NASD

Notice To Members

National Association of Securities Dealers, Inc. June 1991

Number 91-31

Suggested Routing:*

✓ Senior Management	Internal Audit	✓ Operations	Syndicate
Corporate Finance	✓ Legal & Compliance	Options	Systems
Government Securities	Municipal	Registration	✓ Trading
Institutional	Mutual Fund	Research	Training

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

Subject: Solicitation of Members' Comments on Proposals to Curb SOES Abuse; Last Date for Comments: June 21, 1991

EXECUTIVE SUMMARY

The NASD Board of Governors has approved two additional proposals to curb Small Order Execution System (SOES) abuse — expanding the definition of "day trading" and permitting a short period between executions (such as 15 seconds) for market makers to update their quotations. The Securities and Exchange Commission (SEC) has published these proposals in the *Federal Register* (SEC Release No. 34-29181 and 34-29182), and we urge members that use SOES to comment on the proposals. Send your comments before June 21, 1991 to the SEC addressed to:

Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549.

BACKGROUND

The NASD's Small Order Execution System (SOES) is designed to improve the efficiency of executing small-sized customer orders in Nasdaq securities by offering an alternative to traditional telephone contact and negotiation with market makers. SOES provides automated execution of small customer orders with Nasdaq market makers at the best available market price. Since the exclusive purpose of the service is to facilitate the execution of small customer orders, the Association has taken steps in the past to ensure market-maker presence in the service[1] and to prohibit misuse of the service by professional traders.[2] In furtherance of that purpose, the Association is proposing amendments to curb further misuse of the SOES system by professional traders.

The NASD is proposing to define professional trading accounts to include accounts with day trades that have *one or both sides* executed through SOES. This rule change would prevent professional traders using SOES from automatically executing one side of a day trade against a market maker while executing the other side of the day trade outside of SOES to elude the "five day trade" criteria currently in the SOES rules. The term "professional trading account" in the SOES rules includes accounts in which there have been

[1]See SR-NASD-88-01, Release 34-25791, 53 FR 22594, approved June 16, 1988, mandating participation in SOES by Nasdaq market makers in Nasdaq National Market System securities.

[2]See SR-NASD 88-43, Release No. 34-26361, 53 FR 51605, approved December 22, 1988.

five or more day trades executed through SOES.

Second, the NASD is proposing a period of time (i.e., 15 seconds) following an execution to allow a market maker to update a quotation before being obliged to execute a second transaction in the same security on the same side through SOES. Currently, the SOES service can almost instantaneously execute multiple orders against a market maker until the market maker's exposure limit in the security is exhausted. Exposure limits assure liquidity in the Nasdaq issues traded through SOES, but currently do not allow time for market makers to update their quotations in response to executions occurring through the system.

This proposal for a quotation update period would not diminish market makers' responsibilities to participate in SOES or to post mandatory size in quotations; the update period would give market makers time to react to executions and adjust their markets, if appropriate, to reflect an execution or altered market conditions.

SEC Rule 11Ac1-1, the "firm quote rule," requires brokers and dealers to execute orders to buy and sell securities at their published quotations unless the broker-dealer is communicating a revised bid or offer to the NASD or has effected a transaction in the security and is updating its quotation.[3] Nasdaq market makers are required to maintain firm quotes and be willing to execute trades at their quotations. Allowing time in between these automated executions of SOES, while still retaining the automated features of the SOES service, strikes an appropriate balance between the small customer's desire for efficiency and immediacy in executions and the NASD's responsibilities to operate a system that provides a fair, responsive trading environment for the parties extending the capital commitment to the Nasdaq market.

Following receipt of an execution report of a purchase or sale through SOES, a market maker would have a period of time (15 seconds) to update its quote prior to executing any subsequent purchase or sale at the same quote. If a market maker has executed a sale, and subsequently receives a purchase order, SOES would execute that order. If a customer order is executed against the market maker's bid and the market maker subsequently updates its offer or its size in the security, the quotation update period would expire immediately because any update to the market maker's quotation terminates the update period. If an update is accomplished before the period expires, executions would resume immediately after the update. Executions would also resume against the market maker after the update period has elapsed, regardless of whether the quote has been changed.

Comments on these rule proposals should be sent to the SEC at the address referenced in the Executive Summary. Questions on the proposals may be directed to Beth E. Mastro, Assistant General Counsel, at (202) 728-6998.

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[3]SEC Rule 11Ac1-1(c)(3)(ii).

NASD

Notice To Members

National Association of Securities Dealers, Inc. June 1991

Number 91-32

Suggested Routing:*

✓ Senior Management	✓ Internal Audit	__ Operations	__ Syndicate
__ Corporate Finance	✓ Legal & Compliance	__ Options	__ Systems
__ Government Securities	__ Municipal	✓ Registration	__ Trading
__ Institutional	__ Mutual Fund	__ Research	✓ Training

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

Subject: Request for Comments on Compensation Arrangements for Activities of Registered Representatives Who Are Also Registered With the Securities and Exchange Commission as Investment Advisers; Last Date for Comments: July 1, 1991

EXECUTIVE SUMMARY

The NASD requests comments on the compensation arrangements for investment advisory activities of registered representatives who are also registered as investment advisers and are conducting their advisory activities outside the scope of their association with the employing member.

BACKGROUND

The NASD has recently received several requests from members seeking advice on the applicability of Article III, Sections 27, 40, and 43 of the Rules of Fair Practice to the investment advisory activities of registered representatives who are also registered with the Securities and Exchange Commission (SEC) as investment advisers ("RR/IA") where such activity is not undertaken through the member with which the RR/IA is registered.

Article III, Section 40 provides that any person associated with a member who participates in a private securities transaction must, prior to such participation, provide written notice to the member with which the person is associated, describing the proposed transaction and stating whether he or she will receive selling compensation. The member must then respond in writing whether it approves or disapproves the proposed transaction. If the registered person is to receive selling compensation, the member, if it approves the transaction, must record the transaction on its books and records and supervise this transaction under Article III, Section 27 of the Rules of Fair Practice as if the transaction were its own. If the registered person will not receive selling compensation and the member approves the transaction, the member may, at its discretion, require the registered person to adhere to specified conditions in connection with his or her participation in the transaction.

