SPECIAL NASD NOTICE TO MEMBERS 94-59

Rule Proposals Of The Industry/Regulatory Council On Continuing Education

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Executive Summary

The NASD Board of Governors requests member comment on rule proposals developed by the Industry/Regulatory Council on Continuing Education (the Council). These proposals codify and expand the conceptual recommendations made by a special task force comprised entirely of industry representatives and published by six self-regulatory organizations (SROs)[1] in September 1993. The proposed rules would establish a formal, two-part continuing education program for securities industry professionals that would require uniform training on regulatory matters and ongoing programs by firms to keep their registered persons up to date on job-specific subjects.

* * *

The text of the proposed rules of the Council, which are amendments to Schedule C to the NASD By-Laws, follow this introduction. Background information and an explanation of these proposals are in the *Status Report on the Continuing Education Program,* which is reprinted in this Notice. A special section of the report, entitled "Questions and Answers Regarding The Securities Industry Continuing Education Proposal," helps further understanding of the proposed continuing education program in member firms.

The NASD Board of Governors urges members to comment on this important new regulatory initiative. Member comments will be considered by the Council, the NASD Membership Committee, and the NASD Board of Governors and will have an important impact on the final structure of the continuing education program.

Comments should be submitted no later than **October 15, 1994**, and be addressed to Joan C. Conley, Corporate Secretary, National Association of Securities Dealers, Inc., 1735 K Street, N.W., Washington, D.C. 20006. If you have questions about this Notice or want additional copies of the report, contact Frank J. McAuliffe, Vice President, Membership & Qualifications, at (301) 590-6694, or Mark F. Costley, Senior Qualifications Analyst, at (301) 590-6697.

Text Of Proposed Amendment To Schedule C Of The NASD By-Laws

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

Part XII

Continuing Education Requirements

This Part prescribes requirements regarding the continuing education of certain registered persons subsequent to their initial qualification and registration with the NASD. The requirements shall consist of a Regulatory Element and a Firm Element as set forth below.

(1) Regulatory Element

(a) Requirements — No member shall permit any registered person to continue to, and no registered person shall continue to, perform duties as a registered person, unless such person has complied with the requirements of Section (1) hereof.

[1] The six SROs include the American Stock Exchange (AMEX), the Chicago Board Options Exchange (CBOE), the Municipal Securities Rulemaking Board (MSRB), the National Association of Securities Dealers, Inc. (NASD), the New York Stock Exchange (NYSE), and the Philadelphia Stock Exchange (PHLX).

(i) Each registered person shall complete the Regulatory Element on three occasions, at intervals of two, five and 10 years after the effective date of their registration, or as otherwise prescribed by the NASD. On each of the three occasions, the Regulatory Element must be completed within one hundred twenty days after the person's registration anniversary date. The content of the Regulatory Element shall be prescribed by the NASD.

(ii) Registered persons who have been continuously registered for more than 10 years as of the effective date of this Part shall be exempt from participation in the Regulatory Element, provided such persons have not been subject to any disciplinary action within the last 10 years as enumerated in subsection (1)(c)(i)-(ii) of this Part. In the event of such disciplinary action, a person will be required to satisfy the requirements of the Regulatory Element by participation for the period from the effective date of this Part to 10 years after the occurrence of the disciplinary action.

(iii) Persons who have been currently registered for 10 years or less as of the effective date of this Part shall initially participate in the Regulatory Element within 120 days after the occurrence of the second, fifth or tenth registration anniversary date, whichever anniversary date first applies, and on the applicable registration anniversary date(s) thereafter. Such persons will have satisfied the requirements of the Regulatory Element after participation on the tenth registration anniversary.

(iv) All registered persons who have satisfied the requirements of the Regulatory Element shall be exempt from further participation in the Regulatory Element, subject to re-entry into the program as set forth in subsection (1)(c) of this Part.

(b) Failure to Complete — Unless otherwise determined by the NASD, any registered persons who have not completed the Regulatory Element within the prescribed time frames will have their registrations deemed inactive until such time as the requirements of the program have been satisfied. Any person whose registration has been deemed inactive under this Part shall cease all activities as a registered person and is prohibited from performing any duties and functioning in any capacity requiring registration. The NASD may, upon application and a showing of good cause, allow for additional time for a registered person to satisfy the program requirements.

(c) Re-entry into Program — Unless otherwise determined by the NASD, a registered person will be required to re-enter the Regulatory Element and satisfy the program's requirements in their entirety commencing with initial participation within 120 days of a disciplinary action becoming final, and on three additional occasions thereafter, at intervals of two, five and 10 years after re-entry, notwithstanding that such person has completed all or part of the program requirements based on length of time as a registered person or completion of ten years of participation in the program, whenever the registered person has been:

(i) subject to any statutory disqualification as defined in Section 3(a)(39) of the Securities Exchange Act of 1934 (See also Rule 346(f));

(ii) subject to suspension or to the imposition of a fine of $5,000 or more for violation of any provision of any securities law or regulation, or any agreement with or rule or standard of conduct of any securities governmental agency, securities self-regulatory organization, or as imposed by any such regulatory or self-regulatory organization in connection with a disciplinary proceeding; or

(iii) ordered to re-enter the continuing education program by the Securities and Exchange Commission, any securities self-regulatory organization or any state securities agency.

(d) Any registered person who has terminated association with a member and who has, within two years of the date of termination, become reassociated in a registered capacity with a member shall participate in the Regulatory Element at such intervals (two, five and 10 years) that may apply based on the initial registration anniversary date rather than based on the date of reassociation in a registered capacity.

(e) Definition of registered person — For purposes of this Part, the term "registered person" means any person registered with the NASD as a representative, principal or assistant representative pursuant to Parts II, III or IV respectively of Schedule C to the By-Laws.

(2) Firm Element

(a) Persons Subject to the Firm Element — The requirements of this section shall apply to any person registered with a member who has direct contact with customers in the conduct of the member's securities sales, trading and investment banking activities, and to the immediate supervisors of such persons (collectively, "covered registered persons"). "Customer" shall mean any natural person and any organization, other than another broker or dealer, executing securities transactions with or through or receiving investment banking services from a member.

(b) Standards for the Firm Element

(i) Each member must maintain a

continuing and current education program for its covered registered persons to enhance their securities knowledge, skill, and professionalism. At a minimum, each member shall at least annually evaluate and prioritize its training needs and develop a written training plan. The plan must take into consideration the member's size, organizational structure, and scope of business activities, as well as regulatory developments and the performance of covered registered persons in the Regulatory Element.

(ii) Minimum Standards for Training Programs — Programs used to implement a member's training plan must be appropriate for the business of the member and, at a minimum must cover the following matters concerning securities products, services and strategies offered by the member:

a. General investment features and associated risk factors;

b. Suitability and sales practice considerations;

c. Applicable regulatory requirements.

(iii) Administration of Continuing Education Program — A member must administer its continuing education programs in accordance with its annual evaluation and written plan and must maintain records documenting the content of the programs and completion of the programs by covered registered persons.

(c) Participation in the Firm Element — Covered registered persons included in a member's plan must take all appropriate and reasonable steps to participate in continuing education programs as required by the member.

(d) Specific Training Requirements — The NASD may require a member, individually or as part of a larger group, to provide specific training to its covered registered persons in such areas the NASD deems appropriate. Such a requirement may stipulate the class of covered registered persons for which it is applicable, the time period in which the requirement must be satisfied and, where appropriate, the actual training content.

STATUS REPORT *On The Continuing* EDUCATION *Program*

THE INDUSTRY/REGULATORY COUNCIL
ON CONTINUING EDUCATION

AUGUST 1994

BACKGROUND

In March 1993, six self-regulatory organizations (SROs)[1] announced the formation of an industry task force to consider whether the industry should develop a uniform continuing education program for registered persons. The task force was composed of experienced individuals with diverse backgrounds from a broad range of firms, thus ensuring consideration of the interests and needs of a wide cross section of the industry. The SROs noted that the increasing complexity of the securities industry demands that professionals who deal with the public or are in supervisory positions maintain minimum standards of competence and professionalism. The SROs also said that a formal industry-wide continuing education program to keep professionals up to date on products, markets, and rules might be needed. By initiating a broad-based industry effort, the SROs hoped to provide a unified industry-wide approach acceptable to all segments of the industry.

In September 1993, the industry task force issued a report calling for a formal two-part continuing education program for securities industry professionals that would require uniform periodic training in regulatory matters (Regulatory Element) and ongoing programs by firms to keep employees up-to-date on job and product-related subjects (Firm Element). The report also recommended the creation of a permanent Industry/Regulatory Council on Continuing Education (the Council)[2] to recommend to the SROs the specific content of the uniform Regulatory Element and the minimum core curricula for ongoing firm training programs undertaken to satisfy the requirements of the Firm Element. The task force recommended further that computer-based training be used as a primary delivery vehicle for the uniform Regulatory Element of the program. In November 1993, the SROs endorsed in concept the recommendations of the industry task force.

Since November 1993, the Council has met monthly and has formed separate committees to work on the Regulatory and Firm Elements. The Regulatory and Firm Element Committees have prepared proposed draft rules that would implement the program when approved by the SROs. The Regulatory Element Committee has also developed an initial listing of standardized subject matter for the computer-based training program. The Firm Element Committee has developed standards that firms must adhere to in developing and implementing their training programs.

The Council has now submitted these proposed rules to the various SROs for review with an aggressive schedule to develop and implement the continuing education program. The current target is to have the final rules adopted by the SROs by November 1994 and for the SROs to immediately thereafter file the rules for approval with the SEC. It is anticipated that the rules will be formally approved by the SEC in January 1995. The continuing education program would then be implemented on July 1, 1995.

PROPOSED PROGRAM HIGHLIGHTS

The Regulatory Element proposal requires all registered persons to participate in a prescribed computer-based training session on their second, fifth, and tenth registration anniversary

[1] The SROs include the American Stock Exchange (AMEX), the Chicago Board Options Exchange (CBOE), the Municipal Securities Rulemaking Board (MSRB), the National Association of Securities Dealers, Inc. (NASD), the New York Stock Exchange (NYSE), and the Philadelphia Stock Exchange (PHLX).

[2] The Council includes representatives from 13 broker/dealers and the six SROs. In addition, the Securities and Exchange Commission (SEC) and the North American Securities Administrators Association (NASAA) have each assigned a liaison to the Council. Members of the Council are listed at the end of this report.

dates. Persons who have been registered for more then 10 years and have not been the subject of a serious disciplinary action (as more fully described below) during the most recent 10 years are exempt from the Regulatory Element.

Failure to complete the required Regulatory Element computer-based training session during the prescribed period would result in a person's registration becoming inactive. A person whose registration becomes inactive cannot conduct a securities business or perform any of the functions of a registered person until such person meets the requirement.

Any person who would otherwise be exempt from the Regulatory Element would be required to re-enter the program for another 10 years upon becoming subject to certain disciplinary actions or as otherwise required by a securities regulatory or self-regulatory organization. Such re-entry would be occasioned by a person becoming subject to a statutory disqualification pursuant to the Securities Exchange Act of 1934; if an individual's registration is suspended by a securities regulatory or self-regulatory organization; or if a securities regulatory or self-regulatory authority imposes a fine of $5,000 or more for a violation of any securities law, rule, or regulation, which is the threshold level for determining a serious disciplinary action.

The Regulatory Element computer-based training program will be designed to transmit information broadly applicable to all registered persons. The content will be recommended by a group of industry representatives, subject to Council review and SRO approval. The content will focus on compliance, regulatory, ethical, and sales-practice standards. Because of the general and broadly applicable nature of this material, the Council determined to recommend that the Regulatory Element should be initiated with a "one size fits all" approach to the material to be transmitted in the computer-based training program, regardless of the job functions or registration status, such as Series 6 or Series 7.

