NASD NOTICE TO MEMBERS 95-21

Request For Comments On Proposed Suitability Obligations To Institutional Customers Interpretation; **Comment Period Expires: May 17, 1995**

Suggested Routing

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

Executive Summary

The NASD requests member comment on a proposed Interpretation of the NASD Board of Governors to Article III, Section 2 of the NASD Rules of Fair Practice (RFP). The Interpretation would provide guidance to members to fulfill their suitability obligations under Article III, Section 2(a) of the RFP when making recommendations to institutional customers in all equity and debt transactions, except municipals.

Background

On August 15, 1994, the NASD published *Notice to Members 94-62* to request member comment on the Fixed Income Committee's (the Committee) proposal that the NASD adopt a Board Interpretation regarding the suitability obligations of members to institutional investors in all equity and debt transactions, except municipals (the Suitability Proposal).[1] The Suitability Proposal provided that a member's obligation to an institutional customer would be fulfilled if, at the time of the specific transaction, the member has reasonable grounds for determining that the customer:

• has developed resources and procedures to make its own investment decisions;

• is not relying on the member's recommendation on the specific transaction; and

• is capable of understanding the product and its risks or of making an independent investment decision.

Several examples were in the Suitability Proposal to provide guidance to members regarding these determinations.

Fifteen comment letters were received from 14 commenters on the Suitability Proposal. Of the 14 commenters, one commenter supported the Suitability Proposal without significant change, 11 commenters supported the Suitability Proposal with recommended modifications, and one commenter was opposed to the Suitability Proposal. The Committee substantially redrafted the Suitability Proposal to clarify the Committee's original intent and to respond to the principle written and oral comments received by the NASD regarding *Notice to Members 94-62*. At its March 17, 1995, meeting, the Board of Governors approved the issuance of a *Notice to Members* to request additional member comment on the Committee's amended version of the Suitability Proposal.

Summary Of Amended Suitability Proposal

The amended version of the Suitability Proposal clarifies that it merely provides guidelines to determine whether a member has fulfilled its suitability obligations to institutional customers with respect to transactions in all equity or debt securities, except municipals. The Suitability Proposal, therefore, is not intended to create a safe harbor. The many examples that appeared to provide mechanical methods for determining the member's suitability obligation were eliminated. The amended text also provides that the manner in which a member fulfills its suitability obligations in making a recommendation to a customer will vary depending on the nature of the customer and the specific transaction.

The amended Suitability Proposal

[1] *Notice to Members 94-62* also contained a proposed Interpretation of the application of the Mark-Up Policy to transactions in government and other debt securities. Revisions to this Mark-Up Policy proposal are under review by the Fixed Income Committee.

states that the Board has identified certain factors that will be considered when the NASD conducts its reviews for compliance with Article III, Section 2(a) of the RFP. These factors are neither requirements nor the only factors considered, but merely provide guidance to the member.

The amended Suitability Proposal first states that a member must determine, based on the information available to it, the customer's capability to evaluate investment risk. In discussing this obligation, the amended Suitability Proposal contrasts situations where a member concludes the customer is not capable, in general or with respect to the particular type of instrument, of making an independent investment decision with situations where the customer ultimately can make an independent investment decision without reliance on the member.

The amended Suitability Proposal also states that the primary consideration in a suitability determination is whether the customer is relying on the member's recommendation rather than the customer making an investment decision based on its own independent assessment of the opportunities and risks presented by a potential investment, market factors, and other investment considerations. This guidance encourages the member to consider the member/customer relationship and to consider the customer's ability to make his or her own investment decisions, including the resources available to the customer to make informed decisions.

The amended Suitability Proposal provides four non-inclusive factors to help members examine the nature of the member/institutional customer relationship.

• The first factor suggests that the member consider whether there exists any written or oral agreement between the member and the customer regarding the customer's reliance on the member for recommendations.

• The second factor suggests that the member consider the presence or absence of a pattern of acceptance of the member's recommendations by the institutional customer.

• The third factor suggests that the member consider the use by the customer of ideas, suggestions, market views, and information obtained from other members or market professionals, particularly those related to the same type of securities.

• The fourth factor suggests that the member consider the extent to which the customer provides the member with current comprehensive portfolio information in connection with discussing recommended transactions or does not provide important information about its portfolio or investment objectives.

The amended Suitability Proposal also provides four non-inclusive factors to help the member consider the customer's capability to make independent investment decisions, including the resources available to the customer to make informed decisions.

• The first factor suggests that the member consider whether the customer has the use of one or more investment advisers or bank trust departments.

• The second factor suggests that the member consider the general level of experience of the staff of the institutional customer in financial markets and specific experience with the type of securities under consideration.

• The third and fourth factors suggest that the member consider the customer's ability to independently evaluate how market developments would affect the security and the complexity of the security or securities involved.

One public commenter recommended that the institutional customer definition should not be drawn from the institutional account definition of $50 million in assets under Article III, Section 21(c)(4) of the RFP. The Committee agreed with the commenter's concern that the proposed asset test could inadvertently apply to certain small municipalities with significant assets but a nominal investment portfolio. The above Article III, Section 21(c)(4) definition of institutional account was eliminated.

As an alternative, the Committee considered the qualified institutional buyer definition in Rule 144A(a)(1) of the Securities Act of 1933, which focuses on the aggregate amount of securities the investor has in its portfolio and under management. Upon review, the Committee believes that the Suitability Proposal should not include a classification of customer sophistication based on mere portfolio size and that such a portfolio-size definition was not intended under the Government Securities Amendments of 1993. The amended Suitability Proposal, therefore, provides that while it is potentially applicable to all institutional customers other than natural persons, the guidance contained therein should be applied, at a minimum, to an institutional customer with at least $10 million invested in securities in the aggregate in its portfolio and under management.

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 20006-1500

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

Comments must be received by May 17, 1995. Changes to the NASD RFP must be approved by the Board of Governors and filed with and approved by the SEC before becoming effective.

Text Of Proposed Amendment To Article III, Section 2 Of The Rules Of Fair Practice

(**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 institutional customers. The Board believes this Interpretation is applicable not only to government securities but to all debt securities, excluding municipals.[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.

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 manner in which a member fulfills its suitability obligation in making a recommendation to a customer will vary depending on the nature of the customer and the specific transaction. While it is difficult to define in advance a member's suitability obligation with respect to a specific institutional customer transaction recommended by a member, the Board has identified certain factors which are considered when the NASD conducts its reviews for compliance with Article III, Section 2(a) of the Rules of Fair Practice. These factors are not intended to be requirements or the only factors to be considered but are offered merely as guidance in determining a member's suitability obligation.

In determining its suitability obligation, a member must determine, based on the information available to it, the customer's capability to evaluate investment risk. In some cases, the member may conclude that the customer is not capable of making independent investment decisions in general. In other cases, the staff employed by the institutional customer may have general capability, but may not be able to understand a particular type of instrument or its risks, and therefore may be relying on the member's opinion to a degree sufficient to trigger application of the suitability rule. This is more likely to arise with relatively new types of instruments, or those with significantly different risk or volatility characteristics than other investments generally made by the institution. On the other hand, the fact that a customer initially needed help understanding a potential investment need not necessarily imply that the customer did not ultimately develop an understanding and make an independent investment decision without reliance on the member.

The primary consideration in determining a member's suitability obligation is whether the customer is relying on the member's judgement as reflected in a recommendation rather than making an investment decision based on its own independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations. A determination of reliance will depend on an examination of the following:

1. The nature of the relationship that exists between the member and the customer. Relevant considerations could include:

• any written or oral understanding that exists between the member and the customer regarding the customer's reliance on the member;

• presence or absence of a pattern of acceptance of the member's recommendations;

• the use by the customer of ideas, suggestions, market views and information obtained from other members or market professionals, particularly those relating to the same type of securities; and

• the extent to which the customer provides the member with current

[1] Rules for municipal securities are written by the Municipal Securities Rulemaking Board.

comprehensive portfolio information in connection with discussing recommended transactions or does not provide important information regarding its portfolio or investment objectives.

2. The customer's capability to make its own investment decisions including the resources available to the customer to make informed decisions. Relevant considerations could include:

• the use of one or more investment advisers or bank trust departments;

• the general level of experience of the staff of the institutional customer in financial markets and specific experience with the type of instruments under consideration;

• the customer's ability to independently evaluate how market developments would affect the security; and

• the complexity of the security or securities involved.

Members are reminded that these factors are merely guidelines which will be utilized to determine whether a member has fulfilled its suitability obligations and that the inclusion or absence of any of these factors is not dispositive of the determination of suitability. Such a determination can only be made on a case-by-case basis taking into consideration all the facts and circumstances of a particular member/customer relationship, assessed in the context of a particular transaction.

For purposes of this Interpretation, an institutional customer shall be any entity other than a natural person. In determining the applicability of this Interpretation to an institutional customer, the NASD will consider the dollar value of the securities that the institutional customer has in its portfolio and under management. While this Interpretation is potentially applicable to any institutional customer, the guidance contained herein should at a minimum be applied to an institutional customer with at least $10 million invested in securities in the aggregate in its portfolio and under management.

NASD NOTICE TO MEMBERS 95-22

SEC Approves Amendments To Article III, Section 44 Of The NASD Rules Of Fair Practice About Filing Requirements For Modified Guaranteed Annuity And Life Insurance Contracts

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 March 2, 1995, the Securities and Exchange Commission (SEC) approved amendments to Article III, Section 44 of the Rules of Fair Practice (Corporate Financing Rule) to exempt modified guaranteed annuity contracts and modified guaranteed life insurance contracts from the filing requirements of the Corporate Financing Rule.

Background And Description

The Corporate Financing Rule requires members to file with the NASD documents and information relating to a public offering of securities for review of the fairness of underwriting compensation and arrangements. The filing requirements in the Corporate Financing Rule also apply to Schedule E of the NASD By-Laws and Article III, Section 34 of the NASD Rules of Fair Practice. Thus, the filing requirements apply to public offerings of debt, equity, and public limited partnership securities.