Section 40 defines "private securities transaction" as any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities that are not registered with the SEC. Selling compensation is defined as any compensation paid directly or indirectly, from whatever source, in connection with or as a result of the purchase or sale of a security, including, though not limited to, commissions; finder's fees; securities or rights to acquire securities; rights of participation in profits, tax benefits, or dissolution proceeds, as a general partner or

otherwise; or expense reimbursements.

In *Notice to Members 85-84*, which announced the approval of Article III, Section 40, attention was directed to what constitutes selling compensation. The notice stated that this definition was deliberately broad in its scope and was meant to include the receipt of any item of value whether directly or indirectly from the execution of any such securities transaction. The notice also discussed the fact that Article III, Section 40 was specifically designed to apply not only to situations where registered persons were acting in a sales capacity outside of their association with the member but also to any situations where the registered person was involved in securities transactions including but not limited to acting in the capacity of a general partner.

The NASD's National Business Conduct Committee (NBCC), at its May 1991 meeting, considered the applicability of Article III, Section 40 to investment advisory activities. The NBCC concluded that Section 40, consistent with the policy announced when this section was adopted, should be applied in such a manner as to cover these situations. The NBCC believes that Section 40 should apply to all investment advisory activities conducted by registered representatives other than their activities on behalf of the member that result in the purchase or sale of securities by the associated person's advisory clients. The NBCC believes that if the RR/IA receives no compensation from any source whatever in connection with the outside activities, the books, records, and supervisory obligations of Article III, Section 40 would not apply. If, however, the RR/IA receives compensation for, or as a result of, such advisory activities, from a person or entity other than the member, the books, records, and supervision requirements of Section 40 would apply. The Committee believes that to conclude otherwise would permit registered persons to participate in securities transactions outside the scope of the oversight and supervision of the employer member and of a self-regulatory organization to the potential detriment of customers.

The NBCC also examined the issue of whether the receipt of management or advisory fees for activities conducted away from the member would constitute the receipt of selling compensation under the rule. The Committee determined that the receipt of any compensation by RR/IAs outside the scope of their employment with a member, whether that compensation is directly related to the transactions (e.g., a portion of the commission) or in the form of an asset- or performance-based advisory fee, constitutes the receipt of selling compensation. Members that allow their registered persons to conduct such activities are fully subject to the requirements of Section 40 and must, therefore, record all such transactions on their books and records and supervise them as if these transactions had occurred at the member.

The NBCC believes that Article III, Section 43 is inapplicable to these situations since this section specifically excludes from its coverage activities subject to the requirements of Article III, Section 40.

The NBCC is concerned that there may be compensation arrangements including "wrap" fees other than those discussed above that have not been considered, and solicits comments on any such compensation arrangements to help it determine which, if any, of the provisions of Article III, Section 40 should be applied to those arrangements. In addition, the NBCC would like to receive comments on whether broader-based amendments to the NASD's supervision rule (Article III, Section 27) should be considered in addition to the application of Article III, Section 40. Prior to making any final determinations on these other arrangements, the Committee believes that it should have information concerning other arrangements that may be affected by its conclusions.

The NASD encourages all members and other interested parties to comment on these compensation arrangements. Comments should be forwarded to:

Stephen D. Hickman, Secretary
National Association of
Securities Dealers, Inc.
1735 K Street, NW
Washington, DC 20006-1506.

Comments should be received **by July 1, 1991.**

Questions concerning this notice should be directed to John E. Pinto, Executive Vice President, at (202) 728-8233, T. Grant Callery, Vice President and Deputy General Counsel, at (202) 728-8285, or Craig L. Landauer, Assistant General Counsel, at (202) 728-8291.

NASD

Notice To Members

National Association of Securities Dealers, Inc. June 1991

Number 91-33

Suggested Routing:*

✓ Senior Management	Internal Audit	Operations	Syndicate
✓ Corporate Finance	✓ Legal & Compliance	Options	Systems
Government Securities	Municipal	Registration	✓ Trading
Institutional	Mutual Fund	Research	Training

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

Subject: Request for Comments on Proposed Nonquantitative Designation Criteria for Partnerships Listed on the Nasdaq National Market System; Last Date for Comments: July 1, 1991

EXECUTIVE SUMMARY

The NASD requests comments on a proposed amendment to Part III, Section 5 of Schedule D to the NASD By-Laws to provide nonquantitative designation criteria for limited partnerships that list on the Nasdaq National Market System (Nasdaq/NMS). The text of the proposed amendment follows this notice.

BACKGROUND

In the past, the NASD has considered the need to adopt nonquantitative designation criteria for limited partnerships. Such criteria have never been adopted due to the relatively small number of partnerships that list on and trade in the Nasdaq National Market System (Nasdaq/NMS). However, for the following reasons, the Direct Participation Programs/Real Estate Committee has recommended, and the Board of Governors has agreed, that comments should be solicited on proposed listing standards for partnerships that intend to list on Nasdaq/NMS.

The NASD believes that limited partnership investors should be provided with certain protections analogous to those enjoyed by shareholders of corporations whose stock is listed on Nasdaq/NMS. The NASD's concern is prompted by a belief that the absence of "governance" standards leaves limited partners without the benefits and protections that corporate shareholders enjoy such as independent directors, annual and interim reports, an audit committee, and provisions for annual meetings. The NASD is also concerned that compliance with the current nonquantitative designation criteria required of companies whose securities trade in Nasdaq/NMS is not possible for partnerships.

PROPOSED AMENDMENT

Under the proposal, partnerships would be required to distribute an annual report containing audited financial statements to investors. The report would be distributed within a reasonable period of time after the close of the partnership's fiscal year. Similarly, interim reports detailing operating results or operational and financial position would be required.

