990

EXECUTIVE SUMMARY

To improve disclosure of broker-dealer compensation for order flow and to make the disclosure more uniform, the NASD Board of Governors approved a change to the NASD Rules of Fair Practice on which members are requested to vote. The change would require specific language to appear in bold typeface in a prominent location on each applicable customer confirmation disclosing the kind of compensation arrangements. Prior to becoming effective, the change must be filed with and approved by the Securities and Exchange Commission. The text of the proposed change follows this notice.

BACKGROUND AND EXPLANATION

In the past several months, the subject of broker-dealer compensation for sending customer orders to particular market makers has come under scrutiny by the NASD and the Securities and Exchange Commission. In June 1989, the NASD issued a questionnaire to market makers that, among other things, requested information about their "hard dollar" payment practices. In July 1989, the SEC hosted the "Roundtable on Commission Dol-

lar and Payment For Order Flow Practices," which featured commentators from broker-dealers, self-regulatory organizations, money managers, and pension plan sponsors.

The NASD survey and SEC roundtable showed that, although payment for order flow practices exist, they are generally well documented in broker-dealer records and are generally disclosed to customers with boiler-plate language on the back of confirmations. In order to study the issue further and to determine if any NASD regulatory action were warranted, the NASD formed a special subcommittee of the Trading Committee. The subcommittee reviewed current compensation practices and found that, while disclosure to customers was being made, the quality and method of disclosure varied from firm to firm.

In the interest of improving disclosure to customers and making it more uniform, the subcommittee recommended, and the NASD Board of Governors approved, a change to the NASD Rules of Fair Practice, Article III, Section 12, "Disclosure on Confirmations." The Board of Governors believes that payment for order flow practices should be more specifically disclosed and highlighted on customer confirmations and that members should again be reminded of their obligations to assure best execution for customer trades

processed under these arrangements.

Disclosure of Compensation

Rule 10b-10 under the Securities Exchange Act of 1934 prescribes information that a broker or dealer must disclose to its customer on the confirmation form. The rule requires, among other things, that the broker-dealer disclose whether additional remuneration has been or will be received in connection with a transaction, and that the source and amount of such payment be furnished to the customer upon written request.¹ Under this rule, therefore, payments received by a retail firm from a market maker in return for directing its order flow to the market maker is considered additional compensation and must be disclosed to the customer. The NASD Board of Governors believes that this disclosure must be more specifically stated than is the current practice and that the following language must appear in **bold typeface**, in a prominent location, on each customer confirmation transaction that has been subject to a compensation plan:

The firm may receive remuneration for directing orders to a particular broker or dealer, through which your transaction is executed. Such remuneration is considered compensation to us and the source and amount of any compensation will be disclosed upon request.

The Board believes that the proposed language, appearing prominently in bold print on customer confirmations, will more clearly disclose these compensation arrangements. Therefore, it approved submitting the rule change to the SEC for approval, pending membership vote on the change.

Best Execution

The Interpretation of the Board of Governors on Execution of Retail Transactions,² the "Best Execution Interpretation," requires that:

[i]n any transaction for or with a customer, a member and persons associated with a member shall . . . buy or sell . . . so that the resultant price to the customer is

as favorable as possible under prevailing market conditions.

In accordance with longstanding NASD policy, this requirement is particularly applicable to situations in which firms direct their order flow to a selected dealer. Although examinations by the NASD indicate that firms that have entered into agreements for payment for order flow are obtaining the best execution of their customers' transactions, it is important for all firms to assure that they continue to obtain the best execution of trades subject to these arrangements. NASD examiners will continue to review this area during on-site examinations to ensure ongoing compliance.

The NASD Board of Governors believes this change to the Rules of Fair Practice is necessary and appropriate and recommends that members vote their approval. Please mark the attached ballot according to your convictions and return it in the enclosed, stamped envelope to The Corporation Trust Company. Ballots must be postmarked **no later than April 5, 1990**.

Questions or comments regarding this notice may be directed to P. William Hotchkiss in the Surveillance Department at (202) 728-8235.