The Corporate Financing Rule filing requirements provide that certain offerings of securities will be exempt from the filing requirement under its Subsection 44(b)(8). Modified guaranteed annuity contracts and modified guaranteed life insurance contracts (Contracts) do not fall within any of the current exemptions in the Corporate Financing Rule filing requirements. As a result, the Contracts will be subject to the filing requirements of the Corporate Financing Rule unless the NASD adopts a specific exemption for such instruments.

The Contracts are similar to variable annuity contracts in that they are issued by an insurance company, offered on a continuous basis, subject to the registration requirements and regulatory scheme of state insurance law, and shift investment risk to the contract owner by offering variable, non-guaranteed rates of return under certain circumstances. That is, the Contracts are subject to a market-value adjustment upon a Contract surrender or partial withdrawal before the end of a guarantee period. However, unlike variable annuities, the individual account values of the Contracts do not reflect the investment experience of one or more separate accounts registered under the Investment Company Act of 1940. Instead, like traditional fixed annuities, the Contracts are backed by the general account assets of the insurance issuer and are registered as insurance contracts under state insurance law.

The review of the fairness and reasonableness of underwriting terms and arrangements is the central requirement of the Corporate Financing Rule. The NASD believes that it is appropriate to exempt the Contracts from the filing requirements of Article III, Section 44 of the NASD Rules of Fair Practice because the structure of the instrument is that of an insurance product, which has traditionally been regulated under state insurance law, and because the issuance and sale of the Contracts on an open-ended basis does not raise the kinds of underwriting issues with which the Corporate Financing Rule is primarily and traditionally concerned. The terms of the Corporate Financing Rule were not developed to address such products.[1]

[1] In addition, Article III, Sections 26 and 29 of the NASD Rules of Fair Practice do not apply to such instruments, because the Contracts are not within the definition of "variable contract" and do not include a separate account registered under the Investment Company Act of 1940. However, as securities, sales of the Contracts are subject to other applicable Rules of Fair Practice when sold by associated persons of a member and the rules and regulations of the SEC, particularly the antifraud provisions thereof.

The NASD has amended Subsection 44(b)(8) of the Corporate Financing Rule to exempt the Contracts from the filing requirements of Subsection 44(b). The new provision is paragraph (E) of Subsection 44(b)(8) of the Corporate Financing Rule, and the remaining paragraphs have been renumbered accordingly.

Questions regarding this Notice may be directed to Carl R. Sperapani, Assistant Director, Corporate Financing Department, at (301) 208-2759; or Robert J. Smith, Attorney, Office of General Counsel, at (202) 728-8176.

Text Of Amendments To Article III, Section 44(b)(8) Of The Rules Of Fair Practice

(**Note:** New text is underlined; deletions are in brackets.)

THE CORPORATE FINANCING RULE

Underwriting Terms and Arrangements

Sec. 44.

(a) Definitions No change.

(b) Filing Requirements

(1) through (7) No change.

(8) Exempt Offerings

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

(A) through (D) No change.

(E) modified guaranteed annuity contracts and modified guaranteed life insurance policies, which are deferred annuity contracts or life insurance policies the values of which are guaranteed if held for specified periods, and the nonforfeiture values of which are based upon a market-value adjustment formula for withdrawals made before the end of any specified period;

[(E)] (F)

[(F)] (G)

[(G)] (H)

NASD NOTICE TO MEMBERS 95-23

SEC Adopts Amendments To Rule 15c2-12, Municipal Securities Disclosure

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 November 10, 1994, the Securities and Exchange Commission (SEC) adopted amendments to Rule 15c2-12 under the Securities Exchange Act of 1934 (Act) that prohibit broker/dealers from underwriting and recommending municipal securities for which adequate information is not available. The amendments will improve disclosure in the primary and secondary markets.

These changes are effective July 3, 1995, except for the requirements concerning recommendations in Paragraph 15c2-12(c), which are effective January 1, 1996. Subparagraphs 15c2-12(b)(5)(i)(A) and 15c2-12(b)(5)(i)(B) will not apply with respect to fiscal years ending before January 1, 1996; and Subparagraphs 15c2-12(d)(2)(ii) and 15c2-12(d)(2)(iii) will not apply to an offering of municipal securities commencing before January 1, 1996.

Background

SEC Rule 15c2-12, which was adopted in 1989, requires an underwriter of municipal securities:

• to obtain and review an issuer's official statement before making a purchase, offer, or sale;

• in negotiated sales, to provide the most recent preliminary official statement to potential customers;

• to deliver to customers, upon request, copies of the final official statement for a specified period of time; and

• to contract to receive sufficient copies of the final official statement to comply with the rule's delivery requirements and any Municipal Securities Rulemaking Board (MSRB) rules.

In September 1993, the SEC Division of Market Regulation staff reported to Congress on several aspects of the municipal securities market. One of the topics discussed was the disclosure requirements of various market participants.

According to the SEC report, investors need sufficient current information about issuers to protect themselves from fraud and manipulation, to evaluate offering prices, to decide which municipal securities to buy, and to decide when to sell. In addition, the report found that, with the growing number of individual investors purchasing municipal securities, the need for sound recommendations by broker/dealers is assuming even greater importance.

As a result of these findings, in March 1994, the SEC issued an interpretative statement regarding disclosure and, in a companion release in the *Federal Register*, proposed amendments to existing Rule 15c2-12.

SEC Interpretative Statement

The interpretative statement focuses largely on the disclosure obligations of municipal securities issuers. While disclosure by municipal issuers has improved significantly over the last two decades for primary offerings, the SEC notes that concerns still exist. The statement also notes that secondary market disclosure practices present greater concerns.

Regarding the obligations of municipal securities broker/dealers, the statement reaffirms earlier interpretations expressed by the SEC. According to the SEC, underwriters must have a reasonable basis for recommending any securities and, in fulfilling that obligation, they must review the accuracy of statements made in connection with the offering.

The SEC also emphasizes the

responsibilities of broker/dealers trading securities in the secondary market. Unlike an underwriter, a broker/dealer ordinarily is not obligated to contact the issuer to verify information. However, if a broker/dealer discovers any factors that indicate the disclosure is inaccurate or incomplete, or signal the need for further inquiry, a broker/dealer may need to obtain additional information, or seek to verify existing information.

Proposing Release

Municipal securities broker/dealers are the link between the issuers whose securities they sell and the investors to whom they recommend securities, therefore the amendments to Rule 15c2-12 were proposed to enhance the disclosure that is available to investors by placing additional requirements on the broker/dealers.

In response to its release, the SEC received comments from all segments of the municipal securities market, including issuers, underwriters, investors, analysts, and financial advisers. The SEC determined to adopt the proposed amendments with certain modifications.

Rule 15c2-12 Amendments

Underwriting Requirements

A municipal securities broker/dealer (referred to as a participating underwriter when used in connection with an offering) is prohibited from purchasing or selling municipal securities in an offering without making a reasonable determination that the issuer, or an obligated person for whom financial or operating data is presented in the final official statement, has undertaken in a written agreement or contract to provide:

• annual financial information for obligated persons to each nationally recognized municipal securities information repository (NRMSIR) and to any appropriate state information depository;

• audited financial statements for each obligated person, when available, if not submitted as part of the annual financial information, to each NRMSIR and to any appropriate state information depository;

• timely notice of these events, if material, to each NRMSIR or to the MSRB, and to any appropriate state information depository:

—principal and interest payment delinquencies;

—non-payment related defaults;

—unscheduled draws on debt service reserves reflecting financial difficulties;

—unscheduled draws on credit enhancements reflecting financial difficulties;

—substitution of credit or liquidity providers, or their failure to perform;

—adverse tax opinions or events affecting the tax-exempt status of the security;

—modifications to rights of security holders;

—bond calls;

—defeasances;

—release, substitution, or sale of property securing repayment of the securities;

—rating changes; and

—timely notice of a failure of any obligated person to provide required annual financial information on or before the date specified in the written agreement or contract, to each NRMSIR or the MSRB, and to any appropriate state information depository.

Written Agreement

The written agreement or contract must identify each person for whom annual financial information and notices of material events will be provided, by name or by the objective criteria used to select such persons and must specify:

• the type of financial information and operating data to be provided as part of annual financial information;

• the accounting principles used to prepare the financial statements and whether the statements will be audited; and

• the date on which the annual financial information for the preceding fiscal year will be provided, and to whom it will be provided.

The written agreement/contract may state that the continuing obligation to provide annual financial information and notices of events may be terminated for any obligated person when that person ceases to be an obligated person with respect to those municipal securities.

Amendments Regarding Recommendations

The paragraph concerning the requirements imposed on broker/dealers recommending the purchase or sale of a municipal security has been modified. Rather than requiring the broker/dealer to review the issuer's information (as stated in the proposing release), the final rule amendments require the broker/dealer to have procedures in place that provide reasonable assurance that it will receive prompt notice of any material

event disclosed pursuant to Subparagraph (b)(5)(i)(C) for secondary sales and Subparagraph (d)(2)(ii)(B) for primary offerings, and notice of a failure to provide annual financial information by the specified date [Subparagraph (b)(5)(i)(D)].

Even though the amendments do not require broker/dealers to review directly an issuer's ongoing disclosure before making a purchase/sale recommendation, the SEC expects that broker/dealers will take into consideration the additional information made available by issuers in making determinations as required by MSRB rules concerning fair dealing and suitability and by the anti-fraud provisions of federal securities laws.

Exemptions

The final amendments adopt, with modifications, the two exemptions contained in the proposing release and an additional third new exemption for short-term securities. Consistent with other provisions of Rule 15c2-12, the amendments only apply to primary offerings of municipal securities with an aggregate principal amount of $1,000,000 or more.

Exemption For Offerings With Limited Number Of Purchasers

Primary offerings in authorized denominations of $100,000 or more are exempt if such securities:

• are sold to no more than 35 persons, whom the participating underwriter reasonably believes have the knowledge and experience to evaluate the risks of the investment and who are not purchasing for more than one account or plan to distribute the securities;

• have a maturity of nine months or less; and

• may be tendered (at the holder's option) for redemption at least as frequently as every nine months until maturity or earlier redemption.