Partnerships would also be required to establish a corporate general partner and to have two independent directors on the board of the general partner. Partnerships could, however, be admitted to Nasdaq/NMS trading on the election of a single

independent director to the board of the corporate general partner, provided they undertake to obtain a second independent director within a 12-month period.

Partnerships would not generally be required to hold annual meetings unless a statute or regulation in the state under which the partnership is formed or does business requires a meeting or the partnership's limited partnership agreement prescribes meeting requirements. In the event of a meeting, a quorum of 33 1/3 percent of the limited partnership interests outstanding would be required, and proxy materials or information statements would be distributed. Proxies would be required to be solicited in connection with meetings in which a majority vote of limited partners would be necessary.

It would be "strongly recommended" but not required that the partnership's corporate general partner maintain an audit committee, a majority of the members of which shall be independent directors.

REQUEST FOR COMMENTS

The Board of Governors asks all members and interested persons to comment on the proposed amendment. The Board also requests comment on the implementation procedures for any requirements that may be adopted. In particular, it must be determined whether partnerships that are currently listed would be exempt or grandfathered from any new requirements and, if not, how much time they would be granted to comply. Comments should be directed to:

Stephen D. Hickman, Secretary
National Association of
Securities Dealers, Inc.
1735 K Street, NW
Washington, DC 20006-1506.

Comments must be received **no later than July 1, 1991**. Comments received by this date will be considered by the NASD's Direct Participation Programs/Real Estate Committee, other appropriate standing committees, and the NASD Board of Governors. If the Board approves the proposed amendment to Schedule D, it must be filed with and approved by the Securities and Exchange Commission before it can become effective.

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

AMENDMENTS TO SCHEDULE D TO NASD BY-LAWS

(**Note:** New language is underlined.)

Section 5. Non-Quantitative Designation Criteria

(a) Applicability

No provision of this Section 5 shall be construed to require any foreign issuer to do any act that is contrary to a law, rule, or regulation of any public authority exercising jurisdiction over such issuer or that is contrary to generally accepted business practices in the issuer's country of domicile. The Association shall have the ability to provide exemptions from applicability of these provisions as may be necessary or appropriate to carry out this intent.

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(l) Requirements for Issuers That are Partnerships

1. Distribution of Annual and Interim Reports

(a) Each Nasdaq/NMS issuer shall distribute to limited partners copies of an annual report containing audited financial statements of the partnership. The report shall be distributed to limited partners within a reasonable period of time after the end of the partnership's fiscal year and shall be filed with the Association at the time it is distributed to limited partners.

(b) (i) Each Nasdaq/NMS issuer which is subject to SEC Rule 13a-13 shall distribute copies of quarterly reports including statements of operating results to limited partners either prior to or as soon as practicable following the partnership's filing of its Form 10-Q with the Securities and Exchange Commission. If the form of such quarterly report differs from the Form 10-Q, the issuer shall file one copy of the report with the Association in addition to its Form 10-Q pursuant to Section 1(c)(12) of Part II hereof. The statement of operations contained in quarterly reports shall disclose, at a minimum, any substantial items of an unusual or nonre-

current nature and net income before and after estimated federal income taxes or net income and the amount of estimated federal taxes if any.

(ii) Each Nasdaq/NMS issuer which is not subject to SEC Rule 13a-13 and which is required to file with the Securities and Exchange Commission, or another federal or state regulatory authority, interim reports relating primarily to operations and financial position shall distribute to limited partners reports which reflect the information contained in those interim reports. Such reports shall be distributed to limited partners either before or as soon as practicable following filing with the appropriate regulatory authority. If the form of the interim report provided to limited partners differs from that filed with the regulatory authority, the issuer shall file one copy of the report provided to limited partners with the Association in addition to the report to the regulatory authority that is filed with the Association pursuant to Section 1(c)(12) of Part II hereof.

2. Corporate General Partner: Independent Directors

Each Nasdaq/NMS issuer which is a partnership shall maintain a corporate general partner or co-general partner and shall maintain two independent directors on the board of the general partner. An issuer which is a partnership may be designated for inclusion in Nasdaq/NMS upon demonstrating that the corporate general partner has one independent director and is undertaking to elect a second such director within 12 months of designation.

3. Audit Committee

It is strongly recommended that the corporate general partner of each Nasdaq/NMS issuer which is a partnership maintain an audit committee, a majority of the members of which shall be independent directors.

4. Shareholder Meetings

A Nasdaq/NMS issuer which is a partnership shall not be required to hold an annual meeting of shareholders unless required by statute or regulation in the state in which the partnership is formed or doing business or by the terms of the partnership's limited partnership agreement.

5. Quorum

In the event that a meeting of limited partners is required pursuant to paragraph (4), the quorum for such meeting shall be not less than 33 1/3 percent of the limited partnership interests outstanding.

6. Solicitation of Proxies

In the event that a meeting of limited partners is required pursuant to paragraph (4), the issuer shall provide all limited partners with proxy or information statements and, if a vote is required, shall solicit proxies thereon.

NASD

Notice To Members

National Association of Securities Dealers, Inc. June 1991

Number 91-34

Suggested Routing:*

__ Senior Management	✓ Internal Audit	__ Operations	__ Syndicate
✓ Corporate Finance	✓ Legal & Compliance	__ Options	__ Systems
__ Government Securities	__ Municipal	__ Registration	__ Trading
__ Institutional	__ Mutual Fund	__ Research	__ Training

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

Subject: Request for Comments on Amendments to the Filing Requirements of the Interpretation of the Board of Governors — Review of Corporate Financing; Last Date for Comments: July 1, 1991

EXECUTIVE SUMMARY

The NASD requests comment on amending the filing requirements of the Interpretation of the Board of Governors — Review of Corporate Financing to exempt offerings of Canadian issuers filed on proposed SEC Form F-9, and on Form F-10 if the securities are distributed pursuant to SEC Rule 415. The text of the proposed amendment follows this notice.