While there will be no grading of individual performance on the Regulatory Element, information feedback will be provided to individuals and their firms regarding areas of apparent strength or weakness as indicated by the individual's interaction with the computer-based training program. In addition, aggregated information will be provided to firms on all their covered registered persons who take the computer-based training program in a given period. Firms will be expected to consider this information when formulating their training plans for the Firm Element, as more fully described below.

Unlike the Regulatory Element, where only those persons registered for 10 years or less are covered, the Firm Element has no time limitations. It is applicable to all persons who conduct business with retail, institutional, or investment banking customers of the firm. The immediate supervisors of such persons are also covered by the Firm Element.

The Firm Element requires each member to establish a training process and identifies certain minimum requirements associated with that process. The firm must prepare a training plan after an analysis of its training needs. Firms must consider certain factors when conducting their analyses and in developing their training plans, such as the firm's size, organizational structure, and scope of business activities, as well as regulatory developments and the performance of covered registered persons in the Regulatory Element. The program requires a training plan to be implemented by a member and requires the member to maintain records that clearly demonstrate the content of its training programs and the completion of the programs by the persons identified in the firm's training plan. Persons who are subject to the training plan would have an affirmative obligation to participate in the programs identified by the member.

The Firm Element also establishes certain minimum standards for the training programs that are used in a member's plan. For example, such programs, when dealing with investment products and services, must identify their investment features and associated risk factors, their suitability in various investment situations and applicable regulatory requirements that affect the products or services. The SROs would have the ability to require members, individually or as part of a group, to provide specific training to covered registered persons in any area the SROs deem necessary. Depending on the issue of concern, these requirements could be directed at specific individuals or portions of a firm, a specific firm or group of firms, or across the entire industry.

IMPLEMENTATION

The SROs propose to fully implement the Regulatory Element on July 1, 1995. The Central Registration Depository (CRD) system will track persons subject to the requirement and notify members in advance of those individuals approaching their second, fifth, and tenth year anniversary dates who are required to participate in a computer-based training session. Follow-up notices will also be sent as persons subject to the Regulatory Element requirement approach the end of the 120 days during which the requirement must be satisfied. In addition, the CRD system will generate monthly reports to members identifying those persons approaching or subject to the Regulatory Element requirement as well as those persons whose registrations have become inactive due to failure to complete the requirement within the specified time.

The Regulatory Element require-

ments will apply to all registered persons whose second, fifth, and tenth registration anniversary dates occur on or after July 1, 1995. Persons who have completed 10 years of registration before July 1, 1995, will be exempt. A person's registration anniversary dates will be measured from his or her first registration in the CRD, regardless of any subsequent firm changes or changes in registration category. Persons who have incurred a disciplinary event during the 10-year period before July 1, 1995, that would require them to re-enter the program will have an initial registration date that coincides with the effective date of the final decision in a disciplinary action.

The NASD PROCTOR® system will be modified to handle the delivery of the computer-based training program in the 55-center PROCTOR network. Future expansion of the network is also being investigated, including the use of temporary centers that would operate periodically in areas located at a considerable distance from a full-time network center. In addition, the Council and the SROs will in the future consider the feasibility of permitting members to deliver the computer-based training on their internal computer systems if certain technical, administrative and regulatory concerns can be adequately resolved.

The Firm Element of the continuing education program will be implemented in two stages. By July 1, 1995, members would be required to complete their training needs analyses and to develop written training plans that would be available for review upon request by the SROs, the SEC, and state regulators. Members would be expected to begin implementing their plans as soon as practicable but, in any event, no later than January 1, 1996. The SROs are committed to developing a consistent approach to examination and enforcement of the Firm Element requirements. Additionally, the SROs will coordinate their field inspection efforts to avoid any unnecessary regulatory overlap in the inspection process for firms that are joint members of two or more SROs.

The Firm Element provides great flexibility to firms in designing training programs appropriate to their needs and consistent with their resources, subject to broad standards defined in the Firm Element. The Firm Element framework is intended to be flexible enough to accommodate differences in the size, scope, and complexity of firm operations. Therefore, the Council and the SROs believe that the training needs analysis and training plan requirements of the proposal are within the capabilities of all organizations, regardless of size.

The Firm Element also proposes that a member would be responsible for assuring that training programs for investment products and services used in its training plan appropriately cover the investment characteristics and associated risk factors of the product or service, their suitability for different investment situations and any regulatory requirements that affect the product or service. The Council and the SROs realize that a great deal of the training material and programs will be provided by a variety of training and education providers. Nevertheless, the proposed rules place the responsibility on each member to assure that such training meets the broad content standards included in the rule as they relate to that particular firm. The SROs do not intend to pre-approve training materials and programs developed by members or providers. They will, however, communicate regularly with members regarding the expectations for the content of training programs. As the program evolves, it is expected some curricula content standards will be defined by the SROs for products and services where heightened regulatory concerns exist.

The Council intends to develop more extensive guidelines to assist firms in carrying out their responsibilities under the Firm Element and will recommend to the SROs that these guidelines be provided to firms when the final continuing education rules are adopted by the SROs and approved by the SEC.

INDUSTRY/ REGULATORY COUNCIL ON CONTINUING EDUCATION

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Questions & Answers Regarding

THE SECURITIES INDUSTRY

Continuing Education Proposals

1.

Q. What is the Industry/Regulatory Council on Continuing Education (the Council) and what role does it play?

A. The Council is comprised of 13 representatives of the securities industry (primarily the former members of the Securities Industry Task Force on Continuing Education) and representatives of six self-regulatory organizations (SROs). In addition, liaison personnel from the SEC and NASAA participate in Council meetings. The Council's role is to develop, update, and coordinate the Continuing Education program and to recommend specific content to the SROs for the Regulatory Element and minimum core curricula for the Firm Element.

In the future, industry representatives will be selected to serve three-year terms through a nominating-committee process designed to maintain representation of a broad cross section of industry firms. The Council will continue to evaluate the program and recommend changes to the SROs as necessary to ensure that the Regulatory and Firm Elements are responsive to industry needs and changes over time.

2.

Q. Why does the program consist of two elements?

A. The Regulatory Element is applicable to all persons registered with an SRO within their first 10 years in the business. Because the Regulatory Element is intended to enhance education and training in broad-based regulatory, compliance, and ethical issues, a "one size fits all" approach is initially contemplated for persons engaged in limited or full-service aspects of the securities business and in a variety of jobs.

The Firm Element is designed to ensure that firms provide ongoing edu-

cation and training to persons who deal directly with individual, institutional, and investment banking customers. This element will focus on topics tailored specifically to the job functions and products handled by those people. Accordingly, the Firm Element has sufficient flexibility to meet the needs of all firms irrespective of their size or product mix.

3.

Q. Who will be covered by the program?

A. Every person registered for 10 years or less will be covered by the Regulatory Element and will be required to take the regulatory portions within 120 calendar days after their second, fifth, and tenth anniversaries.

The Firm Element requirements shall apply to all "covered registered persons" (salespeople, traders, investment bankers, and others who conduct a securities business with customers, and their first-line immediate supervisors) for as long as they are considered "covered registered persons." The term "customer" applies to retail, institutional, and investment banking customers, but does not include other broker/dealers.

4.

Q. Will registered personnel located outside the United States be covered?

A. Yes and the Council is considering what special accommodations may be necessary to deliver the program to such individuals.

5.

Q. Will anyone be grandfathered or exempted?

A. Grandfathering applies to the Regulatory Element only. Those who have been registered more than 10 years and who have not been the subject of a serious disciplinary action (suspension, bar, fine of $5,000 or more, or a statutory disqualification) during the most recent 10 years will be grandfathered from the Regulatory Element.

6.

Q. Are branch managers "covered registered persons" within the Firm Element?

A. Yes. Branch managers are covered registered persons because they directly supervise salespeople in the branch. If a branch manager also has customer accounts, then his/her supervisor is a "covered registered person" as well.

7.

Q. Are research analysts "covered registered persons" within the Firm Element?

A. Yes, if they communicate directly with or engage in sales presentations to customers.

8.

Q. Will either element contain pass/fail tests?

A. No. The Council recommended that the program should focus on increased education and training rather than on periodic examinations.

9.

Q. How will the program be administered?

A. The Regulatory Element will be delivered through computer-based training, in which participants will work through problems and/or scenarios at computer terminals located in an NASD PROCTOR center or other specified location.

The Firm Element will be delivered by firms and may include written materials, videos, audio tapes, classroom training, direct broadcasts, or other media.

10.

Q. What is the rationale behind discontinuing the Regulatory Element after 10 years?

A. Because information to be transmitted through the Regulatory Element is primarily of a compliance, regulatory, and ethical nature, it was perceived that individuals registered for more than 10 years without a significant disciplinary action would have adequately absorbed this material and that this would be reflected in their manner of doing business. In addition, all registered individuals who are "covered registered persons" will continue to be subject to the requirements of the Firm Element throughout their careers.

11.

Q. In the Regulatory Element, will there be a way to verify that individuals have completed the computer-based training?

A. Yes. The CRD system will track and communicate anniversary dates and evidence of completion for the Regulatory Element. The computer-based systems used to transmit the training information can also capture, store, and analyze data as to who took the training, when, where, and other information — in a manner similar to that of the industry qualification testing now conducted through the NASD PROCTOR system.

12.

Q. What is the expected fee for each Regulatory Element session at an

NASD PROCTOR center?

A. The current estimate is about $75; however, the ultimate fee will depend on the overall costs for the program, which will operate on a revenue-neutral basis and be subject to periodic independent audits.

13.

Q. For those firms with internal computer systems and the capability to interface with the NASD PROCTOR system, will there be an opportunity to deliver the Regulatory Element material through these systems?

A. Initial delivery of the Regulatory Element will be on the PROCTOR system; however, the potential for internal delivery on firm computer systems is under discussion. Obviously, arrangements to permit internal delivery depend on the development of appropriate safeguards to ensure the integrity of the program and the ability to capture the necessary information for feedback.

14.

Q. Is the content of the Firm Element left entirely up to the individual firms?

A. No. The firms will be required to update training plans annually to demonstrate that they meet certain prescribed minimum standards with respect to subject material to be disseminated to their "covered registered persons" based on their needs, products, and lines of business.

15.

Q. Will "covered registered persons" need to participate in formal Firm Element training programs every year?

A. Not necessarily. There are no set schedules or required number of hours for the Firm Element, but coverage must be sufficient to meet the criteria established by SRO rules. For example, it may not be necessary to include every "covered registered person" within each calendar year if the firm is engaged exclusively in limited lines of business.

16.

Q. Is the annual compliance meeting required under Section 27 of the NASD Rules of Fair Practice adequate to demonstrate compliance with the requirements of the Firm Element?

A. Not in and of itself. It can certainly be used as an occasion on which to transmit information or conduct training. However, firms must address their own needs with regard to sales practices and product training and carry out effective programs. In most instances, a significant expansion of material covered at the annual compliance meeting will probably be necessary. Also, it may be appropriate to transmit some material in a more timely manner than waiting for scheduled annual compliance meetings.

17.

Q. Can the requirements of the Firm Element be met through continuation of the significant internal training and education programs already in place at some firms?

A. Possibly. For firms with comprehensive ongoing training programs in place, the requirements may result primarily in expanded record keeping, more formalized planning, and the incorporation of any minimum criteria specified by the SROs. It is likely, however, that most firms will need to substantially increase their education and training efforts to meet or exceed these requirements.

18.

Q. Will it be necessary for each "covered registered person" to meet personally with his/her supervisor annually to determine the training requirement for that person?

A. No. However, some firms may elect to conduct such meetings to ascertain individual needs or to do so during regular performance reviews.

19.

