

# ALERT

## Stuart-James, Individuals Pay \$2 Million Fine to NASD

Based on a Letter of Acceptance, Waiver and Consent (AWC), the NASD recently collected a \$2 million-plus fine from The Stuart-James Company; James Padgett, President; Stuart Graff, former Chairman of the Board; and Steven Pata, Head Trader.

Specifically, Stuart-James was fined \$1.9 million and agreed to comply with certain undertakings relative to the scope of its business.

Padgett, currently President and sole shareholder of Stuart-James, was fined \$105,000 and will be prohibited from acting as a supervisor over the markup area for a period of not less than six months.

Graff, former Chairman and a principal shareholder of Stuart-James, was fined \$25,000, suspended from acting as a principal for 60 days, and ordered, thereafter, to re-qualify by examination as a principal. Pata, Stuart-James' head trader, was fined \$30,000 and suspended in all capacities for 20 days.

Without admitting or denying the allegations, Stuart-James, Padgett, Graff, and Pata consented to findings of violations of NASD rules related to excessive markups charged to customers of Stuart-James in principal transactions in four low-priced securities.

In addition, without admitting or denying the allegations, Padgett and Pata consented to violations of NASD rules that require registered persons to provide information on the request of the NASD.

Stuart-James has agreed to make certain changes in its business practices. Specifically, the firm ceased making markets and execut-

ing principal transactions in over-the-counter securities not traded on NASDAQ.

The firm also agreed not to trade or underwrite so-called "blind pool" or "blank check" companies. And it agreed to disclose on written confirmations sent to customers the highest bid and lowest ask prices (i.e., inside market) in the security at the time of purchase or sale and, further, that the spread between bid and ask could constitute revenue for the firm in principal transactions.

In connection with its underwriting activities, Stuart-James agreed to use its best efforts to ensure broader distribution of new issues of securities by syndications through other independent dealers and by registering and delivering certain shares being held in safe-keeping for its customers.

To ensure it complies with these undertakings, Stuart-James has further agreed that a senior executive of

(continued on page 6)

## NASD Focuses On Trading Overseas During Trading Halts

The Market Surveillance Committee reminds members that Article III, Section 42 of the Association's Rules of Fair Practice prohibits trading during an NASD trading halt. Section 42 states, "No member or person associated with a member shall, directly or indirectly, effect any transaction in a security as to which a trading halt is currently in effect."

The Committee has become aware that certain firms are executing transactions during NASD trading halts by matching buy and sell orders in the United States and sending these trades overseas for execution.

This practice is prohibited by the Association's rules if introduced through or effected by an NASD member. All over-the-counter trading by a member in any security subject

(continued on page 6)

## IN THIS ISSUE

- 2 NASD Sanctions Firm, Individuals for Penny-Stock Fraud
- 2 OTC Bulletin Board Starts Strong, Proves Popular
- 3 NASD Imposes Bar, Suspension, Fines on Principals
- 3 Proposal Expands Application of NASD Maximum Sales Charge Rule
- 4 Group Endorses Standards for Clearance and Settlement
- 4 SEC Approves Schedule H Change
- 5 PORTAL<sup>SM</sup> Expected to Benefit Private Placement Market
- 7 NASD Files Higher NASDAQ Standards With Commission
- 7 IPO Fraud Leads to Sanction for Former NASD Member Firm
- 8 NASD Revokes Firm's Membership
- 9 Arbitration Chair Urges Use of Creative Rulings to Set Precedent
- 9 Members Study Concept of Continuing Assessments
- 10 Members Must Report Certain Cash Transactions
- 10 Advertising Department Specifies Policy on FAXing Filings
- 10 Firms Must Accurately Disclose Bond Trading Charges
- 11 Tombstone Advertisements Concern Advertising Department

## NASD Sanctions Firm, Individuals For Penny-Stock Fraud

The NASD took disciplinary action against Huberman Securities Corp. of North Miami Beach, Florida; its President, Michael Huberman; and one of the firm's registered representatives, Lawrence Ivan Kaplan.

The alleged misconduct principally involved fraudulent markups in units of Top Sound International, Inc., then an over-the-counter "penny stock" not traded on NASDAQ, as well as a violation of the NASD Board of Governors' Corporate Financing Interpretation.

Pursuant to an Offer of Settlement, in which the respondents neither admitted nor denied the allegations, the NASD censured the firm and Huberman and fined them \$70,000, jointly and severally.

The firm was suspended from NASD membership for 30 days, and Huberman was suspended from association with any member in any capacity for 30 days, both subject to limited exceptions. In addition, the NASD censured Kaplan, fined him \$20,000, and suspended him from association with any member in any capacity for 60 days.

Huberman Securities and Huberman consented to findings that they violated various NASD rules, including Section 18 of its Rules of Fair Practice that prohibits the use of any manipulative, deceptive, or other fraudulent device in the purchase or sale of any security.

### Excessive Markups Found

The NASD found that, while dominating and controlling the market for Top Sound from November 28, 1986, through January 13, 1987, the firm charged fraudulently excessive markups in 111 principal sales to retail customers. The excessive markups ranged from approximately 10 percent to 100 percent above the prevailing market price for Top

Sound, resulting in customers being substantially overcharged.

The NASD's Market Surveillance Committee, which instituted the disciplinary action, said that "the markups were undisclosed, and there was otherwise little information available to [the firm's] customers to apprise them of the excessive nature of the charges."

The committee found that, by charging excessive markups, "[the firm] and Huberman breached their obligation of fair dealing which they owed to their customers."

### Unfair Compensation Charged

The other principal misconduct relates to an alleged violation of the Corporate Financing Interpretation by Huberman Securities, Huberman, and Kaplan. Kaplan and others received restricted Top Sound common stock for a nominal consideration, within approximately six months of Top Sound's initial public offering in October 1986.

By participating in the offering, the complaint claims, the overall compensation available to NASD members was unfair and unreasonable. In addition, the restricted shares held by Kaplan and others exceeded the 10-percent stock limitation set forth in the Corporate Financing Interpretation, the NASD found.