Small-Issuer Exemption

Primary offerings may be exempt if, at such time as an issuer delivers the securities to the participating underwriters:

• no obligated person is responsible for more than $10,000,000 in aggregate amount of outstanding municipal securities, including the offered securities but excluding other offerings exempt under the limited number of purchasers section;

• an issuer or obligated person has undertaken in a written agreement or contract to provide:

—at least annually to the appropriate state repository, any financial information or operating data, that is publicly available, regarding each obligated person noted in the final official statement; and

—timely notice of material events as specified in Subparagraph (b)(5)(i)(C) to each NRMSIR or the MSRB and to the appropriate state information depository; and

—the final official statement identifies by name, address, and telephone number the persons from which the foregoing information, data, and notices can be obtained.

Short-Term Maturity Exemption

Offerings with a stated maturity of 18 months or less are exempt from the requirements with respect to providing the annual financial information. However, the provisions of the Rule relating to notices of material events apply to these offerings, absent another exemption.

Exemption From The Recommendation Prohibition

The Rule allows broker/dealers to make recommendations in the secondary market of securities that were not subject to the underwriting prohibition. The Rule further provides that securities sold in an offering that is subject to the limited number of purchasers exemption are not exempt from the recommendation prohibition.

Transitional Provision

The Rule contains a transitional provision for the newly adopted amendments to Rule 15c2-12. The underwriting prohibition applies to a participating underwriter that contractually commits to act as an underwriter on or after July 3, 1995; however, issuers need not provide annual financial information for fiscal years ending before January 1, 1996.

The recommendation prohibition becomes effective on January 1, 1996, and broker/dealers must have procedures in place to comply with this prohibition by that time. The limited undertaking condition to the small issuer exemption is not applicable to offerings commencing before January 1, 1996.

* * *

A copy of the SEC release adopting the final amendments follows this Notice. NASD members that conduct a municipal securities business are urged to review it in its entirety. The supplementary information section of the release contains a detailed discussion concerning new provisions of the Rule and details concerning information repositories.

Questions concerning the Notice may be directed to Erin Gilligan, District Coordinator, Compliance Department, at (202) 728-8946.

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-34961; File No. S7-5-94]

RIN 3235-AG13

Municipal Securities Disclosure

AGENCY: Securities and Exchange Commission.

ACTION: Final Rule.

SUMMARY: The Securities and Exchange Commission ("SEC" or "Commission") is adopting amendments to Rule 15c2-12 under the Securities Exchange Act of 1934 ("Exchange Act") to deter fraud and manipulation in the municipal securities market by prohibiting the underwriting and subsequent recommendation of securities for which adequate information is not available. The amendments prohibit a broker, dealer, or municipal securities dealer ("Participating Underwriter") from purchasing or selling municipal securities unless the Participating Underwriter has reasonably determined that an issuer of municipal securities or an obligated person has undertaken in a written agreement or contract for the benefit of holders of such securities to provide certain annual financial information and event notices to various information repositories; and prohibit a broker, dealer, or municipal securities dealer from recommending the purchase or sale of a municipal security unless it has procedures in place that provide reasonable assurance that it will receive promptly any event notices with respect to that security.

DATES: *Effective Date:* This rule is effective on July 3, 1995 except for § 240.15c2-12(c) which is effective on January 1, 1996.

Compliance Date: Sections 240.15c2-12(b)(5)(i)(A) and 240.15c2-12(b)(5)(i)(B) shall not apply with respect to fiscal years ending prior to January 1, 1996; and §§ 240.15c2-12(d)(2)(ii) and 240.15c2-12(d)(2)(iii) shall not apply to an Offering of municipal securities commencing prior to January 1, 1996.

FOR FURTHER INFORMATION CONTACT: Catherine McGuire, Chief Counsel, Janet W. Russell-Hunter, Attorney, or Paula R. Jenson, Senior Counsel (concerning the rule and release generally), (202) 942-0073, Office of Chief Counsel, Division of Market Regulation, Mail Stop 7-10; Gautam S. Gujral, Attorney (concerning information repositories) (202) 942-0175, Office of Market Supervision, Division of Market Regulation, Mail Stop 5-1, and David A. Sirignano, Senior Legal Adviser to the Director (202) 942-2870, or Amy Meltzer Starr, Attorney (concerning annual financial information, obligated persons, and material events generally), (202) 942-1875, Division of Corporation Finance, Mail Stop 7-6 Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549.

SUPPLEMENTARY INFORMATION:

I. Introduction and Summary

The Commission has long been concerned with disclosure in both the primary and secondary markets for municipal securities.[1] As part of the Securities Acts Amendments of 1975, Congress established a limited regulatory scheme for the municipal securities market. This limited regulatory scheme included mandatory registration of municipal securities brokers and dealers, and the creation of the Municipal Securities Rulemaking Board ("MSRB"). In 1989, acting in response to consistently slow dissemination of information in connection with primary offerings of municipal securities, the Commission, pursuant to its authority under Exchange Act Section 15(c)(2),[2] adopted Rule 15c2-12[3] and an accompanying interpretation concerning the due diligence obligations of underwriters of municipal securities.[4] In 1993, the Commission's Division of Market Regulation conducted a comprehensive review of many aspects of the municipal securities market, including secondary market disclosure.[5] Findings in the September, 1993 *Staff Report on the Municipal Securities Market* ("*Staff Report*") regarding the growing participation of individual investors, who may not be sophisticated in financial matters, as well as the proliferation of complex derivative municipal securities, underscored the need for improved disclosure practices in both the primary and secondary municipal securities markets.[6] Information about the issuer and other obligated persons is as critical to the secondary market,[7] where little

[1] Both the Securities Act and the Exchange Act were enacted with broad exemptions for municipal securities from all of their provisions except the antifraud provisions of the Securities Act Section 17(a) and Exchange Act Section 10(b). Municipal securities received special exemptions not only based on considerations of federal-state comity, but also due to the lack of perceived abuses, at the time of enactment, in the municipal securities market as compared with the corporate market. Furthermore, until recently, the typical purchasers of municipal securities were institutional investors with financial expertise.

[2] Section 15(c)(2) of the Exchange Act prohibits municipal securities dealers from effecting any transaction in, or inducing or attempting to induce the purchase or sale of, any municipal security by means of a "fraudulent, deceptive, or manipulative act or practice," and authorizes the Commission, by rules and regulations, to define and prescribe means reasonably designed to prevent such acts and practices. Exchange Act Section 15(c)(2), 15 U.S.C. 78*o*(c)(2). Rule 15c2-12 also was adopted pursuant to the Commission's authority under Exchange Act Section 2, 3, 10, 15, 15B, and 23; 15 U.S.C. 78b, 78c, 78j, 78*o*, 78*o*-4, 78q, and 78w.

[3] 17 CFR 240.15c2-12. Rule 15c2-12 was proposed for adoption in 1988, and adopted in 1989. *See* Securities Exchange Act Release No. 26100 (Sept. 22, 1988), 53 FR 37778 ("1988 Release"); Securities Exchange Act Release No. 26985 (June 28, 1989), 54 FR 28799 ("1989 Release"). Rule 15c2-12 requires an underwriter of municipal securities (1) to obtain and review an issuer's official statement that, except for certain information, is "deemed final" by an issuer prior to making a purchase, offer, or sale of municipal securities; (2) in negotiated sales, to provide the issuer's most recent preliminary official statement (if one exists) to potential customers; (3) to deliver to customers, upon request, copies of the final official statement for a specified period of time; and (4) to contract to receive, within a specified time, sufficient copies of the issuer's final official statement to comply with the rule's delivery requirement, and the requirements of the rules of the MSRB.

[4] The 1989 Release also stated that issuers are primarily responsible for the content of their disclosure documents, and may be held primarily liable under the federal securities laws for misleading disclosure. *See* 1989 Release at n. 84.

[5] Since September, 1993, other initiatives related to the municipal securities market have been taken. On April 7, 1994, the Commission approved changes to MSRB rule G-19 concerning suitability of recommendations, and rule G-8 concerning recordkeeping. Securities Exchange Act Release No. 33869 (April 7, 1994), 59 FR 17632. These changes are designed to ensure that dealers, before making recommendations to customers, take appropriate steps to determine that the transaction is suitable. Concurrently, the Commission approved MSRB rule G-37 relating to the linkage between political contributions and the municipal securities business. Securities Exchange Act Release No. 33868 (April 7, 1994), 59 FR 17621. The rule seeks to end "pay to play" abuses in the municipal securities market by prohibiting dealers from conducting certain types of business with an issuer within two years after any contribution by the dealer or certain affiliated persons of the issuer who could influence the awarding of municipal securities business. On June 20, 1994, the MSRB filed with the Commission a proposal to amend MSRB rule G-14 concerning reports of sales or purchases, and procedures for reporting inter-dealer transactions. Securities Exchange Act Release No. 34458 (July 28, 1994), 59 FR 39803. The proposed rule change is a first step to increase transparency in the municipal securities market by collecting and disseminating information on interdealer transactions. On December 19, 1993, the Commission issued a release proposing for public comment amendments to the rule regulating money market funds, Rule 2a-7 under the Investment Company Act of 1940. Investment Company Act Release No. 19959 (Dec. 28, 1993), 58 FR 68585.

[6] By 1993, individual investors, including those holding through mutual funds and money market funds, held approximately 76% of municipal debt outstanding, as compared with 44% in 1983. *The Bond Buyer*, "Holders of Municipal Debt," (July 1, 1994) at 5.

[7] The municipal securities market is not the only market for debt securities that suffers from information inefficiencies. For that reason, the Commission also is exploring means to increase the amount of information concerning issuers of corporate debt securities. *See* Securities Exchange Act Release No. 34139 (June 7, 1994), 59 FR 29453.

information about municipal issuers and obligated persons is regularly disseminated, as it is in primary offerings, where, as a general matter, good disclosure practices exist. As one industry group testified, today "secondary market information is difficult to come by even for professional municipal analysts, to say nothing of retail investors."[8]

Notwithstanding voluntary industry initiatives to improve disclosure, particularly primary market disclosure, the *Staff Report* recommended that the Commission use its interpretive authority to provide guidance regarding the disclosure obligations of municipal securities participants under the antifraud provisions of the federal securities laws, and that the Commission amend Rule 15c2–12 to prohibit municipal securities dealers from recommending outstanding municipal securities unless the issuer has committed to make available ongoing information regarding its financial condition. In order to assist issuers, brokers, dealers, and municipal securities dealers in meeting their obligations under the antifraud provisions, in March, 1994, the Commission published the *Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others* ("Interpretive Release"),[9] which outlined its views with respect to the disclosure obligations of market participants under the antifraud provisions of the federal securities laws in connection with both primary and secondary market disclosure.