Q. Can firms use training materials or presentations prepared or delivered by outside entities to satisfy the requirements of the Firm Element?

A. Yes, provided that they meet the same standards established for firms.

20.

Q. If firms use materials or presentations prepared or delivered by outside entities to satisfy the requirements of the Firm Element, who is responsible for the content?

A. Individual firms have the ultimate responsibility for the content and adequacy of material or presentations, regardless of who prepares or presents the material.

21.

Q. How can firms obtain guidance on designing and implementing internal training programs adequate to meet the requirements of the Firm Element?

A. The Council anticipates producing a compilation of guidelines taking into account comments and questions received while rule enactment is pending. These guidelines would not be rules but would offer suggestions intended to help firms devise appropriate and reasonable programs consistent with their own unique characteristics and businesses.

22.

Q. Will sessions devoted exclusively to selling skills or prospecting fulfill the requirements of the Firm Element?

A. No.

23.

Q. How will materials or presentations used by firms to satisfy the Firm Element be checked or evaluated?

A. Training plans, materials, outlines, and other required documentation must be retained for regulatory examination (upon request or during routine sales practices examinations) for conformance with standards prescribed by SRO rules. In addition, firms will be required to maintain evidence of participation and completion by their "covered registered persons".

24.

Q. What authority does the Council have to require firms to transmit specific information or carry out training in specific areas?

A. None directly. Explicit authority for the requirements and enforcement of the continuing education program will be established in rules promulgated by the SROs.

25.

Q. If a "covered registered person" has an insurance license and fulfills insurance continuing education obligations, can that serve as a substitute for the Firm Element?

A. Perhaps it may comprise a portion of the Firm Element requirements relating to insurance-related securities products, but it is unlikely that most insurance programs will meet all minimum standards prescribed under this program.

26.

Q. Will study materials be available?

A. A content outline will be prepared for the Regulatory Element. Guidelines will be published for the Firm Element and it is anticipated that additional study materials will be developed and made available by individual firms, product originators, and other outside entities.

27.

Q. When will the Continuing Education rules be enacted?

A. It is expected that the rules will receive SEC approval in January 1995.

28.

Q. When will the Regulatory Element actually go into effect?

A. The Regulatory Element is slated to begin on July 1, 1995. Thus, persons with two-, five-, and 10-year registration anniversaries on or after July 1, 1995 will be required to participate in accordance with those dates.

29.

Q. When and how will the Firm Element become effective?

A. The Firm Element will also begin on July 1, 1995, and, for most firms, will necessitate a two-tier implementation process. Firms will be required to have completed their written training plans by July 1, 1995. The Council and the SROs recognize that firms will likely require additional time to develop and prepare materials, plan budgeting needs, and arrange scheduling; however, the actual implementation of the plan must begin no later than January 1, 1996.

It is anticipated that regulatory examination for Firm Element compliance will also proceed in accordance with the preceding schedule. For example, written training plans are subject to inspection by July 1, 1995, and firm records should demonstrate programs in progress as of January 1, 1996.

30.

Q. How will people be phased into the program initially?

A. Individuals will be phased into the Regulatory Element based on their registration date or, if applicable, based on the date of the most recent disciplinary action against them. For example, persons who became registered in October 1990 would enter the program having been registered for more than four years and would first be required to participate in the Regulatory Element around October 1995 (within 120 calendar days after their fifth anniversary of continuous registration). In October 2000 they would again participate to complete their 10-year cycle. Thereafter, they will be exempted from the Regulatory Element, provided they have no serious disciplinary action within the most recent 10-year period.

The Firm Element will begin for all "covered registered persons" no later than January 1, 1996, in accordance with their firms' written plans.

31.

Q. How does a serious disciplinary action affect one's status in the Regulatory Element?

A. A serious disciplinary action would effectively pre-empt one's original registration date as a trigger for entry into the full 10-year cycle of the Regulatory

Element. Within 120 days of imposition of the disciplinary action, that individual will be required to participate in a Regulatory Element session, followed by additional sessions at the second, fifth, and tenth anniversaries of the date of the disciplinary action.

32.

Q. Is a serious disciplinary action the only factor that might mandate re-entry into the Regulatory Element?

A. No. A federal or state regulatory authority or self-regulatory organization may require re-entry into the Regulatory Element as part of a sanction in a disciplinary matter.

33.

Q. How will the registration date be calculated for individuals who have acquired multiple registrations (For example: The Series 6 in 1988 plus the Series 7 in 1991)?

A. The original registration date (1988 in the above example) will be used, provided that the person has remained continuously registered since that time.

34.

Q. How will temporary lapses in registration be handled?

A. These will be treated similar to the way in which qualification testing is handled. If individuals become unregistered for less than two years, they will maintain their original registration date, but will first be required to participate in any Regulatory Element program that may have been missed during the period in which they were unregistered. For example, an individual whose registration lapses at four and a half years who wishes to reactivate at what would be his/her six-year anniversary must complete the fifth year Regulatory Element before reactivation of registration.

35.

Q. What will be the status of a person who becomes unregistered for a two-year period or more?

A. This person would begin the entire registration process anew. He or she would be required to take the appropriate qualification examination(s) and would enter the Regulatory Element at the beginning of its 10-year cycle.

36.

Q. What regulatory consequences will result when an individual does not complete the required continuing education?

A. Non-compliance with Regulatory Element requirements will result in an individual's registration being deemed inactive until he/she fulfills all applicable elements. Firms must ensure that those deemed inactive are not permitted to engage in activities requiring registration. Failure to comply with Firm or Regulatory Element requirements may subject the firm and individuals to disciplinary action.

37.

Q. Will firms that are members of two or more SROs be subject to redundant inspections for compliance with the continuing education requirements?

A. The SROs will coordinate their field inspection efforts to avoid any unnecessary regulatory overlap for joint members. The SROs are especially committed to developing a consistent approach to examining for and enforcing the Firm Element requirements.

NASD

NOTICES TO MEMBERS

National Association of Securities Dealers, Inc. August 1994

Notices

NASD NOTICE TO MEMBERS 94-60

SEC Approves Guidelines Relating To The Use Of Rankings In Investment Company Advertisements And Sales Literature

Suggested Routing

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

Executive Summary

On July 12, 1994, the Securities and Exchange Commission (SEC) approved amendments adopting Guidelines to Article III, Section 35 of the NASD Rules of Fair Practice that prohibit members from using investment company rankings in advertisements and sales literature unless certain requirements are met. The requirements include, among other things, that the ranking is accurate, is accompanied by certain minimum informational disclosures, includes certain minimum time frames, and is based on a category or subcategory that provides a sound basis for evaluating investment company performance. The text of the amendments, which took effect July 12, 1994, follows the discussion below.

Background

On July 12, 1994, the SEC approved amendments adopting Guidelines to Article III, Section 35 of the NASD Rules of Fair Practice (Guidelines) that prohibit members from using investment company rankings in advertisements and sales literature unless certain requirements are met.

Article III, Section 35(d)(2)(M) of the NASD Rules of Fair Practice requires that a member that makes investment comparisons, directly or indirectly, must ensure that the purpose of the comparison is clear. The comparison must be fair, balanced, and disclose any material differences between the subjects of the comparison. The use of investment company rankings to demonstrate performance qualifies as such a comparison.

As the number of investment companies has increased substantially in recent years, so has the number of investment company ranking entities. The NASD has observed increased references to rankings in investment company advertisements and sales literature. In response to the increased use of investment company rankings, the Investment Company Institute, the national association of the American mutual fund industry, submitted to the NASD suggested standards for the use of rankings in sales materials that served as the foundation for the NASD proposal. The NASD proposed, and the SEC approved, comprehensive Guidelines to be used when investment company advertisements and sales literature include references to investment company rankings.

Description Of The Amendments

The Guidelines apply to all registered investment companies, including open-end and closed-end management companies as defined in Sections 3, 4, and 5 of the Investment Company Act of 1940.

Definition Of Ranking Entity
The term "ranking entity," refers to an entity that provides general investment company information to the public, is independent of the investment company and its affiliates, and whose services are not procured by the investment company or its affiliates to assign a ranking. The definition encompasses entities formed specifically to provide such information as well as financial publications and periodicals that include such a service in their publications.

General Prohibition
Members are prohibited from using investment company rankings in advertising and sales literature unless the rankings were developed by entities that meet the definition of ranking entity. When members use rankings developed by ranking entities, the rankings must conform to the requirements of the Guidelines.

Required Disclosures
All advertisements and sales literature containing a ranking must disclose the name of the investment company category, the number of investment companies in the category, the name of the ranking entity, the period on which the ranking is based, the criteria on which the investment company is ranked, and, for investment companies with front-end sales loads, whether the ranking takes into account sales charges. Also, for advertisements and sales literature containing rankings based on total return or the SEC standardized yield, the advertisements and sales literature must contain a statement as to the material effect on total return or yield, if any, of fees waived or expenses advanced during the period on which the ranking is based. The amendments also require disclosure of the publisher of the ranking data.

Prominent statements and headlines that include or refer to rankings must disclose the name of the investment company category, the total number of investment companies in the category, and the period on which the ranking is based, in close proximity to the headline or prominent statement. Such statement or headline may not state or imply that an investment company is ranked first in a category when it is not.

All advertising or sales literature using a ranking system consisting of a symbol must disclose the meaning of the symbol. All advertising and sales literature containing a ranking must disclose that past performance is no guarantee of future results.

Time Periods
To ensure that rankings are based on meaningful, not misleading, information, the Guidelines require that the information be current and provide a minimum standard of what is current. Rankings should be at least current to the most recent calendar quarter, though use of more current ranking data is permissible.

For all investment companies except money market mutual funds, rankings based on a period of less than one year can be misleading and, therefore, are prohibited. Additionally, for all investment companies except money market mutual funds, rankings based on total return or the SEC standardized yield must be accompanied by rankings based on total return for the one-year period for investment companies in existence for one year; the one- and five-year periods for investment companies in existence for at least five years; and the one-, five-, and 10-year periods for investment companies in existence for at least 10 years. The ranking information for the periods must be supplied by the same ranking entity and the periods must end on the same date.

The NASD believes that a meaningful comparison of rankings in excess of one year should include multiple time periods for comparison to avoid the possibility of selecting only those time periods in which an investment company was highly ranked. Also, the required use of the one-year period prohibits a member from using a ranking that ranks investment companies over, for example, a three-year period only.

Categories
The NASD believes it is important to set standards for methods of investment company categorization that provide a sound basis for evaluating investment company performance. Generally, advertisements and sales literature must use only categories or subcategories created by a ranking entity. Advertisements or sales literature using rankings based on a subcategory must disclose the name of the full category, the investment company's ranking and the number of investment companies in the full category, unless the subcategory is based solely on the investment objectives of the investment company and is created by a ranking entity.

Categories or subcategories created by an investment company or its affiliate may be used as long as performance is measured by the same performance measurements as those used by a ranking entity. However, categories or subcategories created by an investment company or its affiliate must also prominently disclose the fact that the investment company or its affiliate has created the ranking category, the number of investment companies in the category, the basis for selecting the category, and the identity of the ranking entity that developed the performance measurements and data on which the ranking is based. Headlines and prominent statements using a ranking created by an investment company or its affiliate must indicate in close proximity to the headline or statement that the ranking is based on a category created by the investment company or its affiliate.

Advertisements or sales literature must not use any ranking category based on the investment company's asset size because such information does not provide a meaningful basis on which the investment company's performance can be evaluated.

Multiple Class/Two-Tier Investment Companies
Advertisements or sales literature containing rankings for more than one class or investment company with the same portfolio must disclose the fact that the investment companies or classes have a common portfolio.

* * *

The NASD believes that by establishing a baseline of standards for the use of investment company rankings

in advertising and sales literature, the amendments will prevent the misleading use of such rankings and will help investment company investors make informed investment decisions based on information set forth in a clear and uniform manner.