## OTC Bulletin Board Starts Strong, Proves Popular

Participation in the NASD's new OTC Bulletin Board, a nationwide screen-based system for the display of trading information on over-the-counter stocks, exceeded expectations as the number of market makers grew from 75 to 108 in its first full week of operation.

Similarly, the number of market making positions increased from 3,888 in 2,285 securities at start up to 7,235 positions in nearly 3,000 securities.

Sixty-six percent of the quotes

at the end of the week were firm on both sides of the market, and another 17% were firm on one side or the other.

"The interest and participation of members in the new OTC Bulletin Board is revolutionizing the over-the-counter market," says John T. Wall, Executive Vice President, Marketing and Market Operations. "We expected 50 market makers, and we already have 100 using our new electronic quote system.

"And the number of firm prices they are quoting is astounding, when you consider that only one week ago, real-time price information of any kind was simply unavailable except on a stock-by-stock basis through individual calls to market makers," Wall says.

### Better Information

According to Wall, the improved quality of information will clearly benefit over-the-counter companies, their investors, and regulators. The pre-Bulletin Board OTC market had, at best, day-old information printed on paper sheets; the new OTC market now has real-time data. The old printed sheets generally lacked price quotations; in the new OTC market, the vast majority of securities have price information.

In the old OTC market, brokers had to call at least three market makers to determine the best price for a security; already the OTC Bulletin Board is electronically handling about 12,000 inquiries per day, thus reducing the need to obtain quotes by telephone.

The OTC Bulletin Board permits market makers to display firm quotes, non-firm quotes or unpriced indications of interest for as many over-the-counter securities as they choose to trade. At present, about 9,000 securities are eligible for Bulletin Board quotation.

The information the market makers enter is visible, on-line, and carried on more than 2,700 terminals in the trading rooms of NASD member firms.

For issuers, the new OTC market will be a seasoning ground,

preparing them until they qualify for listing on the NASDAQ Stock Market.

Companies too small to qualify for NASDAQ will have the benefit of the OTC Bulletin Board, a nationwide, automated quotation facility, to bring their securities to the attention of investors and to help them grow until they are eligible for the NASDAQ Stock Market.

### Market Distinctions

The new over-the-counter market, i.e., the OTC Bulletin Board, is separate and distinct from the NASDAQ market. The principal differences between the two are;

- NASDAQ has listing standards for companies while there are none for those whose securities will be quoted in the OTC Bulletin Board;

- NASDAQ price quotations are firm, i.e., a market maker is obligated to trade at his stated prices, both his bid and offer, while on the OTC Bulletin Board, market-maker quotations may be one or two-sided and may be firm, non-firm, or simply unpriced indications of interest;

- NASDAQ provides automatic execution of orders in NASDAQ issues via the Small Order Execution System (SOES) while the OTC Bulletin Board is a quotations-only service; and

- NASDAQ transmits price and volume information on NASDAQ securities to market data vendors and to the press wire services for newspaper publication while the OTC Bulletin Board (at least initially) does not.

## NASD Imposes Bar, Suspension, Fines on Principals

**C**harging inadequate supervision and fraudulent markdowns, the NASD recently took disciplinary action against Marc J. Rothenberg and Joseph A. Friscia.

Their misconduct involved

transactions with customers in Advanced Viral Research Corp. units and common stock, two over-the-counter "penny stocks" not traded on NASDAQ.

Rothenberg and Friscia were principals of Diversified Equities Corp., a former member of the NASD located in New York City.

### Fines Imposed

The NASD fined Rothenberg and Friscia \$500,000, jointly and severally, barred Rothenberg as of March 9 from association with any member in any capacity, and suspended Friscia as of April 2 from association with any member in any capacity for one year.

The NASD's decision followed a disciplinary hearing and was based on findings that Rothenberg violated various NASD rules, including Section 18 of the NASD's Rules of Fair Practice that prohibits the use of any manipulative, deceptive, or other fraudulent device in the purchase or sale of any security.

### Controlling the Market

Diversified Equities underwrote Viral's initial public offering, dated April 25, 1986, and placed 100 percent of the issue with its clients. The NASD found that from the beginning of aftermarket trading on May 14, 1986, through June 13, 1986, the firm, acting through Rothenberg, dominated and controlled the market for Viral securities.

In that position, the firm, acting through Rothenberg, engaged in fraudulently excessive markdowns in 125 principal purchases from customers owning Viral units and in six principal purchases from customers owning Viral common stock.

The excessive markdowns ranged from 12.5 percent to 60 percent below the prevailing market price of the securities.

As a result, customers received approximately \$381,500 less than they should have received in selling Viral securities to the firm.

In its decision, the NASD stated that, "by charging excessive and fraudulent markdowns, Rothenberg

breached his obligation of fair dealing and good faith which he owed to his customers."

### Inadequate Supervision

The NASD also found that Friscia violated the NASD's rules by failing to supervise adequately the firm's trading to assure compliance with markup and markdown policies.

It added that Friscia played a "substantial role" in the excessive markdowns and concluded that he failed to discharge his supervisory responsibilities. The investigation was carried out by the NASD's Anti-Fraud Section. In addition to carrying out its own investigations, the NASD routinely cooperates with other self-regulatory organizations, the SEC, and criminal law-enforcement agencies.

In this case, the NASD referred portions of its investigation to the Atlanta regional office of the SEC, which resulted in a complaint being filed by the SEC on December 14, 1989, against Viral, its president, and its secretary-treasurer, for violations of the federal securities laws.

On January 14, 1990, the company and the named individuals, without admitting or denying the allegations, agreed to be permanently enjoined from violating anti-fraud and other provisions of the federal securities laws.

## Proposal Expands Application of NASD Maximum Sales Charge Rule

**T**he NASD is reviewing member comments on a proposal to apply the maximum sales charge rule to funds that impose asset-based sales charges.