Concurrent with the publication of the Interpretive Release, the Commission published Securities Exchange Act Release No. 33742 ("Proposing Release"),[10] which requested comment on amendments to Rule 15c2–12 ("Proposed Amendments") designed to enhance the quality, timing, and dissemination of disclosure in the municipal securities market by placing certain requirements on brokers, dealers, and municipal securities dealers. In proposing the amendments, the Commission intended to further deter fraud by preventing the underwriting and recommendation of transactions in municipal securities about which little or no current information exists. Brokers, dealers, and municipal securities dealers serve as the link between the issuers whose securities they sell and the investors to whom they recommend securities. Investors, especially individual investors, place their reliance on these securities professionals for their recommendations of municipal securities.

The amendments to Rule 15c2–12 ensure that brokers, dealers, and municipal securities dealers will review the secondary market disclosure practices of issuers and other obligated persons at the time of an offering of municipal securities.[13] This scrutiny at the time of initial issuance of municipal securities will result in the dissemination of important information by issuers and other obligated persons throughout the term of the municipal securities. As a result of the amendments, brokers, dealers, and municipal securities dealers will be better able to satisfy their obligation under the federal securities laws to have a reasonable basis on which to recommend municipal securities, as well as their obligations under the rules of the MSRB.

The availability of secondary market disclosure to all municipal securities market participants will enable investors to better protect themselves from misrepresentation or other fraudulent activities by brokers, dealers, and municipal securities dealers. A lack of consistent secondary market disclosure impairs investors' ability to acquire information necessary to make intelligent, informed investment decisions, and thus, to protect themselves from fraud.

In the Proposing Release, comment was requested on each aspect of the Proposed Amendments, as well as on standards for recognition of nationally recognized municipal securities information repositories ("NRMSIRs"). In response to the request for comments, the Commission received over 390 comment letters representing over 475 groups and individuals. The commenters represented all types of participants in the municipal securities market, including issuers, underwriters, investors, counsel, analysts, financial advisers, banks, insurance providers, disclosure services, and the MSRB.[14] The comment letters presented a variety of thoughtful views on the issues raised by the Proposing Release.[15] The Commission has determined to adopt amendments to Rule 15c2–12, with certain modifications that are designed to address concerns expressed by commenters.[16] In addition, the suggestions of a group of industry participants that cooperated to assist the Commission in its efforts to improve disclosure in the municipal securities market have been valuable.[17]

Commenters across a broad range of market participants supported the goal of improved secondary market disclosure for the municipal securities market, but emphasized that flexibility is necessary, given the diversity that exists in the municipal securities market.[18] As adopted, the amendments

[8] Statement of Gerald McBride, Chairman, Municipal Securities Division, Public Securities Association, Before the House Committee on Energy and Commerce, Telecommunications and Finance Subcommittee (October 7, 1993) at 5.

[9] Securities Act Release No. 7049 (March 9, 1994), 59 FR 12748.

[10] Securities Exchange Act Release No. 33742 (March 9, 1994), 59 FR 12759. Also on March 9, the Commission published Securities Exchange Act Release No. 33743, which proposed the adoption of Rule 15c2–13. Proposed Rule 15c2–13 would have required brokers, dealers, and municipal securities dealers to disclose mark-up information in riskless principal transactions in municipal securities; and to disclose when a particular municipal security is not rated by a nationally recognized statistical rating organization ("NRSRO"). Due to the recent development of proposals by the MSRB and market participants to make pricing information available to investors, the Commission has determined to defer the riskless principal mark-up proposal for six months. In addition, the portion of proposed Rule 15c2–13 that would require disclosure if a municipal security is not rated by an NRSRO has been deferred, and will be withdrawn if the MSRB acts to adopt similar amendments to its confirmation rule, Rule G–15. *See* Securities Exchange Act Release No. 34962 (November 10, 1994).

[13] Participating Underwriters generally maintain a market in an issue of municipal securities in the period following an offering. Failure by a Participating Underwriter to receive assurances with respect to undertakings to provide secondary market disclosure will increase the difficulty of its formulation of a reasonable basis on which to recommend a municipal security during this period of secondary market trading.

[14] Among others, the Commission received 232 letters representing the views of 242 issuers and issuer associations; 52 letters representing the views of 57 brokers, dealers, and municipal securities dealers; and 8 letters representing the views of 8 investors and investor associations.

[15] The Commission has given consideration to the views of some commenters who questioned the Commission's authority to adopt the amendments to Rule 15c2–12. *See, e.g.*, Letter of ABA Business Law Section; Letter of Hawkins Delafield & Wood; Letter of NABL. The Commission believes that it has ample authority to adopt the amendments.

[16] The comment letters and a summary of the comment letters prepared by Commission staff are contained in Public File No. S7–5–94. *See also* Public File No. S7–4–94.

[17] *See* Joint Response to the Securities Exchange Commission on Releases Concerning Municipal Securities Market Disclosure prepared by American Bankers Association's Corporate Trust Committee, American Public Power Association, Association of Local Housing Finance Agencies, Council of Infrastructure Financing Authorities, Government Finance Officers Association, National Association of Counties, National Association of State Auditors, Comptrollers and Treasurers, National Council of State Housing Agencies, National Federation of Municipal Analysts, Public Securities Association ("Joint Response").

[18] *See, e.g.*, Joint Response; Letter of Chapman and Cutler; Letter of Florida Division of Bond Finance of the State Board of Administration; Letter of J.P. Morgan Securities, Inc.; Letter of National

Continued

to Rule 15c2–12 will further that goal by prohibiting underwritings unless there are commitments to provide ongoing disclosure, while, at the same time, providing issuers with significant flexibility to determine the appropriate nature of that disclosure. The amendments retain the requirement that a Participating Underwriter ascertain that an issuer or obligated person has undertaken to provide secondary market disclosure, including notices of material events, to information repositories, but rely on the parties to the transaction to establish who will provide secondary market disclosure, and what information is material to an understanding of the security being offered.

The amendments build upon and reinforce current market practices that have provided, as a general matter, good quality disclosure in official statements, and extend those practices to the secondary market. As is currently the practice, under the amendments, the participants in an underwriting would continue to determine which persons are material to an understanding of the Offering. Information concerning those persons would be included in the final official statement. Financial information and operating data that is material to an offering at the outset generally remains material throughout the life of the securities. Under the amendments, that information would be provided on an annual basis. Put simply, the amendments reflect the belief that purchasers in the secondary market need the same level of financial information and operating data in making investment decisions as purchasers in the underwritten offering.

The Proposed Amendments would have prohibited a broker, dealer, or municipal securities dealer from recommending the purchase or sale of a municipal security, unless it had reviewed the annual and event information provided pursuant to the undertaking. Commenters anticipated that such a prohibition would have a considerable negative impact on secondary market liquidity. Furthermore, brokers, dealers, and municipal securities dealers considered the proposed recommendation prohibition to be problematic from a compliance perspective. The Commission has modified this provision to require instead that brokers, dealers, and municipal securities dealers recommending municipal securities in the secondary market have procedures to obtain material event notices. Because under existing law brokers, dealers, and municipal securities dealers are required to use information disseminated into the marketplace in forming a reasonable basis for recommending securities to investors, the rule does not impose mechanical review requirements on a trade-by-trade basis.

The amendments contain an exemption to minimize the effect on small issuers. Offerings in which neither the issuer nor any obligor is obligated with respect to more than $10 million dollars in municipal securities outstanding following an offering will be exempt from the amendments, on the condition that there is a limited undertaking to provide upon request, or annually to a state information depository, at least the financial information or operating data they customarily prepare, and that is publicly available. In addition, the undertaking must meet the amendment's requirement regarding notices of material events.

II. Description of Amendments To Rule 15c2–12

A. Amendments With Respect to the Underwriting of Municipal Securities

Under the amendments to Rule 15c2–12, a broker, dealer, or municipal securities dealer ("Participating Underwriter") [19] will be prohibited, subject to certain exemptions, from purchasing or selling municipal securities in connection with a primary offering of municipal securities with an aggregate principal amount of $1,000,000 or more ("Offering"),[20] unless the Participating Underwriter has made certain determinations.[21] Specifically, the Participating Underwriter must reasonably determine that an issuer of municipal securities or an obligated person, either individually or in combination with other issuers of such municipal securities or other obligated persons,[22] has undertaken in a written agreement or contract for the benefit of holders of such securities, to provide, either directly or indirectly through an indenture trustee or a designated agent, certain annual financial information and event notices to various information repositories.[23]

The "reasonable determination" required by the amendments to Rule 15c2–12 must be made by the Participating Underwriter prior to its purchasing or selling municipal securities in connection with an Offering. A Participating Underwriter would, therefore, need to receive assurances from the issuer or obligated persons that such undertakings would be made before agreeing to act as an underwriter. A dealer could look to provisions in the underwriting agreement or bond purchase agreement that describe the undertakings for the benefit of bondholders made elsewhere, such as in a trust indenture, bond resolution, or separate written agreement.[24] In a competitively bid offering, such assurances also might be found in a notice of sale. Of course, representations concerning commitments to provide secondary market disclosure, like any other key representations by an issuer, are subject to specific verification, such that a Participating Underwriter has a reasonable basis to believe that such representations are true and accurate. Thus, investigation of an issuer's or obligated person's undertakings to provide secondary market disclosure would be an element of the Participating Underwriter's professional review of offering documents.[25]

Because the amendments prohibit Participating Underwriters from purchasing or selling securities in the absence of undertakings in a written agreement or contract, such agreement or contract would have to be in place at the time the issuer delivers the securities to the Participating Underwriter.[26] As discussed below, in conditioning the closing of an Offering on the existence of an agreement or contract, this provision of the amendments permits flexibility as to where undertakings for continuing disclosure are memorialized.[27]

Association of Bond Lawyers ("NABL"); Letter of Orrick, Herrington & Sutcliffe ("Orrick Herrington"); Letter of Public Securities Association ("PSA").