Questions regarding this Notice may be directed to R. Clark Hooper, Vice President, Advertising/Investment Companies Regulation Department, at (202) 728-8325; Thomas A. Pappas, Assistant Director, Advertisement/Investment Companies Regulation Department, at (202) 728-8330; or Robert J. Smith, Attorney, Office of General Counsel, at (202) 728-8176.

Approved Amendments To Article III, Section 35 Of The NASD Rules Of Fair Practice.

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

* * *

Guidelines For The Use Of Rankings In Investment Company Advertisements And Sales Literature

I. Definition of "Ranking Entity"

For purposes of these guidelines, the term "Ranking Entity" refers to any entity that provides general information about investment companies to the public, that is independent of the investment company and its affiliates, and whose services are not procured by the investment company or any of its affiliates to assign the investment company a ranking.

II. General Prohibition

Members shall not use in investment company advertisements, sales literature or general promotional material any investment company rankings other than those developed and produced by entities that meet the definition of "Ranking Entity," and which conform to the requirements of the Guidelines herein.

III. Required Disclosures

A. Headlines/Prominent Statements

1. A headline or other prominent statement must not state or imply that an investment company is the best performer in a category unless it is actually ranked first in the category.

2. Prominent disclosure of the investment company's ranking, the total number of investment companies in the category, the name of the category, and the period on which the ranking is based (i.e., the length of the period and the ending date; or, the first day of the period and the ending date), must appear in close proximity to any headline or other prominent statement that refers to a ranking.

B. All advertisements and sales literature containing an investment company ranking must disclose, with respect to the ranking:

1. the name of the category (e.g., growth);

2. the number of investment companies in the category;

3. the name of the Ranking Entity;

4. the length of the period and the ending date, or, the first day of the period and the ending date;

5. criteria on which the ranking is based;

6. for investment companies which assess front-end sales loads, whether the ranking takes into account sales charges;

7. if the ranking is based on total return or the current SEC standardized yield, fees have been waived or expenses advanced during the period on which the ranking is based, and the waiver or advancement had a material effect on the total return or yield for that period, a statement to that effect; and

8. the publisher of the ranking data (e.g., "ABC Magazine, June 1993").

The disclosure required by B1, B2, B3 and B4 must be set forth prominently in the body of the advertisement or sales literature.

C. If the investment company ranking consists of a symbol (e.g., a star system) rather than a number, the advertisement or sales literature also must disclose the meaning of the symbol (e.g., a four-star ranking indicates that the investment company is in the top 30% of all investment companies).

D. All advertisements and sales literature containing an investment company ranking must disclose that past performance is no guarantee of future results.

IV. Time Periods

A. Any investment company ranking set forth in an advertisement or sales literature must be, at a minimum, current to the most recent calendar quarter ended, in the case of advertising, prior to the submission for publication, or, in the case of sales literature, prior to use.

B. Except for money market investment companies:

1. advertisements and sales literature must not use any ranking based on a period of less than one year;

2. an investment company ranking based on total return must be accompanied by rankings based on total return for the one-year period for

investment companies in existence for at least one year; the one-and five-year periods for investment companies in existence for at least five years, and the one-, five-, and ten-year periods for investment companies in existence for at least ten years supplied by the same Ranking Entity in the category and based on the same time period; and,

3. an investment company ranking based on yield may be based only on the current SEC standardized yield. An investment company ranking based on the current SEC standardized yield must be accompanied by rankings based on total return for the one-year period for investment companies in existence for at least one year; the one- and five-year periods for investment companies in existence for at least five years, and the one-, five-, and ten-year periods for investment companies in existence for at least ten years supplied by the same Ranking Entity in the category and based on the same time period.

V. Categories

A. The choice of category (including a subcategory of a broader category) on which the investment company ranking is based must be one that provides a sound basis for evaluating the performance of the investment company.

B. Subject to the standards below, an investment company ranking must be based only on (1) a published category or subcategory created by a Ranking Entity or (2) a category or subcategory created by an investment company or an investment company affiliate, but based on the performance measurements of a Ranking Entity.

C. When the investment company ranking is based on a subcategory, the advertisement or sales literature must disclose the name of the full category and the investment company's ranking and the number of investment companies in the full category. This requirement does not apply if the subcategory is (1) based solely on the investment objectives of the investment companies included and (2) created by a Ranking Entity. This disclosure could be included in a footnote.

D. The advertisement or sales literature must not use any category or subcategory that is based upon the investment company's asset size (whether or not it has been created by a Ranking Entity).

E. If an advertisement uses a category created by the investment company or an investment company affiliate, including a "subcategory" of a category established by a Ranking Entity, the advertisement must prominently disclose:

1. the fact that the investment company or its affiliate has created the ranking category;

2. the number of investment companies in the category;

3. the basis for selecting the category; and

4. the Ranking Entity that developed the research on which the ranking is based.

F. An advertisement or sales literature containing a headline or other prominent statement that proclaims an investment company ranking created by an investment company or its affiliate must indicate, in close proximity to the headline or statement, that the investment company ranking is based upon a category created by the investment company or its affiliate.

VI. Multiple Class/Two-Tier Investment Companies

Investment company rankings for more than one class or investment company with the same portfolio must be accompanied by prominent disclosure of the fact that the investment companies or classes have a common portfolio.

NASD NOTICE TO MEMBERS 94-61

SEC Approves Amendment To Code Of Arbitration Procedure Permitting Arbitrator Disciplinary Referrals

Suggested Routing

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

Executive Summary

On July 11, 1994, the Securities and Exchange Commission (SEC) approved an amendment to Section 5 of the Code of Arbitration Procedure (Code) to specify that arbitrators, at the conclusion of a proceeding, may refer matters arising or discovered during the course of a proceeding for disciplinary investigation. The text of the amendment, which takes effect on August 15, 1994, follows the discussion below.

Background

On July 11, 1994, the SEC approved an amendment to Section 5 of the Code to specify that arbitrators, at the conclusion of a proceeding, may refer for disciplinary investigation matters that come to their attention during the course of an arbitration proceeding.

The amendment was adopted because the NASD believes that potential violations uncovered during arbitration hearings should be investigated by the NASD as part of its comprehensive regulatory program. The NASD is aware that while customers who suffer a financial loss as a result of misconduct by their registered representative may bring arbitration actions, they often do not pursue formal complaints with a self-regulatory organization (SRO) necessary to trigger an investigation of the potential violation. Further, while the filing of an arbitration complaint will alert an SRO to the existence of a potential violation,[1] because customer complaints in arbitration often do not allege or disclose sufficient information to indicate obvious misconduct on the part of a respondent, they may not trigger a disciplinary investigation. Indeed, in such cases, violations of the securities laws or the NASD's rules are not apparent until an arbitration hearing occurs and the parties testify and introduce evidence about the relevant events. Thus, in some cases, the NASD is never made aware of securities law violations or violations of the NASD's rules, notwithstanding the fact that the financial injury to the customer resulting from the violation is the subject of an arbitration proceeding.

The NASD has also observed that arbitrators seldom refer matters that come to their attention during the course of an arbitration proceeding for disciplinary investigation. Because the NASD believes that arbitration matters, and the evidentiary material related to or produced in such matters, constitutes a valuable source of information concerning potential violations of the NASD's rules and the federal securities laws, bringing such information to the attention of the NASD's regulatory staff should improve the efficacy of the NASD's regulatory function. Accordingly, the NASD believes that this amendment provides a mechanism in the Code for arbitrators to bring such information to the attention of the NASD's regulatory staff for investigation that will serve the public interest by ensuring that potential violations of the NASD's rules and the federal securities laws are not overlooked.

In addition, the NASD believes that it is important for arbitrators to understand that the arbitration process is for the resolution of civil dis-

[1] The filing of a customer-initiated arbitration complaint against an associated person alleging damages of $10,000 or more triggers a requirement of the member or associated person to amend the associated person's Form U-4 or U-5, as appropriate. Information supplied pursuant to such an amendment will be entered into the Central Registration Depository and will also be forwarded to the appropriate NASD District Office for preliminary investigation.

putes between the securities industry and others, and that the securities industry maintains a regulatory apparatus separate from the arbitration process that is designed to address misconduct that affects the public interest and the integrity of the financial markets. Thus, to the extent arbitrators are aware that they may refer matters rather than engage in ad hoc disciplinary sanctions as part of awards, the fairness of the arbitration process will be enhanced and challenges to arbitration awards may be reduced, an occurrence that would redound to the benefit of successful claimants.

The amendment to Section 5 specifies that if any matter comes to the attention of an arbitrator during the course of a proceeding, the arbitrator may initiate a referral of the matter to the NASD for disciplinary investigation. The amendment also specifies, however, that any such referral should only be initiated by an arbitrator after final disposition of the matter through settlement or award. Although the NASD is not setting forth a specific procedure for such referrals, the NASD contemplates that arbitrators will direct referrals to the Association through the Arbitration Department staff and the Director of Arbitration.

Questions regarding this Notice may be directed to the NASD Arbitration Department at (212) 858-4400.

Text Of Amendment To Section 5 Of The Code Of Arbitration Procedure

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

Code of Arbitration Procedure

Non-Waiver of Association Objects and Purposes

Sec. 5. The submission of any matter to arbitration under this Code shall in no way limit or preclude any right, action or determination by the Association which it would otherwise be authorized to adopt, administer or enforce. <u>If any matter comes to the attention of an arbitrator during and in connection with the arbitrator's participation in a proceeding, either from the record of the proceeding or from material or communications related to the proceeding, that the arbitrator has reason to believe may constitute a violation of the Association's rules or the federal securities laws, the arbitrator may initiate a referral of the matter to the Association for disciplinary investigation; provided, however, that any such referral should only be initiated by an arbitrator after the matter before him has been settled or otherwise disposed of, or after an award finally disposing of the matter has been rendered pursuant to Section 41 of the Code.</u>

NASD NOTICE TO MEMBERS 94-62

NASD Solicits Member Comments On The Application Of The NASD Mark-Up Policy To Transactions In Government And Other Debt Securities, And Suitability Obligations To Institutional Customers In Debt And Equity Transactions; **Comment Period Expires September 30, 1994**

Suggested Routing

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

Executive Summary

With the enactment of the Government Securities Act Amendments of 1993, the NASD's regulatory jurisdiction was intended to encompass, among other things, sales practices relating to government securities. In conjunction with this authorization to adopt rules and regulations relating to government securities, the NASD requests member comment on proposed Interpretations of the Board of Governors to Article III, Sections 2 and 4 of the Rules of Fair Practice (RFP). The first Interpretation would provide further guidance to members on their suitability obligations under Article III, Section 2(a) of the RFP when making recommendations in equity or debt transactions, except municipals, to customers that are institutional accounts as defined under Article III, Section 21(c)(4) of the RFP. The second Interpretation would provide guidance to members regarding the application of the NASD Mark-Up Policy under Article III, Section 4 of the RFP to transactions in government and other debt securities, except municipals.

Background

In December 1993, Congress enacted the Government Securities Act Amendments of 1993 which, in part, authorizes the NASD to apply its sales practice rules to government securities, except municipal securities. To address this issue in the most effective and efficient manner and incorporate the views and ideas of those industry officials actually involved in the government securities markets, the NASD's Fixed Income Committee (Committee) appointed a Subcommittee on Government Securities (Subcommittee) to review the NASD's sales practice rules and draft proposed amendments to address the NASD's expanded authority to government securities.

On June 27, 1994, the Committee reviewed recommendations and draft amendments from its Subcommittee and approved a Resolution to the Board of Governors to merge the NASD Government Securities Rules into the RFP and to issue two Board Interpretations to the RFP.