BACKGROUND

The Securities and Exchange Commission, (SEC or "Commission") has published a proposal intended to facilitate cross-border offerings of securities. The proposal is referred to as the "Multi-Jurisdictional Disclosure and Modification to the Current Registration and Reporting System for Canadian Issuers" ("MJDS"). Under MJDS, the SEC has proposed four new registration statement forms (F-7, F-8, F-9, and F-10) and has developed criteria regarding both the issuers that may utilize the registration statements and the types of securities that may be offered. The NASD's Corporate Financing Committee considered the SEC's proposal and recommended to the Board of Governors that it would be appropriate to amend the NASD's filing requirements to exempt offerings by Canadian companies in the United States on Forms F-9 and F-10 from review by the Corporate Financing Department ("Department").

BACKGROUND ON MJDS

The Commission states that the purpose of MJDS is to remove unnecessary impediments to transnational capital formation by creating a disclosure system that would permit Canadian issuers meeting certain eligibility criteria to satisfy securities registration and reporting requirements in the United States by providing disclosure documents prepared in accordance with the requirements of Canadian regulatory authorities. The Ontario Securities Commission and the Commission des Valeurs Mobilieres du Quebec have also issued for comment proposals that would establish MJDS in Canada.

MJDS is a hybrid of two approaches — mutual recognition and harmonization of disclosure standards — designed to enhance the efficiency of multinational capital formation. Canada was chosen as the first partner for MJDS, in part, because of the similarities in United States and Canadian investor protection mandates and disclosure require-

ments. MJDS would permit single jurisdiction regulation of certain security offerings (due to the fact that the SEC will not review the registration statements) so that cross-border security offerings in the United States and Canada could be made more efficient and less expensive.

Initially, MJDS will be limited to large Canadian issuers or to certain types of offerings, rather than providing for multi-jurisdictional registration and disclosure for any offering by a Canadian issuer. MJDS would extend to two general categories of registered public offerings: (1) rights offerings, exchange offers, and business combinations by Canadian foreign private issuers and crown corporations; and (2) "substantial" Canadian foreign private issuers and crown corporations. In addition, a Canadian issuer would generally be required to have a three-year reporting history as a public company in Canada and be in compliance, at the time of filing, with the Canadian reporting requirements as administered by Canadian securities regulatory authorities.[1]

BACKGROUND ON FILING REQUIREMENTS

The NASD requires members to file most public offerings with the Corporate Financing Department for review of the fairness and reasonableness of the underwriting terms and arrangements. Historically, the NASD has tried to identify offerings in which review of the underwriting terms and arrangements would be most meaningful. The NASD has exempted from the filing requirements certain issuers and offerings of certain securities based on the premise that factors inherent in the securities markets tend to competitively limit the underwriting compensation to levels acceptable to the NASD.

The NASD believes that it is appropriate to facilitate cross-border offerings of securities of Canadian issuers so long as the NASD is certain that the securities markets will act to similarly limit the underwriting compensation and terms and arrangements entered into by NASD members with Canadian issuers. Therefore, the Board of Governors has decided that the NASD should seek comment on exempting certain offerings of securities of Canadian issuers from NASD review.

REQUEST FOR COMMENTS

Registration Statement Form F-10

The NASD is requesting comment on an exemption from the filing requirements of the Interpretation for any public offering of securities registered with the SEC by Canadian issuers on Registration Statement Form F-10. The NASD believes that requirements for Form F-10, which is restricted to those issuers with a common stock market value of at least (CN) $360 million and a public float of (CN) $75 million, ensures that the Canadian company utilizing the form will be a seasoned company with experience in raising capital from a public market. Additionally, such issuers are likely to be followed by a number of research analysts and have a number of investment banking relationships with NASD members. These factors should act to ensure that an issuer will be able to negotiate fair and reasonable terms with an underwriter in connection with any public distribution.

The NASD also requests comment on extension of the current exemptions from the filing requirements for securities registered on Forms S-3 and F-3 to securities registered by Canadian issuers on Registration Statement Form F-10. The terms of the exemption would be limited to those offerings to be distributed on a delayed or continuous basis pursuant to SEC Rule 415. This would have the effect of treating securities registered by Canadian issuers on the same basis as securities offered by domestic companies on Form S-3 that are offered pursuant to SEC Rule 415.

The NASD also seeks comment on a proposed exemption for securities offered pursuant to a redemption standby firm-commitment underwriting arrangement. This would extend the exemption currently contained within the Interpretation for redemption standby firm-commitment underwriting arrangements for issuers utilizing Form S-3 to Canadian issuers eligible to offer securities registered pursuant to Form F-10.

In connection with the proposed amendments, the NASD is clarifying that foreign companies registering an offering of securities pursuant to Registration Statement Form F-3 to be distributed by a member pursuant to SEC Rule 415, or in connection with a "firm commitment" redemption standby obligation, are exempt from the filing requirements of the Interpretation. The NASD has over the years consistently indicated that members that propose to distribute securities of foreign issuers registered on

[1]For further details regarding MJDS, members may refer to Securities Act Release No. 6879, October 16, 1990.

the Form F-3 may utilize the exemptions contained within the Interpretation for domestic companies utilizing Form S-3.

Registration Statement Form F-9

The NASD is also requesting comment on an exemption from filing for issuers utilizing Form F-9. Registration Statement Form F-9 is available to Canadian issuers that are offering nonconvertible debt and nonconvertible preferred stock that, at the time of effectiveness of the registration statement, is rated investment grade by at least one nationally recognized statistical rating organization as that term is used by the SEC in Rule 15c3-1.

In addition, a Canadian issuer will be permitted to utilize Form F-9 to issue debt or preferred stock that is convertible if such convertibility cannot occur prior to one year from the date of issuance. The issuer also must have a total market value for its common stock of at least (CN) $180 million and have a public float of (CN) $75 million.