[19] *See* Rule 15c2–12(a).

[20] The amendments also include an exemption for small and infrequent issuers. *See* Section II.D.1., *infra*.

[21] Rule 15c2–12(b)(5)(i).

[22] These concepts are discussed in Section II.A.1.b., *infra*.

[23] Information repositories are discussed in Section II.C., *infra*.

[24] *See* Letter of Merrill Lynch, Pierce, Fenner & Smith ("Merrill Lynch").

[25] As noted in the 1988 Release, the obligations of managing underwriters and underwriters participating in an offering differ. An underwriter participating in an offering need not duplicate the efforts of the managing underwriter, but must satisfy itself that the managing underwriter reviewed the accuracy of the information in the official statement in a professional manner and therefore had a reasonable basis for its recommendation. Underwriters participating in offerings, however, have a duty to notify the managing underwriter of any factors that suggest inaccuracies in disclosure, or signal the need for additional investigation. *See* 1988 Release at n. 87.

[26] *See* Letter of Kutak Rock; Letter of Section of Urban, State and Local Government Law, American Bar Association ("ABA Urban Law Section"); Letter of Colorado Municipal Bond Supervisory Board.

[27] In contrast to the requirement in Rule 15c2–12(b)(5) that Participating Underwriters reasonably

The amendments to the definition of final official statement will affect the obligations of Participating Underwriters under Rule 15c2–12. Rule 15c2–12(b)(1) requires that a Participating Underwriter, prior to bidding for, purchasing, offering, or selling municipal securities, obtain and review a DFOS.[28] The Commission expects that Participating Underwriters will review the DFOS with a view to ascertaining that it contains information satisfying the definition of final official statement in Rule 15c2–12.[29] The Commission further expects that the quality of disclosure in the DFOS will improve in a manner that is commensurate with the changes in final official statement disclosure.[30]

Rule 15c2–12(b)(2) requires, for all except competitively bid offerings, from the time a Participating Underwriter has reached an understanding with an issuer of municipal securities that it will act as a Participating Underwriter, until the final official statement is available, that the Participating Underwriter send, to any potential customer, no later than the next business day, a copy of the most recent POS, if any. The Commission expects that the Participating Underwriters' obligations with respect to dissemination of the POS will not change.

1. Determining the Required Scope of the Undertaking to Provide Secondary Market Disclosure

Under the amendments as adopted, the financial information and operational data to be provided on an annual basis pursuant to the undertaking will mirror the financial information and operating data contained in the final official statement with respect to both the issuers and obligated persons that will be the subject of the ongoing disclosure, and the type of information provided. The amendments govern the core financial and operational data to be provided. It does not address the textual disclosure typically provided in annual reports, leaving the scope of that disclosure to market practice.[31] To clarify the intended quantitative focus of the rule, as adopted, the rule uses the term "financial information and operating data."

a. *The Starting Point—Definition of Final Official Statement—(1) Information Concerning Persons Material to an Evaluation of the Offering.* The Proposed Amendments would have revised the definition of final official statement to require that financial and operating information, including audited annual financial statements, regarding the issuer and any significant obligor be included in order to provide a fair presentation of the issuer's and significant obligor's financial condition, results of operations, and cash flow.

Commenters objected to various aspects of the proposed definition, including the general requirement that financial and operating information be presented in the final official statement.[32] Commenters also objected that the use of the term "the issuer," in specifying whose financial information should be included in the final official statement, failed to take into account a variety of situations in which the governmental issuer does not have any repayment obligations on the municipal securities (as with conduit issuers), as well as other situations (such as revenue bonds) in which the payments will be derived from entities, enterprises, funds and accounts that do not prepare separate financial statements. Some commenters took the position that in certain instances, inclusion of the financial statements of the general municipal issuer of which the enterprise is a part may be misleading.[33]

In view of these comments, the definition of final official statement has been revised to require that financial information and operating data be provided for those persons, entities, enterprises, funds, and accounts that are material to an evaluation of the offering.[34] Thus, the definition eliminates the reference to "the" issuer. In addition, the definition no longer requires that the official statement provide information about specific "significant obligors." It leaves to the parties (including the issuer and Participating Underwriters) the determination of whose financial information is material to the offering (including, without limitation, the credit supporting the securities being offered).

The definition does not set its own form and content requirements on the financial information and operating data to be included; in particular, the proposed requirement for audited financial statements has not been adopted. Instead, it provides the flexibility that many commenters asserted is necessary in determining the content and scope of the disclosed financial information and operating data, given the diversity among types of issuers, types of issues, and sources of repayment.[35]

The fact that the amendments rely on the final official statement to set the standard for ongoing disclosure should not serve as an incentive for issuers to reduce existing disclosure practices in the preparation of the final official

determine that issuers or obligated persons have undertaken to provide secondary market disclosure prior to the time they "purchase or sell" municipal securities, Rule 15c2–12(b)(1) requires Participating Underwriters to obtain and review an official statement deemed final by the issuer ("DFOS") prior to the time they "bid for, purchase, offer, or sell" securities. Thus, under Rule 15c2–12(b)(1), in a competitive underwriting, a Participating Underwriter must obtain and review the DFOS prior to placing a bid on an issue of municipal securities. Because the term "offer" encompasses the distribution of a preliminary official statement, as well as oral solicitations of indications of interest, in a negotiated underwriting, a Participating Underwriter is required to obtain and review the DFOS prior to the time it distributes the preliminary official statement to potential investors. If no offers are made, the Participating Underwriter is required to obtain and review the DFOS by the earlier of the time it agrees (whether in principle or by signing the bond purchase agreement) to purchase the bonds, or the first sale of bonds. *See* Mudge Rose Guthrie Alexander & Ferdon (April 4, 1990); Interpretive Release at Section III.C.6.

[28] Information regarding the offering price, interest rate, selling compensation, aggregate principal amount, principal amount per maturity, delivery dates, any other terms or provisions required by an issuer of such securities to be specified in a competitive bid, ratings, other terms of the securities depending on such matters, and the identity of the underwriters, may be omitted from the official statement reviewed by the Participating Underwriter for purposes of Rule 15c2–12(b)(1).

[29] Whether information is in fact known or not reasonably ascertainable at the time the Participating Underwriter must obtain and review the DFOS pursuant to the rule is best determined in the context of each offering by the issuer, the Participating Underwriter, and their respective counsel. *See* Public Securities Association (May 29, 1992)

[30] As a practical matter, the DFOS and the preliminary official statement ("POS") are often the same document. *See* Mudge Rose Guthrie Alexander & Ferdon (April 4, 1990).

[31] *See* Association of Local Housing Finance Agencies, *Guidelines for Information Disclosure to the Secondary Market* (1992); Government Finance Officers Association, *Disclosure Guidelines for State and Local Government Securities* (Jan. 1991); Healthcare Financial Management Association, Principles and Practices Board, *Statement Number 18—Public Disclosure of Financial and Operating Information by Healthcare Providers* (May 1994); National Council of State Housing Agencies, *Quarterly Reporting Format for State Housing Finance Agency Single Family Housing Bonds* (1989) and *Multi-family Disclosure Format* (1991); National Federation of Municipal Analysts, *Disclosure Handbook for Municipal Securities 1992 Update* (Nov. 1992).

[32] *See, e.g.*, Letter of Indiana Bond Bank; Letter of Kutak Rock; Letter of NABL; Letter of Texas Public Finance Authority; Letter of Goldman Sachs & Co. ("Goldman Sachs").

[33] *See, e.g.*, Letter of Department of Community Trade and Economic Development, State of Washington; Letter of American Public Power Association ("APPA"); Letter of Municipal Treasurer's Association; Letter of Orrick Herrington.

[34] *See* Rule 15c2–12(f)(3).

[35] *See, e.g.*, Letter of Association of Local Housing Financing Agencies ("ALHFA"); Letter of Treasurer, State of Connecticut Office of the Treasurer ("Treasurer of the State of Connecticut"); Letter of Council of Development Finance Agencies ("CDFA"); Joint Response; Letter of Securities Industry Association ("SIA"); Letter of Morgan Stanley & Co., Inc. ("Morgan Stanley").

statement. Market discipline and regulatory requirements should ensure that those practices continue at current or improved levels. While issuers remain primarily responsible for the content and accuracy of their disclosures,[36] as noted, Participating Underwriters must review the DFOS in a manner consistent with their obligations.

As the Commission recognized in the Interpretive Release,[37] the extensive voluntary guidelines issued by the Government Finance Officers' Association, and the industry specific guidelines published by industry groups such as the National Federation of Municipal Analysts, are followed widely in the preparation of official statements.[38] The Commission anticipates that such sound practices will continue and develop beyond that mandated by the amendments. Although those guidelines are not mandatory, the Commission encourages market participants to continue to refer to those voluntary guidelines and the Commission's Interpretive Release in preparing disclosure documents. In addition, as noted in the Interpretive Release,[39] final official statements are subject to the prohibition against false or misleading statements of material facts, including the omission of material facts necessary to make the statements made, in light of the circumstances in which they are made, not misleading.

(2) *Use of cross references to publicly available information.* The Proposing Release requested comment on the appropriateness of satisfying disclosure needs through a reference to other externally prepared and located documents. In response, a number of commenters stated that the concept of incorporation of information should be explicitly included in the rule,[40] and that the ability to incorporate information should not be conditioned on a minimum dollar amount of securities in the hands of the public—commonly known as "public float."[41] Some commenters also suggested that any limitation of this practice to "seasoned issuers" should include all investment grade issuers.[42] Some commenters further noted that the final official statement should not have to set forth information that has been filed with the Commission in accordance with its periodic reporting requirements.[43] The commenters suggested one significant prerequisite for permitting cross referencing—the availability of the information in some public repository.[44]

The definition of final official statement has been revised to make explicit[45] that a final official statement may include financial information and operating data either by setting forth the information in the document or set of documents composing the final official statement, or by including a specific reference to documents already prepared and previously made publicly available.[46] For purposes of the amendments, documents will be considered to be publicly available if they have been submitted to each NRMSIR and to the appropriate state information depository or, if the information concerns a reporting company, filed with the Commission. If the document is a final official statement, it must be available from the MSRB.