Under existing rules, funds may impose a maximum front-end sales charge of not more than 8.5 percent of the offering price of a mutual fund share, graded down to 6.25 percent if one or more of three benefits are not offered.

These benefits are dividends

reinvested at net asset value, quantity discounts, and rights of accumulation.

The NASD's approach to regulating asset-based sales charges is to try to ensure that a majority of mutual fund shareholders who own shares of funds with asset-based sales charges pay no more for sales and sales-promotion expenses than is permitted by the provisions of the current NASD maximum sales charge rule.

### Fund-Level Accounting

To accomplish this, the NASD has endorsed fund-level accounting in which there cannot be sales charges after a certain percentage of gross sales is reached.

For example, assume a fund has \$1 million of sales and a sales charge of 6.25 percent. The maximum it could charge for sales-related expenses would be \$62,500.

The NASD is concerned that, with fund-level accounting, long-term shareholders might pay more than the economic equivalent of the maximum permitted front-end sales charge.

However, in the NASD's view, fund-level accounting is the most practical and least burdensome way to proceed. It would provide maximum flexibility to the industry in the financing of sales-related expenses. In addition, this approach would ensure that most investors in mutual funds, regardless of the method of financing used, would pay no more for the expenses incurred for distribution than the current NASD rule permits.

## Group Endorses Standards for Clearance and Settlement

**T**he International Councils of Securities Dealers and Self-Regulatory Associations recently endorsed procedures aimed at resolving inefficiencies in the ways securities are paid for and delivered in international stock trading.

The International Councils, representing self-regulatory organizations and dealers in the United States, Canada, United Kingdom, France, and Japan, endorsed recommendations of the Group of Thirty on development of common standards for clearance and settlement of securities transactions in all countries.

The Group of Thirty is a London-based organization of financial experts throughout the world. By endorsing the Group's resolutions to speed up the clearance and settlement process and reduce risk to participants, the Councils took a step toward promoting the growth of cross-border equity trading.

### Cross-Border Barriers

"Among the major barriers to growth of international stock trading," says Joseph R. Hardiman, President of the NASD, which co-hosted the April meeting in Washington, D.C., with the Securities Industry Association (SIA), "are the very practical inefficiencies investors confront in buying and selling stocks internationally."

"Our participant group," Hardiman says, "addressed perhaps the most significant inefficiency, the lack of standards to facilitate cross-border clearance and settlement. This crucial process by which securities are delivered and paid for by investors in international transactions is marked by the existence of widely varying systems, time frames, and procedures."

The Council of Self-Regulatory Associations also agreed to share information on its members as an essential element for achieving effective regulation of international securities markets.

The group adopted principles mandating furnishing of financial and other information on a confidential basis when necessary for enforcement, except where contrary to law or where the recipient member is unable to provide reasonable indemnification.

The Councils affirmed their support for broadening the concept of self-regulation in markets where it ex-

ists as well as in other major equity markets with active international participation and addressed the need for coordinated capital adequacy requirements for financial intermediaries.

The publication of an international guide to regulators, associations, and capital markets information was also approved.

## SEC Approves Schedule H Change

**O**n May 1, the SEC approved an amendment to Schedule H of the NASD By-Laws to require member firms to file specified information with the NASD before initiating (or resuming) a quotation of a non-NASDAQ over-the-counter security ("non-NASDAQ security") in any quotation medium.

Quotation mediums include the OTC Bulletin Board, the National Quotation Bureau's Pink Sheets™ publication, regional/local mediums comparable to the Pink Sheets™, and any other service that falls within the broad definition of "quotation medium," as defined in Rule 15c2-11(e)(1) under the Securities Exchange Act of 1934 (the "Act").

### Information Covered

The new NASD filing requirements encompass information that broker-dealers must maintain pursuant to paragraphs (a)(1) - (5) of Rule 15c2-11.

In addition, member firms will have to specify the factors considered in establishing their initial priced entries for a non-NASDAQ security before such entries may be published in any quotation medium.

In those instances where a member firm can rely on one of the stated exemptions from Rule 15c2-11, including the so-called "piggyback" exemption, no filing would be necessary. These new requirements will take effect July 2, 1990.

### Daily Reporting Obligations

Members are reminded that under Schedule H to the By-Laws

adopted in June 1988, they have an ongoing obligation to report price and volume for principal transactions in OTC equity securities that are not part of the NASDAQ system, including activity in foreign securities. Member firms must report daily activity in over-the-counter (OTC) securities not traded on NASDAQ.

Schedule H requires members executing principal transactions in the applicable securities to provide price and volume data for both purchase and sale transactions if the member's aggregate daily volume of sales or purchases exceeds either a minimum of 50,000 shares or \$10,000.

In addition, members must report price and volume data for both sides of the market if the aggregate share or dollar volume is reached on either side of the market.

For example, if a member executes an aggregate purchase volume in a non-NASDAQ issue of 70,000 shares and has an aggregate sale volume of 20,000 shares, it has to report both the purchase and sale sides of the transaction, as well as price data, because the minimum threshold level was reached on the buy side of the market.

If they choose to do so, members may report even if the minimum threshold levels established by Schedule H are not reached.

Members meeting the daily minimum reporting levels also have to report the highest price at which the member sold, and the lowest price at which it bought, the non-NASDAQ OTC equity security.

In addition, the member has to indicate whether these trades were executed with a customer or with another broker-dealer. The price on customer transactions includes markups or markdowns.

### How To Report

NASDAQ subscribers must use their NASDAQ/Harris terminals, NASDAQ Workstation<sup>SM</sup> terminals, or authorized foreign-terminal emulations to report this information.

Members using a computer-to-computer interface (CTCI) with

NASDAQ, either directly or through service bureaus, may use the interface to report price and volume data.

Member firms that are not NASDAQ subscribers can report through a dial-up electronic reporting system developed by the NASD for this purpose.

The mandatory reporting requirements of Schedule H are a critical part of the NASD's surveillance responsibilities.