In requesting comment, the NASD recognizes that a current exemption from the filing requirements of the Interpretation for securities offered by a corporate issuer that has nonconvertible debt with a term of issue of at least four years, or nonconvertible preferred securities rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories, may presently be utilized by foreign corporate issuers distributing securities in this country. When the NASD amended the Interpretation to include this exemption in 1984, it made clear that foreign private issuers could rely on this exemption.[2] The NASD has also interpreted this exemption to cover a current offering of investment-grade-rated debt or preferred securities.

In soliciting comment on an exemption for debt and preferred securities registered by a Canadian issuer on Form F-9, the NASD recognizes that the exception would realistically expand the scope of an existing exemption only to include investment-grade-rated convertible debt and convertible preferred securities.

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The NASD notes that MJDS may be extended in the future to foreign issuers of jurisdictions other than Canada. While the NASD generally believes that it is appropriate to extend to foreign issuers the same exemptions from the filing requirements enjoyed by domestic issuers, it is not yet prepared to extend the exemptions contained in the Interpretation to issuers of jurisdictions other than Canada. The NASD believes that it is appropriate to carefully scrutinize any expansion of MJDS to determine if the same treatment can be accorded to issuers of other countries.

It should also be noted that the NASD has decided not to amend the provisions of Schedule E to the By-Laws as it may relate to foreign offerings. Schedule E is meant to address potential conflicts of interest that exist when a member participates in the public distribution of its own securities or those of an affiliate. The NASD believes that the comprehensive protections against conflicts of interest under Schedule E continue to be appropriate. Therefore, Schedule E would be applicable to offerings filed on Forms F-7, F-8, F-9, and F-10.

REQUESTS FOR COMMENTS

The Board of Governors asks all members and interested persons to comment on the proposed amendment. Comments should be directed to:

Stephen D. Hickman, Secretary
National Association of
Securities Dealers, Inc.
1735 K Street, NW
Washington, DC 20006-1506.

Comments must be received **no later than July 1, 1991**. Comments received by this date will be considered by the NASD's Corporate Financing Committee, other appropriate standing committees, and the NASD Board of Governors. If the Board approves the proposed amendments to the filing requirement of the Interpretation of the Board of Governors — Review of Corporate Financing, it must be filed with and approved by the SEC before it can become effective.

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

[2]See Securities Act Release No. 34-21480, November 14, 1984.

INTERPRETATION OF THE BOARD OF GOVERNORS — REVIEW OF CORPORATE FINANCING

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Filing Requirements

(**Note:** New language is underlined.)

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Documents related to the following public offerings need not be filed with the Association for review, unless subject to the provisions of Schedule E to the By-Laws, provided, however, it shall be deemed a violation of Article III, Section 1 of the Rules of Fair Practice, or Appendix F to Article III, Section 34 of the Rules of Fair Practice if a direct participation program, 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 Interpretation or Appendix F, as applicable:

(1) securities offered by a corporate, foreign government or foreign government agency issuer which has non-convertible debt with a term of issue of at least four years, or non-convertible preferred securities, rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories;

(2) securities registered with the Securities and Exchange Commission on registration statement Forms S-3, and F-3 and securities registered by Canadian issuers on registration statement Form F-10 and offered pursuant to Rule 415 adopted under the Securities Act of 1933, as amended;

(3) securities offered pursuant to a redemption standby "firm commitment" underwriting arrangement registered with the Securities and Exchange Commission on Forms S-3 and F-3 and securities offered pursuant to a redemption standby "firm commitment" underwriting arrangement registered by Canadian issuers on registration statement form F-10;

(4) direct participation program interests in a pool of financing instruments which are rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories. (NASD CCH ¶2151, page 2027); and

(5) debt and preferred securities registered with the Securities and Exchange Commission by a Canadian issuer on registration statement Form F-9.

NASD

Notice To Members

National Association of Securities Dealers, Inc. June 1991

Number 91-35

Suggested Routing:*

✓ Senior Management	Internal Audit	✓ Operations	Syndicate
Corporate Finance	✓ Legal & Compliance	Options	Systems
Government Securities	Municipal	Registration	✓ Trading
Institutional	Mutual Fund	Research	Training

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

Subject: Proposed SEC "Penny Stock" Disclosure Rules

EXECUTIVE SUMMARY

The Securities and Exchange Commission (SEC or "the Commission") recently issued Release No. 34-29093 proposing for public comment the so-called "Penny Stock Disclosure Rules" to implement certain provisions of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990. These proposed rules further define the term "penny stock" and provide certain exemptions from the definition. They also would require broker-dealers selling penny stocks to their customers to provide the customers with (1) a risk disclosure document; (2) monthly statements giving the market value of penny stocks held for customers; (3) disclosure of current bid and ask quotations, if any; (4) disclosure of the compensation of the broker-dealer and the salesperson with respect to the trade; and (5) disclosure when the broker-dealer is acting as sole market maker in the security. Comments on the proposed rules may be submitted to the SEC until July 19, 1991.

BACKGROUND

In its Release 34-29093, the Securities and Exchange Commission (SEC) proposed for public comment rules under the Securities Exchange Act of 1934 to implement certain provisions of the Securities Enforcement Remedies and Penny Stock Reform Act of 1990. The Penny Stock Reform Act grants the SEC broad rule-making authority to address serious abuses and misconduct identified in the distribution and secondary trading of penny stocks.

The NASD continues to aggressively pursue its regulatory and enforcement efforts to eliminate fraud in the penny-stock market. Working on its own as well as with other enforcement agencies, the NASD remains focused on NASD members and associated persons who use high-pressure tactics and other fraudulent and deceptive practices to sell penny stocks to the public. Certain of these cooperative efforts with federal law enforcement agencies have resulted in criminal prosecution relating to securities fraud.