On July 15, 1994, the NASD Board of Governors (Board) reviewed the Committee's Resolution and concurred with the Committee's recommendation that, consistent with the manner in which other securities products are handled, a single set of NASD sales practice rules is also appropriate for NASD membership in connection with government securities, and clarifications regarding the application of the RFP to government securities and other debt markets should be provided through Board Interpretations under the RFP.

The NASD Government Securities Rules, therefore, will be deleted and merged into the RFP, which will be expanded to cover government securities, except municipals, by replacing the phrase "exempted securities" with the phrase "municipal securities" in Article I, Section 4 of the RFP, "Effect on Transactions in Exempted Securities." In addition, the Rules of Fair Practice would be expanded to NASD members who do business solely in government securities, by amending Article I, Section 5(a) of the RFP, "Applicability," by deleting the phrase "other than those members registered with the Securities and Exchange Commission solely under the provisions of Section 15C of the Act and persons associated with such members."

In addition, the Board specifically requested member comment on two proposed Board Interpretations that address the application of the NASD's Mark-Up policy to government securities and other debt securi-

ties (except municipals), and member suitability obligations to institutional customers in debt and equity transactions (except municipals). The Board's action to approve the merger of the Government Securities Rules into the NASD's RFP will be filed with the SEC for approval as part of an overall filing that includes these proposed Interpretations once member comments have been received, analyzed, and acted upon by the Board.

Discussion And Summary Of Proposed Board Interpretations

I. Proposed Interpretation Of The Board Of Governors—Suitability Obligations To Institutional Customers

The Committee affirmed Article III, Section 2(a) of the NASD Rules of Fair Practice (Section 2(a)) as an important investor-protection provision that should be applied to all transactions in the government securities market as well. However, the Committee also determined that the expansion of NASD rules to the government securities market, a market with a broad institutional component, requires that the Association provide further guidance to members on their suitability obligations under Section 2(a) of the RFP when making recommendations to certain institutional customers. Article III, Section 2(a) of the RFP states,

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

The Committee believes that a principal assumption underlying Section 2(a) is that the member's relationship with the customer gives rise to a duty to help the customer determine reasonable investment parameters. The Committee expressed concerns that, in the case of certain institutional customers, this principal assumption underlying Section 2(a) does not reflect the reality of the member/customer relationship leading to the execution of a transaction. The Committee, therefore, believes it is necessary to further clarify and give guidance as to a member's suitability obligations under Article III, Section 2(a) of the RFP with regard to certain institutional investors through the issuance of a new Interpretation of the Board. The Committee notes that many institutions develop resources and procedures that provide them with the sophistication to make independent investment decisions and, in certain cases, the institution develops more sophistication than that maintained by the NASD member. The Committee also believes that many such institutional customers do not rely on a particular member's recommendations, but only use the member as one source of market and/or product information and ideas for transactions.

The Committee, therefore, proposed a new Interpretation of the Board of Governors—Suitability Obligations to Institutional Customers (Suitability Interpretation). The purpose of the proposed Suitability Interpretation would be to explain how the suitability obligations contained under Article III, Section 2(a) of the RFP should operate in the context of certain institutional client relationships consistent with generally accepted business practices that have resulted from such clients' needs and demands. Because the Committee believes the nature of the relationship between the firm and customer is the same regardless of the product involved, the Committee recommends that the proposed Suitability Interpretation apply not only in government and other debt securities (except municipals) but to equity securities as well. The Committee referred the issue of applying the Suitability Interpretation to equity securities to the NASD National Business Conduct Committee (NBCC). The NBCC reviewed the request before the July 1994 Board meeting and supported the application of the proposed Suitability Interpretation to equity securities.

The proposed Suitability Interpretation would be applicable only to customers of institutional accounts, as defined in Article III, Section 21(c)(4) of the Rules of Fair Practice (institutional customer). Section 21(c)(4) defines the term "institutional account" for purposes of Article III, Section 2 of the RFP as the account of (i) a bank, savings and loan association, insurance company, or registered investment company; (ii) an investment adviser registered under Section 203 of the Investment Advisers Act of 1940; or (iii) any other entity (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million. The proposed Suitability Interpretation would be applicable to transactions in debt and equity markets, except municipal securities.

The proposed Suitability Interpretation states that underlying Article III, Section 2(a) is the assumption that a member's relationship with the customer gives rise to a duty to help the customer determine reasonable investment parameters. It then provides that, in the case of certain institutional customers, this assumption may not reflect the reality of the member/customer relationship. The proposed Suitability Interpretation specifically recognizes that the reality of the member/customer relationship can be significantly altered when institutional customers develop resources and

procedures to make their own independent investment decisions. A non-exclusive list of examples is provided as guidance to members in determining when the resources and procedures for independent investment decisions may exist.

The proposed Suitability Interpretation further provides that even if the institutional customer has developed resources and procedures to make independent decisions, factors should also be present that provide reasonable grounds for the belief that the institutional customer is not relying on the member's recommendations in connection with a particular transaction or market product. In other words, there is no safe harbor presumption created for any institutional accounts, but rather the proposed Suitability Interpretation provides that in dealing with institutional customers, this method of compliance with its suitability obligations under Article III, Section 2(a) would continue to be determined on a transaction-by-transaction basis. The existence of such factors is key to members fulfilling their suitability obligations for each such institutional customer. The proposed Suitability Interpretation discusses a number of examples that help the member determine that it is fulfilling its suitability obligations under Article III, Section 2(a) of the RFP for a particular transaction with an institutional customer.

The proposed Suitability Interpretation also highlights that in the case of a new product, or a security with significantly different risk or volatility characteristics than other investments generally made by the institution, the member should ascertain whether the institutional customer is relying on the member to explain the new product and its risk(s) or is relying on other sources.

The proposed Suitability Interpretation clarifies that a member would not be considered to be fulfilling its suitability obligations under this Interpretation if, before the transaction, the member knows or can reasonably conclude, based on information available to it, that the institutional customer is not capable of understanding the product or its risks, or of making an independent investment decision.

The Committee believes that the proposed Suitability Interpretation will clarify the applicability of Article III, Section 2(a) of the RFP to certain member/customer relationships where such Section is currently difficult to apply. In doing so, the proposed Suitability Interpretation will promote just and equitable principles of trade, eliminate confusion that may currently impede the markets, and further protect investors and the public interest in the debt and equity markets.

II. Proposed Interpretation Of The Board Of Governors—Application Of The NASD Mark-Up Policy To Transactions In Government And Other Debt Securities

The Committee believes the nature of the debt market often requires reconsideration or reexamination of the traditional equity analysis for calculating markups and mark-downs. For instance, unlike the equities market, inter-dealer transactions in certain debt securities are rare, and this difference can, at times or often, make applying the traditional method of determining the prevailing market price for purposes of calculating markups difficult. For example, government securities broker/dealers, unlike their equity counterparts, usually do not continuously trade or make markets in just one government security, but instead may make continuous markets in similar types of debt securities. Unlike the equity markets, where the concept of similar securities is not applicable because each issuer is a unique entity, in the government securities markets such a concept can be very relevant. Such similarity can reflect the financial nature of the instruments in the debt market and may exist because the price/yield of a particular debt security is more dependent on objective external market factors, such as interest rates, and comparable to alternative debt securities, the prices of which are based on the same or similar external market factors.

Based on its discussions, the Committee concluded that notwithstanding that inter-dealer transactions in certain debt securities are rare, the fact that broker/dealers often make continuous markets in similar types of debt securities provides the debt market with additional factors in determining the prevailing market price.

The Committee, therefore, recommends the addition of an Interpretation of the Board of Governors (Mark-Up Interpretation) regarding the application of the NASD Mark-Up Policy under Article III, Section 4 of the Rules of Fair Practice to transactions in debt securities, excluding municipal securities, which remain subject to MSRB Rule G-30. The proposed Mark-Up Interpretation recognizes that inter-dealer transactions ordinarily are the best evidence of the prevailing market price. The proposed Mark-Up Interpretation notes that inter-dealer transactions in the debt market may be rare or nonexistent and states that imposing a contemporaneous cost standard would not be appropriate without first considering other relevant factors.

In the absence of inter-dealer transactions, the proposed Mark-Up Interpretation lists five other contemporaneous factors for members to consider before contemporaneous

cost is used for determining the prevailing market price. The first factor would allow the member to consider the prices of recent dealer transactions in the security in question with institutional accounts, as defined above under Article III, Section 21(c)(4) of the Rules of Fair Practice. The Committee believes that referencing the prices of such transactions is a fair and reasonable alternative to inter-dealer transactions, given the significant institutional participation in the debt market.

The second factor would allow the member to consider validated inter-dealer quotations in the security in question through a quotation mechanism, for example, inter-dealer brokers, through which transactions do occur from time to time at prices that are equal to or close to the displayed quotations.

The third, forth, and fifth factors would allow a member to consider (i) yields calculated from prices of inter-dealer transactions in similar securities; (ii) yields calculated from prices of transactions with sophisticated institutional customers in similar securities; and (iii) yields calculated from prices of validated inter-dealer quotations in similar securities. The Committee believes that allowing a member to reference prices in transactions of such similar securities reflects the important distinction from equities in the debt markets whereby prices of similar securities can be reasonably compared. When inter-dealer transactions in the same debt security are absent, the reference to contemporaneous transactions in such similar securities is often more fair and reasonable for determining prevailing market price than referencing contemporaneous cost.

The proposed Mark-Up Interpretation, in addition to listing the preceding five factors for determining prevailing market price, states that consideration may also be given to a value constructed by aggregating the values of components of the security where those values can be derived from the prices and yields of similar securities as reflected in transactions or validated quotations in the market between dealers or with sophisticated institutional customers. The proposed Mark-Up Interpretation provides a nonexclusive list of examples of such components, such as embedded call options, detachable call options, bond insurance, guarantees, and pools of collateral.

The Committee recommends that because the concept of similarity between securities in the debt market plays a significant role in the determination of prevailing market price, it would be appropriate for the Interpretation to provide guidance through a nonexclusive list of factors for members to reference in determining the similarity of debt securities. The proposed Mark-Up Interpretation, therefore, provides the following nonexclusive list of factors on the subject of similarity:

1. Credit quality considerations, such as whether the security is issued by the same or similar entity, bears the same or similar credit rating, is supported by a similarly strong guarantee or collateral;

2. The extent to which the security trades at a comparable spread over Treasuries of similar duration;

3. General structural characteristics of the issue, such as coupon, maturity, duration, complexity or uniqueness of the structure, callability (and likelihood of being called, tendered, or exchanged) and other embedded options;

4. Technical factors, such as the size of the issue, the size of the transactions or quotations being compared, the float and recent turnover of the issue, legal restrictions on transferability, extent of institutional participation in the market for the security, and/or the disclosure regime governing transactions in the security; and

5. The cost and availability of financing, and the cost, availability and effectiveness of hedging for the issue when held by dealers in inventory as well as the volatility of the spread of the issue to Treasuries or to alternative hedging vehicles available to dealers.

The Committee also recommends that a definition of markup and mark-down be provided in the Interpretation for transactions in debt securities. As in footnote 2 to the proposed Mark-Up Interpretation, the term "markup for sales to customers" is defined as the difference between the sales price to the customer and the prevailing price on the sell side of the market. The term "mark-down for purchases of customers" is defined as the difference between the purchase price to the customer and the prevailing market price on the buy side of the market.

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

Ms. Joan C. Conley
Corporate Secretary
National Association of
Securities Dealers, Inc.
1735 K Street, NW
Washington, DC 20006-1506

Questions concerning this Notice may be directed to Walter J. Robertson, NASD Compliance, (202) 728-8236; or John H. Pilcher, NASD Office of General Counsel, (202) 728-8287.