If cross referencing is used, for purposes of determining the appropriate scope of the ongoing information undertaking, the final official statement will be deemed to include all information and documents that have been cross referenced.[47] The amendment does not place limitations on the type of issuer that may use cross referencing. This approach is consistent with the goal of making the repositories the principal source of information concerning municipal securities. Once received by a repository, the referenced information should be readily available regardless of the nature of the issuer.

As commenters noted, permitting cross referencing to other externally prepared and available information should result in official statements that are clear and concise, yet provide information material to the Offering.[48] Moreover, the use of cross referencing also should ease some expressed apprehension about the ability of some issuers to obtain information about parties not within their control, to the extent that information about these parties is made available to the repositories or, if a reporting company, filed with the Commission.[49]

(3) *Description of information undertakings.* The definition of final official statement also has been changed from the Proposed Amendments to include a requirement that the undertakings provided pursuant to the rule be described in the final official statement.[50] As the Commission recognized in the Interpretive Release[51] and a number of commenters echoed,[52] it is important for investors and the market to know the scope of any ongoing disclosure. By including a description of the undertaking in the final official statement, market participants will know the identity of the entities about which information will be provided, and the type of information to be provided. By reviewing the final official statement, investors in the secondary market will be able to ascertain the scope of that undertaking and whether it has been satisfied.

Critical to any evaluation of a covenant is the likelihood that the issuer or obligated person will abide by the undertaking. The definition of final official statement thus has been

[36] *See* 1989 Release.

[37] Interpretive Release at Section III.B. The Interpretive Release is cited in the Preliminary Note to Rule 15c2–12 as a source of guidance as to the disclosure obligations of issuers of municipal securities, as well as the role of brokers, dealers, and municipal securities dealers.

[38] *See* note 31, *supra.*

[39] *See* Interpretive Release at Section III.A.

[40] *See* Joint Response.

[41] *See* Letter of ABA Urban Law Section; Letter of Bose McKinney & Evans; Joint Response; Letter of Mudge Rose Guthrie Alexander & Ferdon ("Mudge Rose"); Letter of Dormitory Authority of the State of New York ("New York Dormitory Authority").

[42] *See* Letter of Mudge Rose; Letter of New York Dormitory Authority.

[43] *See* Letter of ABA Urban Law Section; Letter of Kutak Rock; Letter of Texas Public Finance Authority.

[44] *See, e.g.,* Letter of Bose McKinney & Evans; Joint Response. One commenter also stated that if cross referencing was permitted, there should be a delay between the distribution of the official statement and the offering. The delay would enable potential purchasers and others to obtain any materials that were referenced in the official statement and make an informed investment decision. *See* Letter of Prudential Investment Corp.

[45] *See* 1989 Release (discussing the definition of "final official statement" in Rule 15c2–12 as originally adopted, and stating that the definition recognizes that the issuer's final official statement may be composed of one or more documents).

[46] Rule 15c2–12(f)(3). To avoid confusion with the technical aspects of incorporation by reference for registrants under the Commission's registration rules, the amended rule does not use that term.

At least two states, New York and Texas, have prepared a standard disclosure document for state information.

[47] Participating Underwriters and other market participants must keep in mind their obligations under the rule with respect to the DFOS and final official statement, and under the antifraud provisions of the federal securities laws. To the extent that cross references are used, the DFOS should be disseminated in sufficient time for review by Participating Underwriters, and the POS should be made available in time to enable prospective purchasers to make informed investment decisions based upon the referenced materials. *See* Interpretive Release at Section III.C.6.

[48] *See, e.g.,* Letter of New York Dormitory Authority; Letter of the Treasurer of the State of Connecticut.

[49] *See, e.g.,* Letter of Fieldman, Rolapp & Associates; Letter of State of Florida, Office of Auditor General; Letter of San Francisco International Airport; Letter of Texas Water Development Board; Letter of State of Washington, Office of the Treasurer.

[50] Rule 15c2–12(f)(3).

[51] *See* Interpretive Release at Section III.C.4.

[52] *See, e.g.,* Letter of Chemical Securities, Inc. ("Chemical Securities"); Letter of Ferris Baker Watts; Letter of National Federation of Municipal Analysts ("NFMA").

modified to require disclosure of all instances in the previous five years in which any person providing an undertaking failed to comply in all material respects with any previous informational undertakings called for by the amendments.[53] This information is important to the market, and should, therefore, be disclosed in the final official statement. The requirement should provide an additional incentive for issuers and obligated persons to comply with their undertakings to provide secondary market disclosure, and will ensure that Participating Underwriters and others are able to assess the reliability of disclosure representations.[54]

The amendments do not prohibit Participating Underwriters from underwriting an Offering of municipal securities if an issuer or obligated person has failed to comply with previous undertakings to provide secondary market disclosure. However, if a failure to comply with such previous undertakings has not been remedied as of the start of the Offering, or if the party has a history of persistent and material breaches, it is doubtful whether a Participating Underwriter could form a reasonable basis for relying on the accuracy of the issuer's or obligated person's ongoing disclosure representations.

b. *Entities about which information must be provided to the secondary market.* It is critical that current financial information and operating data is provided to the secondary market about the persons that would be important to investors in evaluating the security. The Proposed Amendments would have required the Participating Underwriter to determine that the issuer had committed to provide, at least annually, current financial information concerning the issuer of the municipal securities and any significant obligor.[55] The identity of persons about which information should be provided to the secondary market was the subject of a substantial number of comment letters.[56] As with the proposed definition of final official statement, a large number of commenters expressed particular concern about the provision of information on a continuing basis for conduit issuers who have no ongoing liability for repayment of municipal securities.[57] There also were a significant number of comments received critiquing the concept of significant obligor.[58]

Under the amendments as revised, the identity of the persons for which information must be provided on an annual basis is determined by the information included in the final official statement. If the final official statement includes financial information or operating data on a person, information about that person must continue to be provided to the secondary market if the person is committed by contract or other arrangement to support payment of the obligations on the municipal securities.[59] Thus, the obligation to provide ongoing information relates to those persons for which financial information or operating data is included in the final official statement *and* that have a contractual or other connection to repayment of the municipal obligations.

(1) *The obligated person concept.* The Proposed Amendments defined a significant obligor as "any person who, directly or indirectly, is the source of 20 percent or more of the cash flow servicing the obligations on the municipal security." The proposed definition generated a significant amount of comment, including concerns that it could be interpreted to include significant taxpayers and customers,[60] credit enhancers (including banks that are letter of credit providers and insurers providing bond insurance),[61] providers of guaranteed investment contracts,[62] as well as state and federal governments that provide revenue sharing, grant, state and local aid and other cofinancing arrangements.[63] Commenters raised technical concerns as to the appropriate percentage of repayment obligation necessary to trigger inclusion in the definition of significant obligor,[64] and when the percentages were to be measured.[65] Some commenters also expressed concern that, in the bond pool context, the definition of significant obligor may not have permitted sufficient flexibility in determining which obligors in a pool would be the subject of the requirement to provide information on an ongoing basis.[66]

Commenters suggested a number of modifications to the significant obligor concept. First, a number of commenters indicated that the definition of significant obligor should include a requirement that a contractual relationship exist between the obligor and the repayment of the obligation before a continuing information obligation is imposed.[67] Second, commenters recommended modifying the definition to include different percentages of cash flow, ranging from a low of no threshold to a high of 50% of cash flow.[68] Third, some commenters suggested replacing the entire definition of significant obligor with the concept of materiality, in which the issuer and the other offering participants would determine, on a continuing basis, whose information would be provided.[69]

[53] *See* Rule 15c2-12(f)(3).

[54] *See* Letter of PSA.

[55] Paragraph (b)(5)(i)(A) of the Proposed Amendments.

[56] *See, e.g.*, Letter of Fidelity Management and Research Company; Letter of First Albany Corporation; Letter of Maine Municipal Bond Bank; Letter of NABL; Letter of National Council of Health Facilities Finance Authorities ("NCHFFA"); Letter of Realvest Capital Corporation; Letter of South Carolina Economic Developers Association, Inc.

[57] *See, e.g.*, Letter of ABA Urban Law Section; Letter of Gilmore & Bell, P.C. ("Gilmore & Bell"); Letter of New York State Housing Finance Agency, State of New York Mortgage Agency, New York State Medical Care Facilities Finance Agency ("New York State Housing Finance Agency"); Letter of Orrick Herrington.

[58] *See, e.g.*, Letter of Section of Business Law, American Bar Association ("ABA Business Law Section"); Letter of Treasurer of the State of California ("Treasurer of the State of California"); Letter of Goldman Sachs; Letter of IDS Financial Corporation; Joint Response; Letter of Kutak Rock; Letter of Morgan Stanley; Letter of National Association of State Treasurers ("NAST").

[59] Providers of bond insurance, letters of credit, and liquidity facilities have been excepted from the definition of obligated person to eliminate the need to separately obtain and disseminate annual information about such providers. *See* Section II.A.1.b.(1). *infra.*

[60] *See, e.g.*, Letter of American Municipal Power—Ohio, Inc. ("AMP—Ohio"); Letter of Gilmore & Bell; Letter of Treasurer of the State of California.

[61] *See, e.g.*, Letter of Financial Guaranty Insurance Company ("FGIC"); Letter of Goldman Sachs; Letter of Hawkins Delafield & Wood; Letter of Thacher Proffitt & Wood.

[62] *See, e.g.*, Letter of Kutak Rock.

[63] *See, e.g.*, Letter of ABA Urban Law Section; Letter of Kutak Rock; Letter of State of Washington, Office of the Treasurer.

[64] *See, e.g.*, Letter of APPA; Letter of George K. Baum & Co.; Letter of CDFA; Letter of Eaton Vance Management; Letter of NCHFFA.

[65] *See, e.g.*, Letter of ABA Business Law Section; Letter of Electricities, Inc.; Letter of Hawkins Delafield & Wood; Letter of Kutak Rock; Letter of Mudge Rose; Letter of San Francisco International Airport.

[66] *See, e.g.*, Letter of ABA Urban Law Section; Letter of A.G. Edwards & Sons, Inc.; Letter of Council of Infrastructure Financing Authorities ("CIFA"); Letter of Hawkins Delafield & Wood; Letter of Program Administration Services, Inc.