PROPOSED AMENDMENT TO ARTICLE III, SECTION 12, NASD RULES OF FAIR PRACTICE

(Note: New language is underlined)

Section 12 (b) A member that receives compensation for sending customer orders to a particular market center or market maker must give or send to each customer, at or before the completion of each transaction, written notification disclosing, in bold print:

The firm may receive remuneration for directing orders to a particular broker or dealer, through which your transaction is executed. Such remuneration is considered compensation to us and the source and amount of any compensation will be disclosed upon request.

¹ Rule 10b-10(a)(7), 17 CFR §240.10b-10(a)(7).

² NASD Manual (CCH) p. 2037.

Notice To Members

National Association of Securities Dealers, Inc.

March 1990

Number 90 - 12**Suggested Routing:*** Senior Management Corporate Finance Government Securities Institutional Internal Audit Legal & Compliance Municipal Mutual Fund Operations Options Registration Research Syndicate Systems Trading Training

*These are suggested departments only. Others may be appropriate for your firm.

MAIL VOTE

Subject: Proposed Amendments to Article III, Sections 2 and 21(c) of the Rules of Fair Practice Re: Customer Account Information; Last Voting Date: April 5, 1990

EXECUTIVE SUMMARY

The NASD requests members to vote on proposed amendments to Article III, Sections 2 and 21(c) of the Rules of Fair Practice ("Rules") that would operate prospectively to require NASD members to make reasonable efforts to obtain certain information pertaining to customer accounts. In the case of non-institutional accounts, the proposed amendment to Section 21(c) would require NASD members to make reasonable efforts to obtain the necessary additional information prior to the settlement of the initial transaction in the account, including discretionary and corporate accounts. Existing requirements regarding institutional accounts are retained,

and the new rule requires that the names of any persons authorized to transact business on behalf of the entities should be obtained, if the customer is a corporation, partnership, or other legal entity.

The proposed amendment to Section 2 requires NASD members to make reasonable efforts to obtain certain additional information prior to the execution of a transaction recommended to a noninstitutional customer. Both proposed amendments exclude transactions and accounts when the investments are limited to money market mutual funds. The text of each proposed amendment follows this notice.

BACKGROUND AND SUMMARY OF AMENDMENTS

Pursuant to Article III, Section 21(c) of the Rules, the accounts of all customers are required to be maintained in such form and manner as to show name; address; age; signatures of the introducing representative and member, partner, officer, or manager accepting the account for the member;

and a customer's association with or employment by another member. In discretionary accounts, the customer's occupation must be noted, along with the signature of each person authorized to exercise discretion in such account. When recommending to a customer the purchase, sale, or exchange of any security, Article III, Section 2 currently requires that a member have reasonable grounds for believ-

ing that the recommendation is suitable for the customer on the basis of any facts disclosed by the customer as to his other security holdings, financial situation, and needs.

The NASD Board of Governors believes that these procedures should be strengthened to require additional information on each account and that sufficient information be obtained to permit the member firm to make more informed determinations about accounts and investment recommendations.

The Board therefore proposes to amend Section 21(c) to require a member to make reasonable efforts to obtain, prior to the settlement of the initial transaction in a noninstitutional customer account, the tax identification or Social Security number of the customer and the occupation and name and address of the employer of each customer for each account, in addition to the above-listed information currently required to be obtained. In addition, if the customer is a corporation, partnership, or other legal entity, the member also must obtain the names of any persons authorized to transact business on behalf of such entity. With respect to discretionary accounts, the member would be required to obtain the signature of each person authorized to exercise discretion in the account and the date such discretion is granted.

Moreover, Section 2 is proposed to be amended to provide that, prior to the execution of a transaction recommended to a noninstitutional customer, a member must make reasonable efforts to obtain information concerning that customer's financial status, tax status, investment objectives, and such other information used or considered to be reasonable and necessary by the member or registered representative in making recommendations to the customer.

The proposed amendments exclude transactions and accounts in which investments are limited to money market mutual funds.

The Board believes that the proposed amendments to Article III, Sections 2 and 21(c) of the Rules will provide extra protection for both customers and firms. The requirement of "reasonable effort," can be met by prepared questionnaires for customers to complete and return or by telephone inquiry. It is not necessary to obtain a written statement from a customer in each instance in order to be in compliance with the rule.