Comments must be received **no later than September 30, 1994.** Changes

to the NASD Rules of Fair Practice must be approved by the Board of Governors and filed with and approved by the SEC before becoming effective.

Text Of Proposed Interpretation

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

Interpretation Of The Board Of Governors—Suitability Obligations To Institutional Customers

As a result of broadened authority provided by amendments to the Government Securities Act adopted in 1993, the Association is extending its sales practice rules to the government securities market, a market with a particularly broad institutional component. Accordingly the Board believes it is appropriate to provide further guidance to members on their suitability obligations when making recommendations to customers who are institutional accounts as defined in Article III, Section 21(c)(4) of the NASD Rules of Fair Practice. The Board believes this Interpretation is applicable not only to government securities but to all debt securities.[1] Furthermore, because of the nature and characteristics of the institutional customer/member relationship, the Board is intending this Interpretation to apply equally to the equity securities markets as well.

Members have requested, in particular, further guidance regarding their suitability obligations under Article III, Section 2(a) of the NASD Rules of Fair Practice when dealing with institutional customers who have developed resources and procedures for the purpose of making their own independent investment decisions. Article III, Section 2(a) requires that,

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

The Board believes that underlying Article III, Section 2(a) is the assumption that the member's relationship with the customer gives rise to a duty to help the customer determine reasonable investment parameters. In the case of certain institutional customers, the Board believes that this assumption may not reflect the reality of the member/customer relationship.

For example, institutional customers may have developed resources and procedures in order to make their own independent investment decisions. Many institutional customers have at least one or more experienced professionals charged with the specific responsibility for making or recommending investment decisions on behalf of the institution. Institutional customers may also invest through one or more registered investment advisors or a bank trust department, and these intermediary entities have a fiduciary responsibility for determining an appropriate investment strategy for the institutional customer. Many institutional customers have developed a pattern of utilizing the resources of more than one dealer to transact business, and taking into consideration numerous alternative investment recommendations prior to making an investment decision. The extent to which the institutional customer utilizes resources for alternative market information, including quotation services and research materials from independent sources, may also be relevant.

However, even if the institutional customer has developed resources and procedures to make independent investment decisions, factors should also be present that provide reasonable grounds for the belief that the institutional customer is not relying on the member's recommendations in connection with a particular transaction or market product.

A primary consideration is the extent to which the institutional customer appears to be relying on the member's recommendations. The element of reliance may be established to exist in the member/customer relationship through affirmative statements made at the time of the transaction that the institutional customer is relying on the member's recommendations, or by a pattern of acceptance of the member's advice through the execution of all or nearly all of the recommended transactions. On the other hand, an institutional customer that initiates transactions on an unsolicited basis or who maintains substantive relationships with a number of members may be demonstrating by such actions that it is not relying on a particular member's recommendations, but only using the member as one source of market and/or product information and ideas for transactions.

Many institutional customers independently determine their investment strategy and provide the member with explicit investment guidelines. If explicit guidelines are made available to the member, then it is reasonable to believe that the institutional customer is assuming responsibility for the suitability obligation traditionally held by the member. If the member's investment recommendations are consistent with such guidelines, then the member generally should be regarded as having fulfilled its suitability obligations to the

[1]Except for municipal securities, the rules for which are written by the Municipal Securities Rulemaking Board.

institutional customer. Consistency with guidelines may be evident from the document or may be derived from a reasonable interpretation by responsible officers or agents of the institutional customer at or before the time of the transaction.

Sometimes the institutional customer's investment guidelines set forth percentage limitations for categories of investments. If the institutional customer does business with a number of dealers, and does not provide a particular member with current information on its portfolio holdings, then that member should generally not be responsible for investments that exceed the guideline limitations unless, the Registered Representative executing the transaction on behalf of the member or other persons with member supervisory responsibilities has actual knowledge that the transaction will result in a position that exceeds the guideline limitation.

If based on the consideration set forth above, the member has concluded that the institutional customer is not relying on the member for recommendations in connection with a particular transaction, then the member generally should be viewed as having fulfilled its suitability obligations regarding the institutional customer with respect to that particular transaction. In dealing with such institutional customers, this method of member compliance with its suitability obligations under Article III, Section 2(a) would continue to be determined on a transaction-by-transaction basis.

In the case of a new product, or a security with significantly different risk or volatility characteristics than other investments generally made by the institution, the member should ascertain whether the institutional customer is relying on the member to explain the new product and its risk(s) or is relying on other sources. A member would not be considered to be fulfilling its suitability obligations under this Interpretation if, prior to the transaction, the member knows or can reasonably conclude, based on information available to it, that the customer is not capable of understanding the product or its risks, or of making an independent investment decision.

* * *

Interpretation Of The Board Of Governors—Application Of The NASD Mark-Up Policy To Transactions In Government And Other Debt Securities

As a result of the amendments to the Government Securities Act adopted in 1993, expanding the NASD's sales practices authority to encompass government securities, the Board believes it is appropriate to provide guidance to the membership on markup and markdown practices for such securities, and at the same time, for other debt securities as well.[2]

Ordinarily, the best evidence of the prevailing market price for a security against which a markup or mark down should be measured, is inter-dealer transaction prices. In the market for government or other debt securities, however, inter-dealer transactions may be rare or non-existent for certain securities. Therefore, establishing inter-dealer transaction prices in a particular bond, note or other debt obligation may be difficult. In the equity securities market, if evidence does not exist of inter-dealer transaction prices, the contemporaneous cost to the dealer has traditionally been used as the basis for determining the appropriate markup and markdown.[3] On the other hand, in the debt securities market, the Board believes that imposing such a contemporaneous cost standard would not be appropriate without first considering other relevant factors. The Board believes, specifically, that the use of the contemporaneous cost standard as the primary determinative factor in assessing the prevailing market price against which the fairness and reasonableness of a markup or markdown should be judged, is unnecessary because there are other sources of pricing information which more accurately reflect the prevailing market price of debt securities.

Factors which the Board believes may be taken into consideration in determining the prevailing market price of debt securities in the absence of inter-dealer transactions, include but are not limited to:

1. Prices of any dealer transactions in the security in question with institutional accounts as defined in Article III, Section 21(c)(4) of the NASD Rules of Fair Practice;

2. Inter-dealer quotations in the security in question made through a quotation mechanism (such as inter-dealer brokers) through which transactions do in fact occur from time to time at prices which are at or about the displayed quotations ("validated inter-dealer quotations");

3. Yields calculated from prices of inter-dealer transactions in "similar" securities, as defined below;

4. Yields calculated from prices of transactions with sophisticated insti-

[2]Except for municipal securities, the rules for which are written by the Municipal Securities Rulemaking Board.

[3]The markup for sales to customers is the difference between the price to the customer and the prevailing market price on the sell side of the market. The markdown for purchases from customers is the difference between the price to the customer and the prevailing market price on the buy side of the market.

tutional customers in "similar" securities; and

5. Yields calculated from validated inter-dealer quotations in "similar" securities. In considering yields of "similar" securities, member firms may not rely on a limited number of transactions that are not fairly representative of the yields of transactions of "similar" securities taken as a whole.

Consideration may also be given to a value constructed by aggregating the values of components of the security where those values can be derived from the prices or yields of similar securities as reflected in transactions or quotations in the market between dealers or with sophisticated institutional customers. Some examples of such components are, embedded call options, detachable call options, bond insurance, guarantees and pools of collateral.

If the application of the foregoing factors does not assist in the analysis of the prevailing market price, the use of contemporaneous cost may be appropriate.

The degree to which a security is "similar" as that term is used in Items 3, 4, and 5 above may be determined by factors which include but are not limited to:

1. Credit quality considerations such as whether the security is issued by the same or similar entity, bears the same or similar credit rating, is supported by a similarly-strong guarantee or collateral;

2. The extent to which the security trades at a comparable spread over Treasuries of similar duration;

3. General structural characteristics of the issue such as coupon, maturity, duration, complexity or uniqueness of the structure, callability (and likelihood of being called, tendered or exchanged) and other embedded options;

4. Technical factors such as the size of the issue, the size of the transactions or quotations being compared, the float and recent turnover of the issue, legal restrictions on transferability, extent of institutional participation in the market for the security, and/or the disclosure regime governing transactions in the security; and

5. The cost and availability of financing, and the cost, availability and effectiveness of hedging for the issue when held by dealers in inventory as well as the volatility of the spread of the issue to Treasuries or to alternative hedging vehicles available to dealers. Consideration should also be given to general market conditions and any likely or threatened changes in those conditions.

NASD NOTICE TO MEMBERS 94-63

New Section 46 Of Article III Of The Rules Of Fair Practice Governing The Repricing Of Open Orders Takes Effect September 15, 1994

Suggested Routing

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

Executive Summary

The NASD is publishing this Notice to remind members that new Section 46 of Article III of the Rules of Fair Practice requiring members holding open orders to adjust the price and size of such orders by the amount of any dividend, payment, or distribution on the day that the security is quoted ex-dividend, ex-rights, ex-distribution, or ex-interest will be effective on September 15, 1994. Members will be required to comply with the new rule on that date regardless of whether automated repricing systems are available internally on proprietary systems or from outside vendors. The NASD is also announcing resolutions of certain issues raised by member firms with respect to the availability of dividend or distribution information and the obligations of member firms.

Background

In *Notice to Members 94-09*, published in February 1994, the NASD announced the Securities and Exchange Commission's (SEC) approval of new Section 46 of Article III of the Rules of Fair Practice requiring members holding open orders to adjust the price and size of such orders by the amount of any dividend, payment, or distribution on the day that the security is quoted ex- dividend, ex-rights, ex-distribution, or ex-interest and announced that the new rule would be effective May 15, 1994. In *Notice to Members 94-22*, the NASD announced that the effective date of new Section 46 would be delayed until September 15, 1994.

Compliance

To comply with the requirements of the rule, members may choose to handle open orders in one or more of the following ways:

1. Manually reprice such orders according to the requirements of the rule;

2. Automatically reprice such orders according to the requirements of the rule by using an in-house proprietary order-handling system;

3. Automatically reprice such orders according to the requirements of the rule by using a Nasdaq® system; (See below for information on the availability of such systems.)

4. Route such orders to an order execution firm for handling pursuant to 1, 2, or 3, above;

5. Accept open orders only on a "do not reduce" (DNR) or "do not increase" (DNI) basis; or

6. Not accept open orders.

Currently, the NASD's Small Order Execution System (SOES℠) limit order file will "pend" an order (take it out of the automatic execution mode) when the security trades ex-dividend. When SOES pends an order, it is returned to the member that entered the order for reconfirmation. If the order is not reconfirmed by the member, it is canceled. When Section 46 takes effect, members will be required to reprice such returned orders according to the requirements of the rule. The member will not be required to return the order to SOES after repricing; however, Section 46 does not permit a member to ignore or refuse to reprice a returned order, unless the order was originally accepted with a DNR/DNI instruction.

Regardless of the method chosen for handling open orders, the member accepting an order from a customer or another member is responsible for ensuring compliance with Section 46. Thus, if a member accepts an open order from a customer and

routes it to another member for execution, the member accepting the order must ensure that the order-executing firm has agreed to and can, in fact, comply with Section 46, and the order-executing firm must, in fact, comply with Section 46. Failure to comply with Section 46 in such a situation may subject both firms to disciplinary action.

Information On Securities Traded Ex
Members have expressed concern about obtaining timely information on securities traded ex to permit them to comply with the requirements of the rule. Currently, issuers are required by SEC Rule 10b-17, adopted under the Securities Exchange Act of 1934, to report dividends or other distributions to the NASD or to the exchange (pursuant to the exchange's rules) on which its securities are listed, unless the SEC has exempted the issuer from complying with the rule. When an issuer reports a dividend to the NASD, for instance, an ex-date is set by the NASD Operations Department and reported to an information vendor. Subscribers to such vendors are, therefore, advised of the dividend and in a position to reprice open orders.