Members failing to meet their reporting obligations under Schedule H will be subject to disciplinary action and possible sanctions. Member firms can refer to *Notices to Members 88-54, 89-54, and 90-40* for further information.

## PORTAL<sup>SM</sup> Expected to Benefit Private Placement Market

The action taken by the SEC in approving Rule 144A and the electronic PORTAL<sup>SM</sup> market will give the multi-billion dollar private placement market greater efficiency and liquidity," says S. William Broka, NASD Vice President, Business Development. "The Rule will greatly facilitate international capital formation, and PORTAL will provide automated efficiency and close regulation for the market."

Rule 144A, as adopted by the Commission April 19, provides new regulations for the private placement market, and particularly for secondary trading in it.

Financial institutions with more than \$100 million invested in securities will be able to trade private placements freely among themselves.

Broker-dealers participating in such transactions will be required to have proprietary positions and assets under management of at least \$10 million.

The PORTAL Market will provide a safe harbor for transactions under Rule 144A. All PORTAL securities and all PORTAL participants have to satisfy the SEC's qualifica-

tion standards, and all PORTAL transactions will be monitored for compliance with the Rule.

### Qualification Requirements

NASD members wishing to participate in PORTAL must qualify as either a "PORTAL dealer" or "PORTAL broker." To qualify as a PORTAL dealer, a member must meet the requirements of a "qualified institutional buyer" under Rule 144A.

Such dealers may execute principal transactions for other qualified institutional buyers or as an investor for its own account.

Other NASD members may function as brokers in PORTAL, but they may not effect principal transactions or participate in firm-commitment underwritings. They may, however, underwrite PORTAL securities on a best-efforts basis.

In addition to membership in the NASD, eligible PORTAL brokers or dealers have to be registered as general securities firms and must be direct or indirect participants in a PORTAL clearing organization, PORTAL depository, and one or both of the Depository Trust Company's account instruction systems.

### PORTAL Transactions

All sales or transfers of PORTAL securities to accounts outside The PORTAL Market must meet certain requirements. First, they must qualify as "exit transactions or transfers."

A transaction qualifies as an exit transaction if:

- The transaction is registered, or exempt from registration, under the Securities Act of 1933;

- The transaction represents an issuer repurchase of outstanding securities; or

- The seller proves to the NASD before the transaction that it is an exempt transaction involving securities that may be freely resold without being registered.

PORTAL participants may not transfer PORTAL securities out of The PORTAL Market except in a "qualified exit transfer," which restricts transfers exiting the market

to the return of borrowed securities and a transfer to the participant's non-PORTAL account.

Members applying to participate in The PORTAL Market must satisfy the NASD that they have supervisory procedures in place to ensure compliance with the restrictions on exit transactions and transfers.

These procedures include preserving proof-of-compliance information on such exit activity and filing a PORTAL Exit Report with the NASD within one business day after the execution of the transaction or transfer.

### PORTAL's Role

Although the private placement market is large and growing, it is presently fragmented and relies mainly on paper and telephone for its communications.

PORTAL will automate the market through the use of personal computers and existing NASDAQ terminals — used by the qualified investors and by broker-dealers — and the NASDAQ network.

These facilities will provide for entry and retrieval of quotations and transaction reports, automated confirmations to parties to transactions, a standard five-day settlement period, settlement by electronic book entry in a worldwide clearing and depository system, and the ability of participants to quote, confirm, and settle in the world's major currencies, thus cutting down currency risk.

### Primary Private Placement

PORTAL will facilitate both the primary and the secondary private placement markets.

In the case of a primary placement, the issuer will negotiate it through an investment bank, which will act as lead manager. Through the automated support of PORTAL, the manager will establish the details of the issue, specify potential qualified investors, and release information for the purpose of gaining indications of interest.

The selected institutional clients will be alerted to the pending placement through their PORTAL screens,

will retrieve the full issue information, and will enter an indication of interest or decline participation.

From the indications of interest, the manager will assess its overall position and make allocations to each client. PORTAL will lock in trade details through automated confirmations to each client.

The manager's trade confirmations will subsequently result in system-generated settlement instructions, which authorize the clearing system to transfer assets from its PORTAL account to the individual PORTAL accounts of the buyers.

### The Secondary Market

Through PORTAL, there will be, for the first time, a visible, liquid secondary market in private placement trading.

Competing dealers will display quotation information available to all participants. The form of the quotations will be flexible; a dealer may enter either one- or two-sided firm quotes, indications of interest, or only a telephone number that may be used to negotiate PORTAL trades.

The secondary market will be dealer-based, with broker-dealers that are PORTAL members making markets or acting in an agency capacity for institutions.

Institutions will see on their PORTAL screens the quotes of individual dealers, but the institutions will not be able to enter quotes or to deal directly with other institutions.

The potential buyer will choose a dealer and negotiate a transaction. The dealer will input a trade report of the sale, which will create a system-generated confirmation to the buyer.

The buyer will enter an acceptance of the transaction, and the system will create a record for transmission to clearing.

### Stuart-James

*(from page 1)*

the firm other than those named in the AWC will be designated as a "senior trading official."

The AWC also provides for the retention of an independent consultant acceptable to and approved by

the NASD who will review Stuart-James' practices and procedures in the markup area and forward a report and recommendation to the NASD's Market Surveillance Committee for final approval.

The NASD action relates to markups charged by the firm to its customers in principal transactions in four securities.

The Market Surveillance Committee found that Stuart-James, acting through those named in the AWC, charged excessive markups in its retail sales in these securities ranging from 6.9 percent to 153 percent over its contemporaneous cost, in circumstances where Stuart-James dominated and controlled the trading of these securities.

To the extent that the markups exceeded 10 percent, Stuart-James consented to a finding of a violation of Section 18 of the NASD's Rules of Fair Practice that prohibits the use of manipulative, deceptive, or other fraudulent devices in the purchase or sale of any security.