[67] *See, e.g.*, Letter of ABA Business Law Section; Letter of APPA; Letter of City of Everett, Washington; Letter of Goldman Sachs; Letter of Hawkins Delafield & Wood; Letter of Merrill Lynch; Letter of Morgan Stanley; Letter of Mudge Rose; Letter of Orrick Herrington. Certain of these commenters noted that by including a contractual or similar relationship between the entity making payments and the financing, customers and taxpayers, having no connection to or responsibility in connection with the financing would not inadvertently be swept within the scope of the definition.

[68] *See, e.g.*, Letter of APPA; Letter of George K. Baum & Co.; Letter of City of Everett, Washington; Letter of IDS Financial Corporation; Letter of Standish, Ayer & Wood, Inc.

[69] *See, e.g.*, Letter of ABA Business Law Section; Letter of ALHFA; Letter of PSA.

As suggested by a number of commenters, the amendments eliminate the reference to significant obligor.[70] Instead, the amendments include a definition of "obligated person," which means a person (including an issuer of separate securities) that is committed by contract or other arrangement structured to support payment of all or part of the obligations on the municipal securities.[71] By including a nexus to the financing through a commitment that is structured to support the payment obligations, the amendments address concerns raised by many commenters that the term "source of cash flow" in the definition of significant obligor was overbroad and could encompass persons with no relationship to the financing.[72] The requirement for a contractual or other arrangement will assist Participating Underwriters in identifying the persons for which information should be provided pursuant to an undertaking.

Some commenters recommended that the commitment with respect to payment of the obligation on the securities consist of a contractual obligation to and enforceable by bondholders.[73] Instead, the definition includes a broader notion of a contract or arrangement that is structured to "support payment," without specifying that it run to bondholders. The definition is intended to include contracts or arrangements where payments are made either to bondholders, to issuers to be used to pay obligations on municipal securities, or through conduit structures.[74] Similarly, the reference to "obligations on municipal securities" is intended to be broad enough to cover debt obligations, lease payments and any other repayment obligation on or resulting from the municipal securities.

As was the case with the proposed significant obligor concept, the term "obligated persons" includes, but is broader than, the concept of issuers of separate securities under Rule 131 pursuant to the Securities Act of 1933 ("Securities Act")[75] and Exchange Act Rule 3b-5.[76] Also, in response to comments raised that the terms "issuer" or "significant obligor" do not sufficiently address financings in which the source of repayment is not a separate person or entity, but a dedicated revenue stream from a specified project, segregated tax revenues or other enterprise, fund or account,[77] the definition includes persons which are obligated generally, such as with full recourse to the person, or, in a more limited manner, such as through an enterprise, fund or account of such person, including a dedicated revenue stream. As noted above, the obligation to provide information must cover all such enterprises, funds or accounts, whether or not there is a separate entity. In such a case, the information undertaking could be provided by the governmental unit or financing authority of which the enterprise, fund or account is a part.[78] For example, a Participating Underwriter could accept an information undertaking from a state issuing bonds secured solely by funds collected under a special tax, to report financial information relating to the special tax; for issues supported both by contracts of assistance of separate authorities or funds in addition to the issuer's own revenues, undertakings from the separate authorities, as well as the issuer could be provided. Accordingly, although the definition of significant obligor has been eliminated, that modification does not reflect a change in the Commission's assessment of the importance of ongoing information concerning the ultimate sources of payment on the securities.

Unlike the significant obligor concept in the Proposed Amendments, there is no need to include a specified percentage of payment in the definition of obligated person, because the issuer and other participants will determine at the time of preparation of the final official statement which obligated persons are material to an Offering.[79] In making that materiality determination, the parties to a financing will evaluate the facts of the Offering.[80]

Determining the obligated persons in pooled financings requires more flexibility, because the composition of the pool may vary over time. Rather than identifying the specific persons for which information will be provided on a continuing basis, under the amendments, bond pools must describe in their official statements, and the undertaking, the objective criteria (presumably including percentage of payment support) they will apply consistently, both in the final official statement and on a continuing basis, in determining whether information concerning an obligated person will be provided.[81] The amendments permit, but do not require this approach for non-pooled issuers. The objective criteria approach ensures that financial information and operating data will be provided about those persons that, at the time of disclosure, meet the objective standards described in the undertakings. Obligated persons could commit to the issuer, at the time of initial participation in a pooled financing, through an undertaking to provide information when and if they

[70] *See, e.g.*, Letter of FGIC; Joint Response; Letter of NABL; Letter of PSA.

[71] *See* Rule 15c2-12(f)(10).

[72] *See, e.g.*, Letter of Bose McKinney & Evans; Letter of Mudge Rose; Letter of New York Dormitory Authority; Letter of Orrick Herrington.

[73] *See, e.g.*, Letter of Bose McKinney & Evans; Letter of Goldman Sachs; Letter of Indiana Bond Bank; Letter of Hawkins Delafield & Wood.

[74] For example, if all or a portion of a project financed by bonds is used by a party that has committed, by contract or other arrangement (written or oral) to pay for such use, and such payments support payment of debt service on the bonds (as structured at the time of issuance), continuing information on the party would be appropriate. Accordingly, parties that support debt service through payments under a lease, loan, installment sale agreement, or other contract relating to use of a project are included in the definition, regardless of whether the financing is a conduit arrangement (such as a non-recourse loan to a manufacturer to finance acquisition of a new facility or to a hospital to acquire equipment) or system or project financing (such as a lease to a particular carrier of a terminal in an airport system or sale of the output of a facility pursuant to a take-or-pay (or take-and-pay) contract). Major customers purchasing power from a municipal light department that, in turn, is under a take-or-pay contract with a joint action public power agency would not be included in the definition, although the municipal light department would likely be included in the definition. Similarly, major taxpayers in a municipal general obligation issue would not be included in the definition; however, an undertaking covering a developer that is the sole landowner in a development district assessment financing in which the future collection of assessments to service the borrowing is dependent upon the developer as part of the structure of the financing may be appropriate.

[75] 17 CFR 239.131.

[76] 17 CFR 240.3b-5

[77] *See, e.g.*, Letter of Fidelity Management and Research Company; Letter of Mudge Rose; Letter of NABL; Letter of Texas Public Finance Authority.

[78] *See* Rule 15c2-12(b)(5)(i).

[79] Under the revised amendments, the concerns of some commenters that the definition of significant obligor failed to take into account short term arrangements (*i.e.* the arrangements with persons providing cash flow were shorter than the term of the securities) is also alleviated in two ways. First, the issuer determines at the outset if an obligated person is material to the offering. Second, assuming an obligated person is included in the final official statement, the undertaking to continue to provide information on such obligated person may be terminated once it no longer has liability for any obligation on or relating to repayment of the municipal securities. *See* Rule 15c2-12(b)(5)(iii); Letter of APPA; Letter of Hawkins Delafield & Wood.

[80] Guidelines and practices that have developed in other contexts may be useful in analyzing both the materiality of an obligated person to the municipal financing and the appropriate level of disclosure relating to such obligated person. For example, in connection with securitization of non-recourse commercial mortgage loans, the 10 percent and 20 percent property assets concentration tests described in Staff Accounting Bulletins 71 and 71A are applied. These percentages are applied by analogy in other asset-backed financings.

[81] Although the amendments do not specify the scope of the objective criteria, the criteria description should be clear as to when and how they are applied.

satisfy that criteria. Obligated persons that no longer meet the objective criteria will no longer need to provide ongoing information. In order to ensure that the selection method is incorporated into the undertaking, the amendments require that Participating Underwriters reasonably determine that the undertakings identify those persons for which the information will be provided, either by name or by the objective criteria to be used to select such persons.[82]

Commenters were divided on whether providers of bond insurance, letters of credit, and other liquidity facilities, should be excluded from the definition of significant obligor.[83] The concept of "obligated person" encompasses these entities because they are committed, at least conditionally, to support payment of principal and interest obligations. Moreover, these persons normally are material to an understanding of the security, and, therefore, official statements should contain financial information concerning such persons either directly or by reference to publicly available materials. A number of commenters stated, however, that it would be inappropriate to put the onus on the issuer to provide information on such providers on an annual basis, particularly where that information is otherwise available to investors either upon request or in public reports that have been submitted to appropriate regulatory authorities.[84]

Commenters indicated a willingness by providers of bond insurance, letters of credit, and other liquidity facilities to deposit publicly available reports in a repository, or otherwise note where such reports may be easily obtained.[85] The issuer or other obligated person providing the undertaking may then refer to such reports in their annual financial information and indicate the location where any such current annual reports can be obtained. Based upon such representations, providers of bond insurance, letters of credit, and liquidity facilities have been excepted from the definition of obligated person to eliminate the need to separately obtain and disseminate annual information about such providers.

The Commission encourages industry participants to work together to adopt appropriate disclosure practices, both with respect to information concerning the provider contained in primary offering materials and on an ongoing basis in the annual financial information. The Commission will monitor developments in this area regarding the nature and quality of information made available about credit enhancers and liquidity providers, and the manner in which information is made available to determine whether further steps are necessary to assure access to this important body of information.

(2) *Who must undertake.* A related question to whose information must be given is who must provide the information undertaking; the person providing the undertaking may not necessarily be the person about which the information relates. The Proposed Amendments would have required that the continuing information undertaking be provided by the issuer. A significant number of commenters raised concerns about which of potentially several persons that could be considered an issuer of municipal securities[86] would be expected to provide the undertaking and who would make that determination.[87] This was a particular concern in light of the potential liability of the issuer providing the undertaking for the provision and the content of information regarding other issuers and significant obligors—persons not necessarily under their control. Commenters made a number of suggestions to address these perceived ambiguities, including requiring that each issuer of a municipal security and each significant obligor undertake to provide the information only with respect to itself.[88]

In response to these concerns, and consistent with the general approach to affording underwriting participants significant flexibility, the undertaking provision has been revised to provide that the undertaking may be made by any issuer of the municipal securities being offered, or by any obligated person for which information is provided in the final official statement. An issuer of a municipal security may provide the undertaking, regardless of whether it is obligated on the municipal security. In addition, obligated persons may provide the undertaking regardless of whether they are deemed an issuer of municipal securities. These obligated persons may be the main, if not the only, credit source for repayment of the obligations on the municipal securities. This approach should allow the governmental issuer to shift to the obligated person the responsibility to provide information on a continuing basis.