To comply with new Section 46, members accepting open orders must ensure that they have access to, whether by subscription, on-line, or some other method, the ex-date information for the securities for which they are accepting orders. The NASD is exploring methods for supplying all ex-date information directly or through a third party and, if created, will announce such a program at a later date.

Finally, members have expressed concern about their liability under Section 46 where the issuer has not reported a dividend or distribution pursuant to SEC Rule 10b-17. The NASD has determined that members should not be liable for failing to reprice orders in such situations and has submitted a proposed rule change to the SEC for approval that would amend Section 46 to exempt open orders where the issuer has not reported the dividend or distribution pursuant to SEC Rule 10b-17. This would mean that orders for the securities of an issuer that was not required to submit 10b-17 reports, or was exempted from reporting under 10b-17 by the SEC, or where the issuer failed to report as required, would not be subject to the repricing requirements of Section 46.

Fractional Pricing
Several member firms have asked whether the 1/8 minimum increment in Section 46 specified for calculating prices is consistent with the possibility that there may be smaller minimum increments for quotations and transaction reports. Further, members have asked whether, for securities quoted or traded in smaller fractions, rounding prices to the nearest 1/8 would create problems for such repriced orders. The NASD recognizes that occasional problems as described might arise; however, because the NYSE relies on 1/8s in pricing and in the interests of having Section 46 function in a manner substantially the same as the NYSE's rule, the NASD does not believe that reducing the repricing increment is advisable at this time. The NASD suggests that if members wish to avoid problems in such situations that they consider accepting open orders for securities that trade in less than 1/8 increments only on a DNR/DNI basis. The NASD will continue to keep abreast of developments in this area.

Nasdaq Systems
The NASD is planning updates of The Nasdaq Stock Market's operating systems by, among other things, improving the features of SOES[1] and implementing the Advanced Computerized Execution System (ACES[SM]). These updates will include automatic repricing of open orders and will permit a member to comply with new Section 46 by placing such orders in the system. It is unlikely, however, that these changes will receive SEC approval before the September 15, 1994, effective date of Section 46. Therefore, the NASD will not be able to provide automated repricing capability for member firms subscribing to our systems on the effective date of the rule. Nevertheless, members will be expected to comply with the requirements of the rule when it becomes effective.

Repricing Calculation Methodology
In *Notice to Members 94-09* announcing the approval of new Section 46, the NASD discussed the calculation methodology to be used to reprice orders in accordance with the rule. The NASD is aware that the discussion appearing on page 44 of that Notice may mislead people into believing that there is a particular dollar value that may be ascribed to a share of stock in a dividend. This is not the case; the value of a stock dividend is a ratio of old stock to new stock that has a dollar value only in the context of a particular open order at a particular price. Thus, when Subsection 46(a)(ii) speaks of the "dollar value" of the stock dividend, it is referring to the dollar value as it relates to the particular order being repriced. As the NASD stated in *Notice to Members 93-61* published in September 1993, the dollar value of a dividend with respect to particular order is discovered by applying the ratio of old shares to new shares to the price of the particular order.

[1]The NASD recently filed proposed rule change SR-NASD-94-13 to adopt a Nasdaq Primary Retail Order View and Execution System (N•PROVE). N•PROVE will replace SOES and will include an automatic repricing feature that will comply with the new Section 46.

This is accomplished by multiplying the current order price by the number of old shares being exchanged and dividing the product by the number of new shares to be issued. For example, in a 3 for 2 distribution, multiply the per share price of the original order by 2 and divide the result by 3. Finally, round the resulting price up to the nearest 1/8. This method eliminates the need to find a dollar value for the split, round it up 1/8, and then subtract it from the current price of the order. Expressing this as a formula:

Where
P = the price per share of the original order,
C = number of shares being exchanged for new shares,
D = number of new shares being distributed, and
n = the resulting new price of the order

Then,
n = (P x C)/D

The resulting new price must then be rounded up to the nearest 1/8.[2]

Combined Cash/Stock Dividends
Finally, the NASD wishes to advise members that for dividends in both cash and stock, do the cash dividend calculation first and the stock calculation second. If the putative dollar value of the combined dividend is less than 25 percent and the NASD sets the ex-date for both on the same date pursuant to current practice, repricing an open order involves calculating the cash dividend adjustment first and then calculating the stock dividend adjustment based on the new price. Thus, if an open order at $10 per share were the subject of a $1.00 cash dividend and a 5 percent stock dividend, the price would first be reduced by $1.00 to $9.00 and then would be reduced by applying the preceding formula, thus: (9 x 20)/21 = $8.57 = 8 5/8. If the putative dollar value of the combined dividend is greater than 25 percent, pursuant to current practice, the NASD sets an ex-date for the cash dividend and then the stock dividend. In such cases, open orders are repriced once on the cash dividend ex-date and once on the stock dividend ex-date.

Treatment Of DNR/DNI Instructions
While Subsection 46(e) states that the provisions of the rule will not apply to orders marked DNR or DNI, several members have inquired whether the provision means, for instance, that an order marked DNI will not be adjusted either for size or price, or just for size. Because the NASD's intent in adopting this rule was for it to function in the same manner as the NYSE's Rule 118, and under Rule 118 a DNI instruction only applies to size adjustments, the NASD has determined that Section 46 should be read in the same manner. Therefore, a DNI instruction in a stock dividend situation will require the member to adjust the *price* of the order pursuant to Subsection 46(a)(ii), but not the size of the order. Similarly, a DNR instruction in a stock dividend situation will require the member to adjust the *size* of the order, but not the price. If a customer does not want the order adjusted as to size or price, both DNR and DNI instructions should be included. The NASD will announce at a later date whether its automated systems will be able to distinguish between orders carrying one instruction and orders carrying both.

Questions regarding this Notice may be directed to Dorothy L. Kennedy, Assistant Director, Nasdaq Operations, at (203) 385-6246, or Elliott R. Curzon, Assistant General Counsel, Office of General Counsel, (202) 728-8451.

[2]Members may apply any formula or method of calculation that yields the same result.

NASD NOTICE TO MEMBERS 94-64

Labor Day: Trade Date-Settlement Date Schedule

Suggested Routing

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

The Nasdaq Stock Market℠ and the securities exchanges will be closed on Monday, September 5, 1994, in observance of Labor Day. "Regular way" transactions made on the preceding business days will be subject to the settlement date schedule listed below.

Trade Date	Settlement Date	Reg. T Date*
Aug. 26	Sept. 2	Sept. 7
29	6	8
30	7	9
31	8	12
Sept. 1	9	13
2	12	14
5	Markets Closed	—
6	13	15

*Pursuant to Sections 220.8(b)(1) and (4) of Regulation T of the Federal Reserve Board, a broker/dealers must promptly cancel or otherwise liquidate a customer purchase transaction in a cash account if full payment is not received within seven (7) business days of the date of purchase or, pursuant to Section 220.8(d)(1), make application to extend the time period specified. The date by which members must take such action is shown in the column entitled "Reg. T Date."

Brokers, dealers, and municipal securities dealers should use these settlement dates to clear and settle transactions pursuant to the NASD Uniform Practice Code and Municipal Securities Rulemaking Board Rule G-12 on Uniform Practice.

Questions regarding the application of these settlement dates to a particular situation may be directed to the NASD Uniform Practice Department at (203) 375-9609.

NASD NOTICE TO MEMBERS 94-65

Nasdaq National Market Additions, Changes, And Deletions As Of July 28, 1994

Suggested Routing

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

As of July 28, 1994, the following 45 issues joined the Nasdaq National Market®, bringing the total number of issues to 3,679:

Symbol	Company	Entry Date	SOES Execution Level
DSGT	Designatronics Incorporated	6/29/94	200
WCBO	West Coast Bancorp	6/29/94	200
BELW	Bellwether Exploration Company	6/30/94	200
HMNF	HMN Financial Resources	6/30/94	500
MSNS	MediSense, Inc.	6/30/94	200
RAWL	Rawlings Sporting Goods Company, Inc.	6/30/94	500
BCBF	BCB Financial Services Corporation	7/1/94	200
TREE	Doubletree Corporation	7/1/94	500
ITGR	Integrity Music, Inc. (Cl A)	7/1/94	500
SMFC	Sho-Me Financial Corp.	7/1/94	500
CINRF	Cinar Films, Inc.	7/6/94	200
XNVAZ	Xenova Group plc (Uts exp 7/8/95) ADR	7/8/94	500
HSTR	American Homestar Corporation	7/12/94	500
FLROW	FluoroScan Imaging Systems, Inc. (Wts exp 7/11/99)	7/12/94	200
FLRO	FluoroScan Imaging Systems, Inc.	7/12/94	200
AGNU	PM Agri-Nutrition Group Limited	7/12/94	500
BPOPP	BanPonce Corporation (Ser A Pfd)	7/13/94	500
GMED	GeneMedicine, Inc.	7/13/94	200
GLFE	Golf Enterprises, Inc.	7/13/94	500
THRD	TF Financial Corporation	7/13/94	500
FBARP	Family Bargain Corporation (Ser A Pfd)	7/14/94	200
HUBCP	HUBCO, Inc. (Ser A Pfd)	7/14/94	500
BCMPY	Bell Cablemedia plc (ADR)	7/15/94	500
JANNF	Jannock Limited	7/15/94	500
PFSB	PennFed Financial Services, Inc.	7/15/94	1000
CHERA	The Cherry Corporation (Cl A)	7/15/94	500
DWYR	The Dwyer Group Inc.	7/19/94	200
CLCI	Cadiz Land Company, Inc.	7/20/94	200
CCCI	Continental Choice Care, Inc.	7/20/94	200
CCCIU	Continental Choice Care, Inc. (Uts exp 4/29/99)	7/20/94	200
CCCIW	Continental Choice Care, Inc. (Wts exp 4/29/99)	7/20/94	200
MATW	Matthews International Corporation (Cl A)	7/20/94	200
STON	GreenStone Industries, Inc.	7/21/94	200
STONW	GreenStone Industries, Inc. (Wts exp 7/20/99)	7/21/94	200
EFCW	Eagle Finance Corp.	7/22/94	200
FLCO	FelCor Suite Hotels, Inc.	7/22/94	200
BREW	Rock Bottom Restaurants, Inc.	7/22/94	500
ASTI	Astrum International Corp.	7/25/94	200
BEST	Best Products Co., Inc.	7/25/94	200

Symbol	Company	Entry Date	SOES Execution Level
MIDI	Midisoft Corporation	7/25/94	200
HAPY	Happiness Express, Inc.	7/26/94	200
NORL	Norrell Corporation	7/26/94	200
TPIFY	P.T. Tri Polyta Indonesia (ADR)	7/26/94	200
HBCCA	Heftel Broadcasting Corporation (Cl A)	7/27/94	500
WCCX	Wackenhut Corrections Corporation	7/27/94	500

Nasdaq National Market Symbol And/Or Name Changes

The following changes to the list of Nasdaq National Market securities occurred since June 27, 1994:

New/Old Symbol	New/Old Security	Date of Change
CMSB/CMSB	Commonwealth Savings Bank/Commonwealth Federal Savings Bank	7/1/94
QVCN/QVCN	QVC, Inc./QVC Network Inc.	7/1/94
DOCSF/QTXXF	PC DOCS Group International/Quartex Corp.	7/5/94
UNNB/UNNB	University Bank & Trust Company/University Natl. Bk & Tr Co.	7/8/94
CHERB/CHER	The Cherry Corporation (Cl B)/The Cherry Corporation	7/12/94
NPCIA/PIZA	NPC International Inc. (Cl A)/National Pizza Company (Cl A)	7/13/94
NPCIB/PIZB	NPC International Inc. (Cl B)/National Pizza Company (Cl B)	7/13/94
BANC/ASAL	BankAtlantic Bancorp Inc./BankAtlantic A Federal Savings Bank	7/14/94
EFMC/EITI	E for M Corp./Enhanced Imaging Technologies Inc.	7/18/94
SIHLF/SIHFV	Sun International Hotels Limited (S/D 7/28/94)/Sun International Hotels Limited (W/I)	7/21/94
CCSC/CCSCV	Coherent Communications Systems Corporation (S/D 8/2/94)/ Coherent Communications Systems Corp. (WI)	7/26/94