The activity involved at least 4,340 transactions reviewed by the NASD that occurred during several months in 1988.

In a separate disciplinary action, which was consolidated for purposes of this settlement, respondents Padgett and Pata consented to findings that they violated NASD rules with respect to their failure to provide "on-the-record" testimony as required by those rules.

### Overseas Trading

*(from page 1)*

to an NASD trading halt is prohibited.

This prohibition does not apply to transactions effected on a U.S. or foreign exchange that has not also halted trading in the particular security.

To be considered a foreign exchange transaction, for purposes of the NASD's trading halt rules, the transaction must be actually effected on, and reported to, a foreign exchange that has not halted trading in the subject security, and the security must be fully listed and subject to listing fees on that foreign exchange.

Under these circumstances, a member may execute an order to purchase or an order to sell on an appropriate foreign exchange.

However, matching buy and sell orders in the United States and forwarding these orders to an overseas exchange or an overseas exchange member for "execution" is not considered to be an exchange transaction and is not permitted during NASD trading halts.

For further information, please contact Katherine A. Malfa, Counsel, Market Surveillance Department, at (301) 590-6445.

## NASD Files Higher NASDAQ Standards With Commission

**T**he NASD has filed a proposed rule change with the Securities and Exchange Commission (SEC) to raise the basic listing requirements for the NASDAQ Stock Market.

The new standards were adopted by the NASD Board of Governors in March.

"There are two principal reasons for the NASD Board's decision," says John T. Wall, Executive Vice President, Marketing and Market Operations. "First, the increases in the initial and maintenance criteria are being made to take into account the effects of inflation since the requirements were last amended in 1981."

The other reason is the SEC's new penny-stock rule. "The NASD's action was prompted by the receipt of a letter dated January 10, 1990, in which the SEC expressed concern that certain promoters might attempt to circumvent the requirements of recently enacted Rule 15c2-6 (the 'penny stock' rule) by seeking a listing on the NASDAQ Stock Market," Wall says.

In the NASD's view, allowing the SEC's penny-stock rule to be circumvented through a NASDAQ listing is contrary to the interests of in-

vestors as well as a step backward in the NASD's efforts to effectively regulate the penny-stock market.

For initial listing of a security on the NASDAQ Stock Market, the filing proposes a minimum of \$4 million in the issuing company's total assets and \$2 million in capital and surplus, compared with the present requirements of \$2 million and \$1 million respectively. In addition to the currently required 100,000 shares of public float for an issue, the float would need a market value of \$1 million. There would also be a minimum bid price of \$3; there is now no such dollar standard.

Under the proposal, the current entry requirement of two market makers would remain unchanged.

The filing also proposes higher standards for the continued listing of a security in the NASDAQ Stock Market. These maintenance standards would require \$2 million in assets, instead of the current \$750,000; \$1 million in capital and surplus, up from \$375,000; a market value of float of \$200,000; two market makers, instead of one; and a minimum bid price of \$1. The higher entry standards will have no impact on issuers currently on NASDAQ. The new, higher maintenance criteria, though, may affect them.

To accommodate such issuers, the NASD intends to delay the effectiveness of the higher maintenance criteria until January 1, 1991.

This will allow existing NASDAQ issuers a reasonable period of time to take appropriate action to remedy any deficiencies that may exist, Wall says.

However, for companies unable to comply with the revised standards, the NASD has provided a new trading mechanism.

The OTC Bulletin Board, approved by the SEC May 1, is a screen-based display service that, for the first time, allows member firms to enter, update, and view quotation information in securities not eligible for NASDAQ on a real-time basis throughout the trading day.

"The NASD has carefully weighed the effect of the new criteria

on the capital formation process," Wall says. "Higher standards enhance the credibility of the NASDAQ Stock Market among individual and institutional investors, and are therefore a major benefit to companies and issues that continue to qualify for NASDAQ."

At present, there are more than 10,000 public companies trading in the over-the-counter market that have successfully raised capital without listing on NASDAQ or an exchange.

According to Wall, companies in this category will have improved visibility through the OTC Bulletin Board, which will help them grow to the point where they may qualify for NASDAQ.

## IPO Fraud Leads To Sanction for Former NASD Member Firm

**T**he NASD recently took disciplinary action against Hampton Securities, Inc., Delores V. Easthom, David D. Slaght, Barry R. Topal, and William B. Brandorff for fraudulent markups and a fraudulent scheme to distribute the initial public offering (IPO) of Reef Capital Corporation securities, a non-NASDAQ, over-the-counter penny stock.

Easthom, Slaght, and Topal were the principals and Brandorff was the trader for Hampton, a former NASD member firm located in West Palm Beach, Florida.

The NASD censured and expelled Hampton and fined it \$99,500 jointly and severally with Easthom and Slaght.

### Censured and Barred

The NASD also censured and barred Easthom from association with any member in a principal capacity and suspended her in all capacities for six months.

In addition, Slaght was censured and suspended from association with any member in a principal capacity for two years and suspended

in all capacities for three months.

Topal was censured and suspended from association with any member in a principal capacity for one year and suspended in all capacities for 60 days.

The NASD also fined him \$20,000. Brandorff was censured, fined \$7,500, and suspended for 30 days.

The NASD's decision was based on the acceptance of Offers of Settlement submitted by Hampton, Easthom, Slaght, Topal, and Brandorff.

### Section 18 Violation

Without admitting or denying the allegations, the respondents consented to findings that they violated various NASD rules, including Section 18 of the NASD's Rules of Fair Practice. Section 18 is the NASD's anti-fraud provision that prohibits the use of any manipulative, deceptive, or other fraudulent device in the purchase or sale of any security.

Hampton underwrote Reef's initial public offering, selling 100 percent of the issue to its own clients.

The NASD's Market Surveillance Committee, which considered the case, found that Hampton, acting through the named individuals, dominated and controlled the aftermarket for Reef from the start of trading on November 17, 1987, through December 1, 1987.