SUMMARY OF PROPOSED SEC RULES 3a51-1 AND 15g-1 THROUGH 15g-7 ("PENNY STOCK DISCLOSURE RULES")

Proposed SEC Rule 3a51-1 (Definition of "Penny Stock")

Proposed SEC Rule 3a51-1 would exclude se-

curities from the definition of penny stock that are: (1) "reported securities" (i.e., securities for which last-sale reports are collected and made available pursuant to an effective transaction reporting plan). Reported securities generally consist of securities quoted on the Nasdaq system that are designated as Nasdaq National Market System securities (Nasdaq/NMS securities), New York Stock Exchange, Inc. (NYSE) and American Stock Exchange, Inc. (Amex) listed securities, and certain regional exchange-listed securities that meet NYSE or Amex listing standards; (2) securities that have a price of $5 per share or more; (3) securities issued by an investment company registered under the Investment Company Act of 1940; (4) put or call options issued by the Options Clearing Corporation; and (5) securities registered or approved for registration on a national securities exchange that has maintenance criteria authorizing, at a minimum, the delisting of a security whose issuer has less than $2 million in net tangible assets or in stockholder equity.

Proposed SEC Rule 15g-1 (Exemptions)

Proposed Rule 15g-1 would exempt selected transactions from the proposed disclosure obligations to customers as follows: (1) transactions in penny stocks by a broker-dealer that does less than 5 percent of its securities business in penny stocks and that has not been a market maker, during the past year, in the penny stock that is the subject of the transactions; (2) transactions in securities the issuer of which has net tangible assets exceeding $2 million, if that issuer has been in continuous operation for at least three years, or $5 million, if the issuer has been in continuous operation for less than three years; (3) transactions in securities where the customer is an institutional accredited investor; (4) transactions that are not recommended by the broker-dealer; and (5) transactions in which the purchaser is the issuer of the penny stock that is the subject of the transaction.

Separately, proposed Rule 15g-1 would exempt two categories of penny-stock transactions from proposed Rules 15g-2 (requiring provision of a risk disclosure document), 15g-3 (requiring disclosure of bid/ask prices), and 15g-6 (requiring provision of monthly account statements), as follows: (1) transactions in securities that are registered and that are executed on a national securities exchange that disseminates transaction reports pursuant to an effective reporting plan; and (2) transactions in Nasdaq securities qualifying as penny stocks that involve a Nasdaq market maker registered in that security, a broker crossing two orders on an agency basis, or an underwriter or any syndicate or selling-group member that is participating in a distribution of the affected penny stock.

Proposed SEC Rule 15g-2 (Risk Disclosure Document)

Proposed Rule 15g-2 would make it unlawful for a broker-dealer to effect transactions in penny stocks without first providing to the customer a standardized disclosure document as contained in proposed Schedule 15G. The document required by the proposed rule explains the risks of investing in penny stocks; important concepts associated with the penny-stock market, such as the meaning of the "bid" and "ask" prices and the significance of the spread between those prices; the broker-dealer's duties to the customers, including disclosures required by each of the proposed rules; a toll-free telephone number through which a customer may inquire about the disciplinary history of a broker-dealer; the customer's rights and remedies in cases of fraud or abuse in connection with transactions in penny stocks; and other significant information of which the investor should be aware.

Proposed SEC Rule 15g-3 (Bid-Offer Quotations Disclosure)

Proposed Rule 15g-3 would make it unlawful for a broker-dealer to effect a transaction in any penny stock without first disclosing and subsequently confirming to the customer current quotation prices or similar market information.

Proposed Rule 15g-4 (Broker-Dealer Compensation Disclosure)

Proposed Rule 15g-4 would make it unlawful for a broker-dealer to effect a penny-stock transaction for a customer unless the broker-dealer first discloses to the customer the amount of any compensation received in connection with that penny-stock transaction. "Compensation" is defined as (1) in an agency transaction, the amount of any remuneration received or to be received from a customer in connection with the transaction; (2) in a "riskless principal" transaction, the difference between the price to the customer and the contemporaneous purchase or sale price; and (3) in any other

principal transaction, the difference between the price to the customer and the prevailing market price in the security.

Proposed Rule 15g-5 (Associated Person Compensation Disclosure)

Proposed Rule 15g-5 would make it unlawful for a broker-dealer to effect a transaction in any penny stock for a customer unless the broker-dealer first discloses and subsequently confirms to the customer (1) the aggregate or per-share amount of cash compensation that the associated person of the broker-dealer has received or will receive from any source in connection with the transaction, in cases where the firm determines compensation on a transactional or per-share basis; and (2) the amount of cash or other compensation that the associated person has received from any source during the preceding calendar year in connection with all penny-stock transactions, if this amount exceeds 25 percent of the total compensation that the associated person received during that year in connection with all securities transactions.

Proposed Rule 15g-6 (Monthly Account Statements)

Proposed Rule 15g-6 would make it unlawful for a broker-dealer that has effected a penny-stock sale to a customer to fail to furnish to that customer a monthly statement disclosing the identity and number of shares of each penny stock in the customer's account, the transaction dates, the purchase price, and the estimated market value of the security, based on the broker-dealer's recent purchase prices or recent dealer bids. The statement must also contain a standardized explanation of the limited market for the securities and the nature of an estimated market value in such a limited market. If the broker-dealer has not effected any penny-stock transactions for the customer for six consecutive months, the rule would provide a limited exemption to permit account statements to be provided on a quarterly basis.

Proposed Rule 15g-7 (Sole Market Maker Disclosure)

Proposed Rule 15g-7 would make it unlawful for a broker-dealer that is the sole market maker in a penny stock, or an affiliated broker-dealer, to effect transactions in the stock unless the broker-dealer has disclosed to the customer that it or its affiliate is the sole market maker and that, by virtue of such status, it or its affiliate exercises substantial influence over the market for the security.

Moreover, the proposed rule makes it unlawful for a broker-dealer or an affiliate that is a market maker in a penny stock to represent directly or indirectly to a customer that a transaction in the stock is being effected "at the market" or at a price related to the market unless the broker-dealer knows, or has reasonable grounds to believe, that a market exists outside the broker-dealer's control. Exempt transactions under proposed Rule 15g-1 would not be exempt from the disclosure required by proposed Rule 15g-7.