Nasdaq National Market Deletions

Symbol	Security	Date
FPUB	Franklin Electronic Publishers, Incorporated	6/29/94
BGENW	Biogen Inc. (Wts exp 6/30/94)	7/1/94
FAHS	Farm & Home Financial Corporation	7/1/94
GVGC	Grand Valley Gas Company	7/1/94
SSVB	Security Savings Bank, F.S.B.	7/1/94
VSBC	VSB Bancorp, Inc.	7/5/94
WBNC	Washington Bancorp, Inc.	7/5/94
SHOP	Shopsmith, Inc.	7/6/94
CFLX	Curaflex Health Services, Inc.	7/11/94
HINF	HealthInfusion, Inc.	7/11/94
JSBK	Johnstown Savings Bank	7/11/94
LSNB	Lake Shore Bancorp, Inc.	7/11/94
MEDS	Medisys, Inc.	7/11/94
CCSCR	Coherent Communications System Corporation (Rights 7/21/94)	7/22/94
CICIQ	Communication Intelligence Corporation	7/22/94
IASG	International Airline Support Group, Inc.	7/22/94

Symbol	Security	Date
ODDEQ	Odd's-N-End's Inc.	7/22/94
CYCLR	Centennial Cellular Corp. (Rights 7/22/94)	7/25/94
WELS	Wellstead Industries, Inc.	7/25/94

Questions regarding this Notice should be directed to Mark A. Esposito, Supervisor, Market Listing Qualifications, at (202) 728-8002. Questions pertaining to trade-reporting rules should be directed to Bernard Thompson, Assistant Director, NASD Market Surveillance, at (301) 590-6436.

NASD NOTICE TO MEMBERS 94-66

Fixed Income Pricing System Additions, Changes, And Deletions As Of July 29, 1994

Suggested Routing

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

As of July 29, 1994, the following bonds were added to the Fixed Income Pricing System (FIPS℠). These bonds are **not** subject to mandatory quotation:

Symbol	Name	Coupon	Maturity
FERL.GB	Ferrellgas, L.P.	7.875	8/1/01
BYD.GA	Boyd Gaming	10.750	9/1/03
TROC.GA	Trans Ocean Container	12.250	7/1/04
ACF.GB	ACF	14.500	12/1/96

As of July 29, 1994, the following changes to the list of FIPS symbols occurred:

New/Old Symbol	Name	Coupon	Maturity
ISCM.GA/INCM.GA	Insight Communication	8.250	3/1/20
HCNA.GA/HARC.GA	Harris Chem. No. Amer.	10.250	7/15/01
HCNA.GB/HARC.GB	Harris Chem. No. Amer.	10.750	10/15/03
HYSY.GA/HYAL.GA	Hyster-Yal	12.375	8/1/99
ISHC.GA/ISPC.GA	ISP Chem/ISP Tech	9.000	3/1/99

All bonds listed above are subject to trade-reporting requirements. Questions pertaining to trade-reporting rules should be directed to Bernard Thompson, Assistant Director, NASD Market Surveillance, at (301) 590-6436.

NASD BOARD BRIEFS

Actions Taken By The Board Of Governors In July

President's Report—At the mid-year mark, The Nasdaq Stock Market℠ continued its record-setting pace. The number of listed companies reached an all-time high with share and dollar volumes, both domestic and foreign, running well ahead of 1993 volumes. The 4,812 companies listed on Nasdaq® surpasses the previous high posted in September 1987 of 4,781 companies. The total number of issues reached 5,646, just shy of the September 1987 record of 5,691.

Share volume on The Nasdaq Stock Market is continuing to increase at a brisk pace and is running ahead of share volume on the New York Stock Exchange (NYSE). Through the second quarter, share volume averaged 299.1 million shares traded daily, versus the January-June 1993 average daily share volume of 245.5 million shares (a 21.8 percent increase). Share volume on the NYSE this year has averaged 295.3 million shares traded daily.

Also, Nasdaq dollar volume is continuing to set new records, after a record-setting $1.35 trillion for all of 1993. Through mid-year, total dollar volume was $751.3 billion, for an average of $6.0 billion daily, compared to $5.1 billion daily for the first half of last year (a 17.6 percent gain).

On June 6, The Nasdaq Stock Market won the Computerworld Smithsonian Award for its "pioneering" application of information technology in developing the world's first and largest screen-based stock market. Winners of the award will be included in a permanent exhibition at the Smithsonian Institution.

Recently, NASD Board members, along with Board members of the exchanges, received a letter from SEC Chairman Levitt reminding them of the critical role they play in the effective enforcement and oversight of self-regulatory organization rules. The letter reminded SROs that they should have in place procedures for the review of their regulatory programs, which include a regular review of the programs' effectiveness. The letter specifically cited listing and reporting standards for public companies as an area that requires close scrutiny. The Board received a full presentation on Nasdaq listing requirements and the procedures/practices utilized by the staff and the review committees in implementing these requirements. Both the California Department of Corporations and the Congressional General Accounting Office have reviewed and approved the NASD and Nasdaq activities in this area.

The SEC approved the short-sale rule to prohibit members from selling Nasdaq National Market® securities short for their own accounts or the accounts of their customers at or below the bid price when it is lower than the previous inside bid in the security. The rule will become effective September 6, 1994, for an 18-month pilot. The limit-order protection rule that prohibits a member firm from trading ahead of its customer's limit order was also approved by the SEC and went into effect July 18, 1994. See *Special Notice to Members 94-58*, dated July 15, 1994, for further information.

Internationally Nasdaq, in cooperation with KPMG, is a consultant to a recently chartered dealers' association in Russia, the Professional Association of Participants of the Securities Markets. Nasdaq was instrumental in pulling the association's charter together and has been advising the dealers on trading system design and operation. Nasdaq has also submitted a proposal to the Agency for International Development to help India design markets for the future. Separately, discussions have begun with several

European groups on the possibility of developing a Pan-European Market similar to Nasdaq.

Market Services—The NASD Board approved filing with the SEC a Schedule D amendment to eliminate a SelectNet℠ feature that permits the mass cancellation of orders in the same security. The Nasdaq Stock Market, Inc., Board of Directors will have to authorize a requisite change to the SelectNet system to implement this proposal.

The Board authorized an amendment to Section 33(b)(3) of the NASD Rules of Fair Practice to provide that short-call and long-put positions in a conventional option-collar transaction need not be aggregated for position-limit purposes, if the following conditions are met:

—The collar must be established with conventional option contracts that provide the options can only be exercised if they are in-the-money, and neither option can be sold, assigned, or transferred by the holder without the writer's previous written consent.

—The options must be European-style (for example, only exercisable when expired), with the short call and long put expiring on the same date.

—The strike price of the short call can never be less than the strike price of the long put.

—No more than one side of the transaction can be in-the-money when establishing the collar.

—The member complies with all NASD requests for information concerning the conventional options.

Another amendment to Section 33(b)(3) was approved by the Board to provide that conventional options overlying securities not subject to standardized options trading (and, therefore, subject to a position limit of 4,500 contracts) may be eligible for a higher position limit (7,500 or 10,500 contracts), depending on the trading volume and public float of the underlying security, the same way securities subject to standardized options trading are eligible for higher position limits.

Based on Board approval, amendments to Schedule D of the By-Laws will be filed with the SEC to insert these names where appropriate—The Nasdaq Stock Market, the Nasdaq National Market, and The Nasdaq SmallCap Market℠. Authorization will be sought to allow the NASD to make changes to any other rules that use or should use the names. This change was based on the Issuer Affairs Committee observation that the NASD has made significant progress in creating greater public recognition of The Nasdaq Stock Market and its two component sectors, the Nasdaq National Market and The Nasdaq SmallCap Market. Including these names in Schedule D will reduce confusion that may exist with the press, issuers, and members.

Member Services—The NASD Board approved the Membership Committee recommendations to amend Parts VI and X of Schedule C of the NASD By-Laws to provide for registration of foreign associates and exemptive provisions for "foreign finders," and authorized appropriate filings with the SEC. In February 1994 the Board requested comments from members via *Notice to Members 94-6* on conforming NASD requirements for foreign finders to interpretations of NYSE Rule 345 that were recently approved by the SEC. These interpretations would permit the payment of transaction-related compensation to nonregistered foreign finders who are not subject to U.S. securities laws.

Although comments generally supported the NASD's attempt to conform its requirements to the disclosure provisions of the interpretation to NYSE Rule 345, members saw potential problems with subjecting foreign finders to full Form U-4 registration—they may refuse to file Form U-4; they may be difficult to supervise; questions may arise regarding regulatory, tax, and other issues in their country of domicile; and they may redirect their business to foreign broker/dealers so they don't have to comply. This would contradict the purpose of the interpretation, which was designed to permit U.S. broker/dealers to be more competitive in global markets where finding arrangements are common.

In April, the Membership Committee developed a different approach to include foreign finders under the portion of Schedule C that identifies persons exempt from registration and to incorporate information disclosure requirements of the interpretation into that section. Provisions also exist for member firms to take reasonable steps to assure that foreign finders are not subject to the statutory disqualification provisions of U.S. securities law.

The NASD Board approved publishing a *Notice to Members* requesting comments on rules for the formal, two-part continuing education program for securities industry professionals that was proposed by the Industry/Regulatory Council on Continuing Education. Since November 1993, rules have been under development for this program. November 1994 is the target to have the rules completed and filed with the SEC. SEC Chairman Levitt has promised to expedite the consideration of the proposed rules at the Commission.

Regulation—The NASD Board approved publishing a special *Notice*

to Members requesting comments on amendments to Article II, Sections 26 and 29 of the Rules of Fair Practice governing member compensation received in the sale and distribution of investment company securities and variable contracts.

The proposed amendments, provide:

—No associated person of a member may accept any compensation, cash or non-cash, from anyone other than the member with which the person is associated.

—No member or person associated with a member may accept any compensation from an offerer that is in the form of securities of any kind.

—A member must maintain records of all compensation, cash and non-cash, received from offerers.

—No member may accept any compensation from an offerer unless the compensation is described in the investment company's current prospectus.

—No member or person associated with a member may directly or indirectly accept any non-cash compensation offered or provided to such member or its associated persons. These gifts are acceptable:

—Gifts that do not exceed an annual amount per person fixed periodically by the Board (initially $100) and are not preconditioned on achievement of a specified sales target.

—An occasional (not frequent) meal, ticket to a sporting event or the theater, or comparable entertainment for persons associated with a member and their guests.

—Payment or reimbursement by offerers in connection with meetings held by an offerer or by a member for training or education of associated persons of a member under certain conditions.

The Board agreed to publish a *Notice to Members* relating to the recommendations of the Fixed Income Committee arising out of the sales-practice-rule authority contained in the Government Securities Act of 1993. The Committee recommends merging the current Government Securities Rules into the Rules of Fair Practice. The Rules of Fair Practice would then apply to all government securities, except municipal securities.

Members will also be asked to comment on an interpretation regarding the applicability of the NASD Mark-Up Policy to transactions in government and other debt securities that acknowledges the differences between the debt and equity markets, and addresses these differences.

In addition, members will be asked to comment on an interpretation of the Board regarding member suitability obligations to institutional customers.