The committee said Hampton "used its dominant position to control the flow of stock among its customers, to regulate its inventory position, and to guarantee itself large and unwarranted profits from essentially riskless trading."

Hampton's profits resulted from fraudulently excessive markups of approximately \$69,500 charged to its customers in 108 retail sales. These markups ranged from 26 percent to 89 percent over Hampton's cost to purchase the securities. The other significant misconduct in the case related to Hampton's, Easthom's, and Slaght's scheme to fraudulently distribute and then repurchase some of the Reef securities distributed in the IPO.

The committee found that Easthom and Slaght distributed a substantial number of Reef units during the IPO to their own customers in exchange for promises from those customers that they would sell the securities back to Hampton on the first day of the aftermarket.

### Promises Made

These promises were made in exchange for Hampton's guarantee of profits to these customers.

In some cases, the committee said, Easthom and Slaght exercised oral discretionary authority over some customer accounts and used that discretion to buy Reef from those accounts on the first day of the aftermarket.

Hampton then resold the Reef stock it acquired to other retail customers with excessive markups, without disclosing the scheme.

The committee found that Hampton, Easthom and Slaght not only defrauded their customers by failing to disclose the scheme, but that the firm also violated SEC Rule 10b-6 by failing to make a *bona fide* public distribution of Reef.

The suspensions imposed on the respondents will commence on June 18, 1990.

## NASD Revokes Firm's Membership

**T**he NASD recently cancelled the membership of Wellshire Securities, Inc., as a result of a revocation proceeding instituted under Article VI of the NASD's Code of Procedure.

This proceeding began as a result of an order of preliminary injunction entered on April 30, 1990, in the United States District Court for the Southern District of New York. The order enjoined Wellshire and two of its principals, Robert Cohen and Carol Martino, from violating Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5 thereunder.

The entry of this injunction caused the firm and the named principals to become statutorily disqualified, and thus they were ineligible for continued membership in the NASD or association with NASD members under the NASD's rules and the federal securities laws.

### SEC Complaint Involved

Earlier, the Securities and Exchange Commission (SEC) had instituted a civil injunctive proceeding against Wellshire and various individuals, and this action resulted in the April 30, 1990, injunction order. The SEC complaint, filed on March 14, 1990, alleges that from June 1988 to the present, Wellshire, under Cohen and Martino, has operated as a penny-stock "boiler room," selling speculative over-the-counter securities to the public through the use of false and misleading statements about various securities and abusive sales practices.

The judge in this order for preliminary injunction made findings that the record was replete with evidence that Wellshire employed misleading tactics to defraud its customers and, together with and through certain of its principals, encouraged investments based on misleading information contained in its market letters, telephone scripts, and correspondence.

The judge also stated that Wellshire brokers, under the guidance and training of certain principals, encouraged investment in "house" stocks based on unfounded price predictions, bogus assurances that the "house" stocks would be imminently listed on the exchange, and by actually manipulating stock prices absent market forces.

### House Stocks Pushed

The opinion also stated that Wellshire's brokers pushed the "house" stocks regardless of a customer's investment needs and contrary to his or her demonstrated investment history.

Under its rules, the NASD has the authority to institute a proceeding to cancel or suspend a member or to bar or suspend from association with



a member a person who either is subject to a statutory disqualification or is ineligible for membership in or registration with the NASD.

## Arbitration Chair Urges Use of Creative Rulings To Set Precedent

National Arbitration Committee Chairman David A. Lipton challenged arbitrators to exercise their authority to fashion creative legal remedies to new and evolving controversial issues.

Lipton, Professor of Law at The Catholic University of America, reviewed new developments in arbitration for an audience of 145 arbitrators at historic Fraunces Tavern in New York's financial district April 17.

In regard to the broad scope of arbitrators' authority now embodied in the Code of Arbitration Procedure, Lipton said that arbitrators could render many creative orders to establish precedent without initiating new rules.

He encouraged them to write reasoned opinions and not to be shy about creating precedent where appropriate.

His presentation, "Generating Precedent in Securities Industry Arbitration," is one in a series of 12 NASD-sponsored seminars on arbitration issues.

The seminars are being given in New York, Chicago, San Francisco, and other major cities. Their purpose is to discuss new procedures and mechanisms in arbitration and to permit an exchange of ideas between arbitrators and the NASD staff.

### "Only Game in Town"

The theme of Lipton's remarks related to the increased responsibility placed on the private arbitration system now that petitioners can no longer seek remedies through litigation.

Two U.S. Supreme Court cases, *Shearson American Express vs. McMahon*, and *Rodriguez vs. Shearson*

*American Express*, have transformed securities industry adjudication from a dispute resolution system dependent on the courts to one that relies on arbitration by self-regulatory organizations.

According to Lipton, a relatively modest arbitration system for small investors has been converted into "the only game in town."

Referring frequently to *The Arbitrator's Manual*, Lipton discussed such issues as nonreceipt of documents during discovery, the need for more effective use of prehearing conferences, and the inability of the arbitration system to develop case-generated precedent.

### Developing Precedent

Specifically, Lipton cited the need for a standard to determine excessive trading in options. He noted the absence of suitability rules applicable to derivative securities products such as index options and called for development of legal precedent relating to punitive damages.

## Members Study Concept for Continuing Assessment

The NASD has circulated for member comment the concept for a program of continuing assessment for securities industry representatives.

Under the program, persons that register as representatives of members after its effective date would be re-tested every three years on their knowledge of financial products and current securities rules and regulations.

"This is one of the more far-reaching proposals to be advanced in the area of continuing qualifications of securities industry personnel," says NASD President Joseph R. Hardiman. "It is evidence of the Board's determination that every avenue be explored to assure investors that they are served by knowledgeable, trained, and responsible brokers."

NASD Vice Chairman Ron Buesinger of A. G. Edwards & Sons, Inc., said that the NASD's Membership Committee, which he chairs, developed the proposal in response to the rapid changes taking place in the securities industry.