The requirement of Section 21(c) that infor-

mation be obtained prior to the settlement of the initial transaction and of Section 2 that information be obtained prior to the execution of a transaction recommended to a noninstitutional customer will also allow some freedom in opening new accounts. In addition, it may be advisable for members to keep a record of efforts that they have made to obtain a customer's tax identification or Social Security number, as required by Section 103.35, Part 103 of Title 31 of the Code of Federal Regulations adopted by the Treasury Department, effective June 1972.

COMMENTS RECEIVED

The proposed amendment to Article III, Section 21(c) of the NASD Rules of Fair Practice was published for comment in *NASD Notice to Members 88-91* (November 1988).* The NASD received 10 comments on the proposed amendment.

One of the commenters unqualifiedly supported the proposal. The remaining nine commenters generally supported the proposal with suggested modifications: five would prefer to delete employment information requirements; two suggested the deletion of tax-status information; two questioned the need for time and date of approval information on discretionary orders; two stated that discount broker-dealers should be exempt from the proposed requirements; and two questioned the application of the proposal to investment company securities accounts.

The Board considered these comments and determined that the proposed requirements for additional account information would benefit the public, were not onerous and, thus, no exemption should be granted to either investment company securities accounts or discount brokers. An exemption was provided, however, for transactions and accounts in which investments are limited to money market mutual funds. For similar reasons, the Board decided that the employment and tax status information requirements were important

* The original proposal did not include an amendment to Section 2. Rather, the amendment to Section 21(c) originally proposed a subsection that encompassed information to be obtained prior to a recommendation made to a noninstitutional customer. After further discussion, the Board concluded that, organizationally, the requirements pertaining to recommendations to customers should be contained in Section 2, rather than Section 21(c).

issues that would not impose an undue burden on members.

However, the Board did delete the requirement of time and date approval for each discretionary order, substituting instead a requirement that a record be kept of the date on which discretion was granted for each account. The Board also extended the definition of the term "institutional account" to include registered investment advisers and entities with total assets of at least \$50 million. In addition, the Board clarified the proposal to state that the names of persons authorized to act on behalf of partnerships and other legal entities, in addition to corporations, should be obtained, and that this requirement should apply to both institutional and noninstitutional accounts.

The Board of Governors thus believes that the proposed amendments to Article III, Sections 2 and 21(c) of the NASD Rules are necessary and appropriate and recommends that members vote their approval. Prior to becoming effective, the proposed amendments also must be approved by the Securities and Exchange Commission.

Please mark the enclosed ballot according to your convictions and return it in the enclosed, stamped envelope to The Corporation Trust Company. Ballots must be postmarked no later than April 5, 1990.

Questions concerning this notice can be directed to Deborah F. McIlroy, Senior Attorney, NASD Office of General Counsel, at (202) 728-8816.

PROPOSED AMENDMENT TO ARTICLE III, SECTION 2 OF THE NASD RULES OF FAIR PRACTICE

(Note: New language is underlined; deleted language is in brackets).

Recommendation to Customers

Sec. 2.(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

(b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information

concerning:

- (i) the customer's financial status;
- (ii) the customer's tax status;
- (iii) the customer's investment objectives; and
- (iv) such other information used or considered to be reasonable and necessary by such member or registered representative in making recommendations to the customer.

PROPOSED AMENDMENT TO ARTICLE III, SECTION 21(c) OF THE NASD RULES OF FAIR PRACTICE

(Note: New language is underlined; deleted language is in brackets).

Books and Records

Sec. 21.

* * * *

[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, officer, 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.]

Customer Account Information

(c) Each member shall maintain accounts opened after (effective date of amendment) as follows:

(1) for each account, each member shall maintain the following information:

- (i) customer's name and residence;
- (ii) whether customer is of legal age;
- (iii) signature of the registered representative introducing the account and signature of the member or partner, officer, or manager who accepts the account; and
- (iv) if the customer is a corporation, partner-

ship, or other legal entity, the names of any persons authorized to transact business on behalf of the entity;

(2) for each account other than an institutional account, and accounts in which investments are limited to transactions in money market funds, each member shall also make reasonable efforts to obtain, prior to the settlement of the initial transaction in the account, the following information to the extent it is applicable to the account:

(i) customer's tax identification or Social Security number;

(ii) occupation of customer and name and address of employer; and

(iii) whether customer is an associated person of another member; and

(3) for discretionary accounts, in addition to compliance with subsections (1) and (2) above, and

Article III, Section 15(b) of these rules, the member shall:

(i) obtain the signature of each person authorized to exercise discretion in the account; and

(ii) record the date such discretion is granted.