Members and other interested parties are urged to contact the SEC to obtain a copy of the full text of the Commission's proposed rules. Comments, in triplicate, on the proposed rule should be sent to Jonathan G. Katz, Secretary, SEC, 450 5th Street, NW, Mail Stop 6-9, Washington, DC 20549. Refer to file no. S7-8-91.

NASD

Notice To Members

National Association of Securities Dealers, Inc. June 1991

Number 91-36

Suggested Routing:*

__ Senior Management	__ Internal Audit	✓ Operations	__ Syndicate
__ Corporate Finance	✓ Legal & Compliance	__ Options	__ Systems
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*These are suggested departments only. Others may be appropriate for your firm.

Subject: Adoption of Amendments to SEC Rule 15c2-11 Regarding Initiation or Resumption of Quotations Without Specified Information

EXECUTIVE SUMMARY

The Securities and Exchange Commission (SEC or "the Commission") recently issued Release No. 34-29094 adopting amendments to Rule 15c2-11 ("the Rule") that became effective June 1, 1991. This is an important SEC rule for broker-dealers engaged in quoting non-Nasdaq, over-the-counter securities in an interdealer quotation medium, such as the NASD's OTC Bulletin Board. Nasdaq and exchange-listed securities are exempt from the Rule's requirements. The Rule was designed primarily to prevent certain manipulative and fraudulent trading schemes and was intended to prevent brokers and dealers from furnishing initial quotations in the absence of information about the issuer.

To comply with the Rule, as amended, a broker-dealer must gather, review, and retain in its files specified information about the issuer before initiating or resuming a quotation for the issuer's security in any quotation medium. The Rule's review and information maintenance requirements can be satisfied in one of only five ways as set forth in paragraphs (a)(1) through (a)(5) of the Rule (collectively, "paragraph (a) information"). The first [(a)(1)] is to review and have on file a prospectus for the issuer that has been filed with the SEC and is less than 90 days old. The second [(a)(2)] is to review and have on file a Regulation A offering statement for the issuer that is less than 40 days old. The third [(a)(3)] is to review and have on file the issuer's latest 10-K, 10-Qs, and 8-Ks. The fourth [(a)(4)] relates to certain foreign issuers that file periodic reports with the SEC. The fifth [(a)(5)] is a provision generally used when the other provisions do not apply and requires the broker-dealer to review and have on file other specified information about the issuer, such as financial statements that cover the past two years.

In addition, the amended Rule now requires broker-dealers to have a "reasonable basis under the circumstances for believing that the information is accurate in all material respects and obtained from reliable sources."

The amendments also require the broker-dealer to have in its records a copy of any trading suspension order, or Exchange Act release announcing a trading suspension, is-

sued by the Commission regarding any of such an issuer's securities during the preceding 12 months, and require the broker-dealer to review paragraph (a) information together with the information contained in the trading suspension orders or releases and any other material information concerning the issuer in the broker-dealer's knowledge or possession.

Finally, the amended Rule (i) expands the information to be gathered for any issuer that files periodic reports with the Commission, (ii) requires retention of all specified documents and information for at least three years, and (iii) specifies a lead time of three business days for submission of certain information to the operator of a quotation medium for covered securities.

Broker-dealers are exempt from Rule 15c2-11 requirements only when they can qualify for any of four exemptions specified in the Rule. The first exemption covers a security listed on any U.S. stock exchange provided that the security trades on the exchange the same day or the business day before the publication or submission of the quotation request to a quotations medium. The second exemption applies when the broker-dealer enters a quotation solely on behalf of a customer and such quotation is not solicited. The third exemption is the piggyback exemption, which exists when the security has been quoted during the past 30 calendar days for at least 12 days with no more than four consecutive days without quotes. The fourth exemption is the Nasdaq exemption applicable to a security that is authorized for quotation on Nasdaq and has not been suspended, terminated, or prohibited.

It should be noted that the Commission has not amended the so-called "piggyback" exemption provided by paragraph (f)(3) of the Rule. However, the Commission has proposed to narrow that exemption in Release No. 34-29095 (April 17, 1991). The deadline for submitting comments on that proposal is January 1, 1992.

The text of the SEC's adopting release follows this notice.

BACKGROUND

The initiative to amend Rule 15c2-11 followed the SEC's establishment of the Penny Stock Fraud Task Force to combat abusive sales and trading practices involving low-priced non-Nasdaq and non-exchange-listed securities. The principal amendments to the Rule focus on the scope of information and documents needed to satisfy paragraphs (a)(1) through (a)(5), the affirmative nature of a broker-dealer's obligation to review such information before initially publishing a quotation for a covered security in a quotation medium, and the data gathering and review process required to resume quotations following the expiration of an SEC trading suspension.

Affirmative Review Requirement

The introductory text of paragraph (a) makes it unlawful for a broker-dealer to publish (or submit for publication) any quotation for a covered security in a quotation medium without having the appropriate paragraph (a) information in its possession. Moreover, before a broker-dealer may publish its initial quotation, it must gather and review the paragraph (a) information (together with any documents or information required by paragraph (b) of the Rule) and form a reasonable basis for concluding that such information is accurate in all material respects and that the information's source is reliable.

In its release adopting the amendments, the SEC emphasized that the affirmative review requirement does not equate to the "due diligence" investigation performed by an underwriter. Likewise, full compliance does not necessitate that a market maker establish a business relationship with the issuer of any covered security. However, the amended Rule clarifies that a broker-dealer must make the specified determinations as to accuracy and source reliability for each of the five categories of information comprising paragraph (a) information. To assist broker-dealers, the SEC has offered specific guidance regarding source reliability and the review of documents containing paragraph (a) information.