### Industry Dynamics

"New products, new rules and regulations, and new tax laws during the last decade have required substantial effort by securities industry participants and member firms to remain current," he says. "The Committee believes the NASD's role in this process should be to assure investors that minimum levels of knowledge are maintained by registrants and that this process should be formalized and embodied in an expanded NASD qualification program."

The proposal would have registered representatives who henceforth enter the industry, tested every three years on such subjects as sales-practice regulation, investment risk, customer suitability, and new product, tax and regulatory developments appropriate to various registration categories.

The computerized assessment program would contain an educational interaction with registrants. The system used to administer the assessment would be designed to confirm correct responses and to explain why an incorrect choice is wrong.

### Improved Examinations

It is believed that this feature would make the tests more instructive than ordinary examinations. Registrants sitting for a periodic assessment would be required to perform at a specified level.

Those who fail would be placed on closer-than-normal supervision and re-tested within 90 days.

Four successive failures would result in the termination of the individual's registration. The individual would then have to pass the normal entry qualification examination before his or her registration could be reinstated.

Member-firm performance standards would also be established. If a

disproportionate number of a firm's registrants fails the tests or shows weakness in a particular area, the firm would be required to improve its training activities.

Failure to do so could lead to NASD disciplinary action. All persons registered when the program begins will be grandfathered.

At current turnover rates in the industry, it is estimated that within a decade, approximately 85 to 90 percent of the personnel then registered would be subject to the continuing assessment program.

### Cooperation With NASAA

The NASD has been cooperating with the North American Securities Administrators Association (NASAA) in developing many aspects of the proposed program.

NASAA has established a Board-level committee to work closely with the NASD to implement to an appropriate program over the next two years.

Both the NASD and NASAA are working to achieve uniformity in this area before the momentum to develop standards shifts to the states where compliance with individual state requirements would prove difficult and costly for members.

Seven states already have this matter under active consideration.

The NASD Board will study all comments received on the concept before deciding on whether to incorporate such a program into the NASD's qualification process.

### Members Must Report Certain Cash Transactions

**M**embers must use revised Form 4789 to file currency-transaction reports with the Internal Revenue Service (IRS). The form is available from the regional IRS distribution centers.

Completed forms should be mailed to:

IRS Detroit Computing Center  
P.O. Box 33604  
Detroit, MI 48232-5604

Members must use the IRS' hotline, 1-800-BSA-CTRS, to report any transactions they suspect are arranged to evade the Bank Secrecy Act's requirement to report cash transactions of \$10,000 or more.

Treasury Department officials have advised the NASD that the IRS hotline is the appropriate phone number to use for these reports, not the Customs Department's hotline, as reported in earlier NASD publications.

Members should use this hotline to report suspicious noncash transactions as well. Firms also may still report suspicious activity directly to their local office of the IRS Criminal Investigation Division.

Such noncash transactions may consist of multiple cashier's checks, money orders, traveler's checks, bank checks under \$10,000, and wire transfers that may involve illegal activities, such as money laundering.

Members should remember that they have an obligation to report such suspicious transactions, even if, as a matter of policy, they do not accept cash. Failure to report such transactions could be construed as aiding and abetting violations of the law, for which members may face civil and criminal charges.

### Advertising Department Specifies Policy On FAXing Filings

**T**he NASD Advertising Department reminds member firms of the following guidelines for FAXing sales material for review:

1. Members may FAX submissions to the Advertising Department at (202) 728-6976. FAXed materials will be reviewed chronologically from date of receipt; they will not be reviewed out of chronological order.

2. The department will accept FAXed submissions that are five pages or less from member firms that have an Advertising Department account balance sufficient to cover the \$25 per-piece filing fee. Please note

that Central Registration Depository funds may not be used for this purpose; instead, contact Shirley Dorsey at (202) 728-8330 to set up a filing fee account.

3. Members should not send hard copy of FAXed material. However, if members decide to follow up the FAXed submission with a hard copy, the cover letter for the latter should clearly indicate that it is a duplicate of an earlier FAXed submission. Duplicate submissions create an accounting problem for the department, and the NASD would appreciate your cooperation in this area.

4. The Advertising Department will not FAX its comments on submitted sales material to members.

### Firms Must Accurately Disclose Bond Trading Charges

**T**he NASD Advertising Department recently found out that some schedules of commission discounts included inaccurate or misleading references to the charges incurred on bond transactions.

Sales pieces showing commission charges on stocks and options transactions have also included references to bonds being sold without commission or charge, and there have been no disclosures of a markup or markdown.

Examples of such references are:

■ "These securities are bought/sold with no commission charge but at yields consistent with the current market."

■ "There is no charge for municipal bond transactions because XYZ Firm acts as principal."

In the first example, "... but at yields consistent with the current market," does not explain to the reader that, while there is no commission charge, there is a fee for each transaction.

In the second example, there is no explanation that acting as principal results in a markup or mark-

down, and the reference to there being "no charge" is not accurate.

It is inherently misleading to discuss the lack of commission charges on any bond (corporate or municipal) on which there is a markup or markdown or any other transaction-related charge.

A reference to bonds may instead be accompanied by language clearly stating the fee, such as "Municipal Bonds - \$10 per bond over or under market price."

Or, if a flat fee is not charged, a simple statement offering more information such as "Municipal Bonds - Call for current price," should suffice.

Questions about this interpretation should be directed to the Advertising Department at (202) 728-8330.

## Tombstone Filings Concern Advertising Department

Recent member filings with the NASD Advertising Department have included a number of "tombstone advertisements" for products registered under the Securities Act of 1933 (the "Act") that did not comply with SEC Rule 134.

The staff is concerned because these advertisements often originate from NASD member firms that underwrite these securities and that are advised by outside counsel.

In addition, many dealers have prepared noncompliant material without legal advice. NASD member firms and associated persons should be aware of the provisions of Rule 134, since the use of material that fails to comply with the rule may carry civil liabilities under the Act. The full text of Rule 134 begins on page 5041 of the *NASD Manual*.