(4) For purposes of this section and Article III, Section 2, the term "institutional account" shall mean the account of:

(i) a bank, savings and loan association, insurance company, or registered investment company;

(ii) an investment adviser registered under Section 203 of the Investment Advisers Act of 1940; or

(iii) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million.

Notice To Members

National Association of Securities Dealers, Inc.

March 1990

Number 90 - 13**Suggested Routing:***

- | | | | |
|---|--|---------------------------------------|--|
| <input checked="" type="checkbox"/> Senior Management | <input type="checkbox"/> Internal Audit | <input type="checkbox"/> Operations | <input type="checkbox"/> Syndicate |
| <input type="checkbox"/> Corporate Finance | <input checked="" type="checkbox"/> Legal & Compliance | <input type="checkbox"/> Options | <input type="checkbox"/> Systems |
| <input type="checkbox"/> Government Securities | <input type="checkbox"/> Municipal | <input type="checkbox"/> Registration | <input checked="" type="checkbox"/> Trading |
| <input type="checkbox"/> Institutional | <input type="checkbox"/> Mutual Fund | <input type="checkbox"/> Research | <input checked="" type="checkbox"/> Training |

*These are suggested departments only. Others may be appropriate for your firm.

MAIL VOTE

Subject: Proposed Technical Amendment to Pending Prompt Receipt Rule;
Last Voting Date: April 5, 1990

EXECUTIVE SUMMARY

The membership is requested to vote on an amendment to a Rule of Fair Practice that the membership voted to approve last year (*Notice to Members 89-20*). The amendment makes a technical change relating to partial deliveries of securities.

PROMPT RECEIPT AND DELIVERY RULE AMENDMENT

The membership has previously approved a new section under Article III of the NASD Rules of Fair Practice that codifies the Board of Governors' Interpretation with respect to Prompt Receipt and Delivery of Securities ("Interpretation"), presently appearing in the NASD Manual under Section 1 of Article III of the Rules of Fair Practice. The new section has not yet been approved by the Securities and Exchange Commission. The section codifies the Interpretation's requirement that a member ascertain that a purchasing customer agrees to receive a partial execution of the order.

The amendment you are asked to vote on at

this time would establish an exception to this requirement for purchase orders of less than a single unit of trading. The provision would be substituted for the exception in the previously approved section that covers purchase orders of a single unit of trading or less. It is believed that the exception should more properly relate to orders for less than a single trading unit with orders of a single trading unit or more being covered by the requirement.

The approved new section to the NASD Rules of Fair Practice, with the amendment being voted on here, will become effective upon SEC approval.¹

Please mark the enclosed ballot according to your convictions and return it in the enclosed, stamped envelope to The Corporation Trust Company. Ballots must be postmarked **no later than April 5, 1990**.

(Note: New language is underlined; deleted language is in brackets.)

¹The new Rule of Fair Practice previously approved was part of a package of new rules and amendments upon which a vote by NASD members was solicited in NASD *Notice to Members 89-20* (Feb. 17, 1989).

**PROPOSED AMENDMENT TO
NASD RULES OF FAIR PRACTICE**

ARTICLE III

Prompt Receipt and Delivery of Securities
Sec. [C]²

(a) **Purchases.** No member or person associated with a member shall accept a customer's purchase order for any security, for [more than] a single unit of trading or more unless it has first ascertained that the customer placing the order or its

agent agrees to receive securities against payment in an amount equal to any execution, even though such an execution may represent the purchase of only a part of a larger order.

²The following is the text of subsection (a) of new Section [C] as approved by the membership last year. The new rule was designated Section [C] in the submission for member vote made in NASD *Notice to Members 89-20* (Feb. 17, 1989). Upon SEC approval, a section number will be substituted for the letter designation.