The requirement to make a determination regarding source reliability is not new. In most circumstances, it is reasonable to consider the follow-

ing parties as reliable sources of paragraph (a) information: (i) the issuer of the covered security; (ii) an authorized agent of the issuer (e.g., the company's officers, directors, attorney, or accountant); (iii) an independent information service such as the SEC's Public Reference Room, a document retrieval service, or standard research sources (e.g., Standard & Poor's *Standard Corporation Descriptions*); and (iv) any lending institution that can represent that it prepared the requisite information or received such information directly from the issuer. On the other hand, if paragraph (a) information is obtained from another market maker (e.g., a copy of a filing made with the NASD pursuant to Section 4 of Schedule H to the NASD By-Laws), the recipient should verify the source of the information compiled by that market maker. The SEC cautions that the presence of a "red flag" — information that under the circumstances reasonably indicates that the source is unreliable — requires that a broker-dealer make further inquiry to determine the reliability and/or ultimate source of the paragraph (a) information.

The second part of the affirmative review relates to the examination of the relevant document(s). Because there are five distinct categories of paragraph (a) information (i.e., subparagraphs (1)-(5) under Rule 15c2-11(a)), a broker-dealer must determine the category appropriate to the particular covered security and gather all specified information and documents. Next, the broker-dealer must review the paragraph (a) information in relation to all other information (particularly adverse information) it may know or possess about the particular issuer.[1] While conducting this review, the broker-dealer must be alert to any "red flags," (i.e., information that reasonably indicates the presence of material inaccuracies). The SEC offered the following examples of "red flags:" (i) a qualified auditor's opinion resulting from management's failure to provide all of the information needed to prepare the financial statements, (ii) financial statements of a development-stage issuer that list as the principal component of net worth an asset wholly unrelated to the issuer's lines of business, (iii) material inconsistencies within the paragraph (a) information itself, or (iv) material inconsistencies between the paragraph (a) information and other information in the broker-dealer's knowledge or possession.

If the review process for initiating or resuming quotations discloses no "red flags," the broker-dealer would have a reasonable basis for believing that the information is accurate.[2] Alternatively, if the review reveals a "red flag," no quotation may be initiated or resumed until the discrepancy or deficiency is resolved. The additional effort required of the broker-dealer will vary with the circumstances and may involve obtaining supplemental information (e.g., the most recent Forms 8-K or 10-Q) or verifying existing information.

Finally, the Commission observed that a broker-dealer would file paragraph (a) information with the NASD, pursuant to Section 4 of Schedule H to the NASD By-Laws. The NASD must complete its review of such information before a member may initiate or resume entry of quotations for a covered security in any quotation medium. The Commission noted that the NASD's review does not alter a broker-dealer's obligations to form a reasonable belief as to the accuracy of the paragraph (a) information and the reliability of its source. Thus, a broker-dealer cannot rely on the NASD's review to meet its affirmative obligations under the Rule.

Action Following a Trading Suspension

The SEC has expressed concern about a broker-dealer's compliance with the Rule following expiration of a trading suspension instituted under Securities Exchange Act Section 12(k). A suspension is a significant, regulatory event that should alert a broker-dealer to the possibility that

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[1] "Other information" would include the information specified by paragraph (b) of the Rule. As amended, paragraph (b) will require the broker-dealer to maintain, as part of its written records, any other material information about the issuer, including adverse information (e.g., a copy of an SEC trading suspension order) that comes to its knowledge or possession that would be considered important in determining whether there is a reasonable basis for believing in the accuracy (and the reliability of the source) of the paragraph (a) information. Paragraph (b) does not require the broker-dealer to maintain trivial information or information from an uncertain source. Also, paragraph (b) does not require a broker-dealer, on a routine basis, to affirmatively seek additional information about the issuer. However, if material information about the issuer comes to the broker-dealer's knowledge or possession (orally or in writing) from an authoritative source, the broker-dealer must include that information in its files (i.e., documents should be retained, and oral information should be recorded and maintained).

[2] Because of the liabilities attaching to documents filed with the Commission, (see e.g., Sections 11 and 24 of the Securities Act, 15 U.S.C. 77k and 77x, and Sections 18 and 32 of the Exchange Act, 15 U.S.C. 78r and 78ffm), a broker-dealer could reasonably have a stronger belief as to the accuracy of information contained in such documents than of information in documents not so filed. Of course, the presence of "red flags" must be considered in the review of any information or documents.

existing information concerning the issuer may no longer be accurate. In this circumstance, the broker-dealer should, at a minimum, obtain assurances or additional information regarding the matters cited in the suspension order or other matters affecting the broker-dealer's reasonable belief as to the accuracy of the information before attempting to resume quotations in the relevant security. Where the source (typically, the issuer or its agents) is unable to provide reasonable assurances about the reliability of the information, the SEC recommends contacting an independent accountant or attorney.

The NASD notes that a Section 12(k) suspension typically lasts for more than four business days. As a result, a broker-dealer cannot rely on the "piggyback" exemption to initiate or resume quotation of a covered security immediately after the suspension expires. The "piggyback" exemption will not be available until the frequency-of-quotation test can be satisfied over a period of 30 days after resumption of quotations in the covered security.

In general, the resumption of quotations immediately after a Section 12(k) suspension requires that a broker-dealer re-establish compliance with the Rule: (i) by obtaining (and in most instances, supplementing) the pertinent paragraph (a) information, (ii) by obtaining a copy of the SEC suspension order (or a copy of the SEC release announcing the suspension), and (iii) by reviewing the applicable information and making the necessary determinations regarding accuracy and source reliability. Furthermore, the broker-dealer must make the filing required by Section 4 of Schedule H to the NASD By-Laws.

Other Amendments to the Rule

Most of the amendments to the Rule are substantive in character. Because of their number, we have chosen to highlight only the most significant changes. However, this notice includes the full text of the Commission's adopting release and all amended provisions of the Rule. Members that act as market makers in covered securities are urged to review this material in its entirety.

Questions concerning this notice may be directed to Kenneth Worm, Roger Sherman, or Daniel M. Sibears of the NASD's OTC Bulletin Board Unit at (202) 728-8149, or Michael Kulczak of the Office of General Counsel at (202) 728-8811.