### Description of Rule

All communications involving securities registered (or pending registration) under the Act are subject to Rule 134 if distributed before delivery of an effective prospectus.

Only issues no longer subject to the Act's prospectus delivery requirements are exempt.

Thus, all advertising, sales literature, and correspondence relating to prospectus offerings should comply with Rule 134 when disseminated before the prospectus.

The Rule operates by describing a communication that will not be deemed a prospectus. It basically lists information that may be included along with items that must be included in the communication.

Because communications that comply with the rule do not carry the civil liabilities associated with a prospectus, Rule 134 provides a "safe harbor" from prospectus liability.

As it applies to most registered securities, Rule 134 is highly restrictive. The information permitted is basic and strictly factual, including, among other items, the name of the issuer, the cost of the securities, and the amount of the issue.

Narrative copy is confined to a brief description of the issuer's general type of business. Because of these content limits, Rule 134 communications are often called "tombstone advertisements." Rule 134 advertisements for mutual funds, variable contracts, and unit trusts may include a broader discussion.

For example, a mutual fund may describe its objectives and methods of operation as well as certain general economic factors within the content of a Rule 134 communication.

However, a limited partnership or new stock issue could not mention these subjects in a tombstone ad.

### Issuer Differences

Many of these nonconforming advertisements result from confusion over which sections of Rule 134 apply to investment-company products and which apply to other issues.

NASD member firms should note that only investment companies registered under the Investment Company Act of 1940 may use the more liberal provisions of the Rule con-

tained in paragraphs (a)(3)(iii) and (a)(13). Other issuers may not use these provisions.

In 1984, the NASD Advertising Department requested the views of the SEC staff regarding the application of Rule 134 to non-investment-company products with a particular emphasis on limited partnerships.

In a letter dated May 24, 1984 (the text of which is reprinted below), John J. Huber, then Director of the Division of Corporation Finance, provided certain interpretations of the Rule.

In accordance with Huber's letter, the SEC staff does not object to the inclusion of logos, corporate symbols or trademarks of either the issuer or marketing organizations in Rule 134 communications on behalf of non-investment companies.

Attention-getting headlines that direct the reader's attention to the text and comply with the other provisions of Rule 134 may also be included. Previously, both of these elements had been restricted to investment company communications only.

The letter also indicated that no other provisions applicable to investment companies could be applied to non-investment-company issuers.

Therefore, discussions of investment objectives, retirement plans, economic conditions, and other subjects are still prohibited in Rule 134 communications on behalf of limited partnerships, new-issue stocks and bonds, and other products not registered under the Investment Company Act of 1940.

### Text of Huber's Letter

The text of Huber's letter follows:

"Thank you for your letter of April 26, 1984, requesting the views of the Division of Corporation Finance on the application of Rule 134 to the inclusion of certain items of information in advertising material disseminated by non-investment companies. As you are aware, Rule 134(a)(3)(iii) permits registered investment companies, because of their unique regulatory status, to include

in their advertising certain special categories of information not permitted of other companies. However, as the Commission noted in Securities Exchange Act Release No. 6518, at footnote 2 (March 30, 1984), this provision does not apply to any company other than a registered investment company even though the issuer might bear some similarities to a registered investment company.

"Nevertheless, the Division has determined that it will not recommend any enforcement action to the Commission if a non-investment company includes in its Rule 134 advertising any logo, corporate symbol or trademark of the issuer or marketing organization, or attention getting headline designed to direct the reader's attention to the textual material included in the communication pursuant to other provisions of Rule 134. The Division will decline to take a no-action position with respect to any other item not specifically permitted by the rule including any picture, illustration or graphic design (including any graphic depiction of statistical information), any statement regarding the eligibility of the securities offered for Individual Retirement Accounts, or any statement or discussion of investment objectives. Finally, it is the Division's view that any press release issued after a registration statement has been filed should comply with Rule 134 and the interpretations set forth above.

"The Division plans to review Rule 134, along with the other rules in the 100 series, as part of its ongoing Sunset review of the forms, rules and regulations under the Securities Act and Securities Exchange Act. The timing of this review will be a function of certain other priority rulemaking efforts."

### **Naming Specific Products**

Another common problem in Rule 134 communications involves material that does not mention a specific product by name, but which is still intended to promote the offer and sale of a specific product. An example would be a seminar invitation referring to tax credit limited partnerships. If a specific fund is to be offered at the seminar, then the invitation must comply with Rule 134.

In a letter dated February 21, 1978, William E. Toomey, then Assistant Chief Counsel of the Division of Corporation Finance, addressed this issue in more detail.

### **Text of Toomey Letter**

The text of Toomey's letter follows:

"This is in response to your letter of January 11, 1978 requesting our views as to whether seminar announcements which discuss tax-sheltered offerings registered under the Securities Act of 1933 (the "Act"), without referring to a specific security, must comply with the provisions of Rule 134 under the Act.

"We understand the facts to be as follows. An NASD member firm has distributed seminar announcements inviting the recipient to attend a seminar at which tax-sheltered offerings registered under the Act are to be discussed. Although the announcements do not make reference to any specific security, they do indicate that registered offerings will be discussed, and that each attendee will receive a prospectus relating to each such offering. You indicate that the NASD has advised that since the announcements discussed tax-sheltered investments registered under the Act, any communication published or transmitted to any person, prior to the delivery of a statutory prospectus, must comply with the provisions of Rule 134 under the Act. Counsel to the member firm, however, has expressed the opinion that such announcements need not comply with Rule 134 on the ground that the announcements do not refer to a specific security and therefore do not offer a security for sale.

"It is this Division's view that published announcements which relate to a seminar at which specific registered offerings will be discussed constitute the first step in an offer and sales of such securities, even though the announcements do not refer to a specific security. Accordingly, such announcements must comply fully with the provisions of Section 2(10)(b) of the Act and Rule 134 there under."