Thus, a Participating Underwriter need only reasonably determine that an issuer of municipal securities or an obligated person for which financial information or operating data is presented in the final official statement has agreed to provide the information called for by the rule; it will not be necessary to obtain an undertaking from all possible issuers and obligated persons. Moreover, to respond to the expressed concern that separate undertakings should be permitted, the amendments have been revised to recognize that undertakings may be provided in combination with other issuers and other obligated persons. In all cases, however, the undertakings, either individually or collectively, must constitute a commitment to provide information with respect to all the persons about which information must be provided on an annual basis.

The amendments have been revised to clarify that dissemination

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[82] *See* Rule 15c2-12(b)(5)(ii).

[83] *See, e.g.*, Letter of ABA Urban Law Section; Letter of Blackwell Industrial Authority, Blackwell, Oklahoma; Letter of Davis Polk & Wardwell; Letter of IDS Financial Corporation; Letter of Kutak Rock; Letter of Oregon Economic Development Department; Letter of Realvest Capital Corporation; Letter of Thacher Proffitt & Wood. Some commenters also were concerned as to whether the definition would encompass providers of guaranteed investment contracts and other investments. *See, e.g.*, Letter of ABA Urban Law Section; Letter of Kutak Rock, on behalf of AMBAC Indemnity Corporation, Capital Markets Assurance Corporation, Capital Reinsurance Company, Enhance Reinsurance Company, Financial Guaranty Insurance Company, Financial Security Assurance, Inc., and Municipal Bond Investors Assurance Corporation ("Kutak Rock on behalf of Financial Guaranty Insurers"). A functional approach determines whether providers of investments should provide ongoing information. For example, if the proceeds of an Offering are invested in guaranteed investment contracts ("GICs"), and the income from the GICs is the predominant source of revenue to repay the obligations on the securities, information about the provider may be material to the Offering, including on an ongoing basis. If, however, other sources of revenue are committed to support payment of the obligations, the relative importance of the provider of the GIC to investors may be diminished.

[84] *See, e.g.*, Letter of ABA Urban Law Section; Letter of Smith, Gambrell & Russell; Letter of Texas Water Development Board. Some commenters noted difficulty in obtaining information from credit enhancers. *See* Letter of Association of Bay Area Governments; Letter of New York State Housing Finance Agency; Letter of State of Washington, Office of the Treasurer.

[85] *See, e.g.*, Memorandum of August 10, 1994 Meeting with Davis, Polk and Wardwell and Various Banks; Letter of Kutak Rock on Behalf of Financial Guaranty Insurers. One commenter recommended that bond insurers and banks providing letters of credit, who are not subject to periodic reporting requirements of the federal securities laws, send publicly available reports to the repositories. *See* Letter of ABA Urban Law Section.

[86] The term "issuer of municipal securities," as defined in Rule 15c2-12, includes issuers of separate securities as well.

[87] *See, e.g.*, Letter of ALHFA; Letter of Hawkins Delafield & Wood; Letter of Kutak Rock; Letter of National State Auditors Association; Letter of the Treasurer of the State of North Carolina.

[88] *See, e.g.*, Letter of ABA Urban Law Section; Letter of ALHFA; Letter of Kutak Rock; Letter of NABL.

responsibilities may be delegated to designated agents or to indenture trustees. As commenters pointed out, there are circumstances in which third parties may be effective in assisting issuers and obligated persons in disseminating the information.[89] Moreover, indenture trustees have expressed concerns about being considered "designated agents" in performing any dissemination role, based on the scope of, and standards affecting, their responsibilities as indenture trustees.[90] The language has been revised in response to clarify that, in addition to designated agents, issuers or obligated persons may contractually empower indenture trustees to disseminate information that an issuer or obligated person has agreed to provide. The parties may authorize an indenture trustee to provide certain information through specific instruction or on its own initiative upon becoming aware of particular facts.

c. *Scope of financial information and operating data to be provided on an annual basis*—(1) *Definition of annual financial information.* The amendments provide a definition of the term "annual financial information,"[91] a concept that was used, without definition, in the Proposed Amendments. The definition of annual financial information specifies both the timing of the information—that is, once a year—and, by referring to the final official statement, the type of financial information and operating data that is to be provided to the repositories. If financial information or operating data concerning an obligated person (or category of obligated persons in the case of financings using the objective criteria approach) is included in the final official statement, then annual financial information would consist of the same type of financial information or operating data. For example, if anticipated cash flow information is provided in the final official statement for a revenue bond financing, cash flow data reflecting actual operations must continue to be provided on an annual basis. Only the annual financial information called for by the undertakings need be sent to the repositories; other types of financial information and reports that may be prepared by the issuer or obligated persons are not subject to the rule's dissemination provisions.

[89] *See, e.g.*, Letter of Bond Investors Association; Letter of PSA; Letter of Texas Public Finance Authority.

[90] *See, e.g.*, Letter of Bank One Corporation; Letter of Reliance Trust Company; Letter of State Street Bank and Trust Company.

[91] Rule 15c2-12(f)(9).

Many commenters addressed the issue of whether the rule should specify form and content of the information that should be provided on an annual basis, as well as for event specific information.[92] Some commenters argued that the rule should include specified formats for information to be provided, including financial statements and certain industry reporting formats,[93] while other commenters contended that no form or content should be specified and that the parties should be permitted to make determinations based on materiality alone.[94] As discussed below, the flexibility afforded by the concept of annual financial information addresses these concerns by providing a minimum standard for ongoing disclosure, but allowing the parties to define that standard with respect to each Offering of municipal securities.

(2) *Financial information.* The proposal to mandate audited financial statements produced considerable comment. As with the proposed definition of final official statement, commenters expressed concern with the availability of audited financial statements on an annual basis, as well as the relevance of financial statements for certain types of financings.

Some commenters indicated that some municipalities were not required by law to have independently audited financial statements, and any such requirement would impose a significant new expense.[95] A number of commenters also expressed doubt as to whether audited financial information could be delivered on an annual basis, because audits may not be completed for a number of years following the close of the fiscal year.[96] Commenters noted that in some cases, financial statements for certain types of entities were audited every year, and in other cases every 2–3 years.[97] Therefore, some of these commenters argued that the requirement for annual audited financial statements would have an adverse impact on an issuer's ability to access the public securities markets or increase its costs of financing.[98]

A number of commenters also raised concerns regarding the availability of full financial statements for certain issuers, whether or not audited.[99] As examples, commenters noted that some issuing entities do not have their own financial statements and may be included in the financial statements of a larger issuer or entity.[100] Commenters from two states indicated that governmental units of the states may be encompassed in the state's comprehensive annual financial report and that there may be only supplemental schedules that described the governmental units.[101]

Some commenters raised the point that financial statements of a general governmental unit may not necessarily be relevant in certain project and structured financings.[102] As an example, one commenter noted that in some asset backed financings, information about the governmental issuer may be relevant only with respect to its experience in managing programs of loan pools.[103]

Commenters proposed a number of alternatives to the requirement to provide annual audited financial statements. Among the alternatives was a suggestion that financial statements be required in the form customarily prepared by the issuer promptly upon becoming available and that audited financial statements be provided to the extent available.[104] Other suggestions included limiting the requirement to those entities required by state or federal law to have audited financial statements.[105]

[92] *See, e.g.*, Letter of Dean Witter Reynolds, Inc. ("Dean Witter"); Letter of National League of Cities; Letter of NFMA; Joint Response; Letter of PSA; Letter of Tillinghast, Collins & Graham; Letter of the Treasurer of the State of Connecticut.

[93] *See, e.g.*, Letter of Dain Bosworth, Inc.; Letter of First Albany Corporation; Letter of MSRB; Letter of NFMA; Letter of Standish, Ayer & Wood, Inc.

[94] *See, e.g.*, Letter of CDFA; Letter of Chapman and Cutler; Letter of CIFA; Joint Response; Letter of H.M. Quackenbush; Letter of NABL.

[95] *See, e.g.* Letter of Texas Water Development Board; Letter of State of Washington, Office of the Treasurer.

[96] *See, e.g.*, Letter of City of Barling; Letter of Dain Bosworth, Inc.; Letter of Friday, Eldridge & Clark.

[97] *See, e.g.*, Letter of AMP—Ohio; Letter of State of Indiana, State Board of Accounts; Letter of State of Montana, Department of Natural Resources and Conservation; Letter of Washington Finance Officers Association.

[98] *See, e.g.*, Letter of AMP—Ohio; Letter of Washington Finance Officers Association.

[99] *See, e.g.*, Letter of ABA Business Law Section; Letter of Florida Division of Bond Finance; Letter of Gust & Rosenfeld; Letter of Office of the State Auditor, Texas ("Texas Office of the State Auditor").

[100] *See, e.g.*, Letter of Treasurer of the State of North Carolina; Letter of Texas Office of the State Auditor.

[101] *See, e.g.*, Letter of the Treasurer of the State of North Carolina; Letter of Texas Office of the State Auditor.

[102] *See, e.g.*, Letter of ABA Urban Law Section; Letter of APPA; Letter of Goldman Sachs; Letter of Gust & Rosenfeld; Letter of The Hospital & Higher Education Facilities Authority of Philadelphia; Letter of Morgan Stanley; Letter of NABL; Letter of New York State Housing Finance Agency.

[103] *See* Letter of ABA Urban Law Section.

[104] *See, e.g.*, Letter of ABA Business Law Section; Letter of Association of Bay Area Governments; Letter of North East Independent School District; Letter of PSA; Letter of Washington Finance Officers Association.

[105] *See, e.g.*, Letter of the Treasurer of the State of North Carolina; Letter of Washington Finance Officers Association.

In view of the comments received, the amendments do not adopt the proposal to mandate audited financial statements on an annual basis with respect to each issuer and significant obligor. Instead, the amendments continue to require annual financial information, which may be unaudited, and may, where appropriate and consistent with the presentation in the final official statement, be other than full financial statements. While it is anticipated that full financial statements will be provided for entities with ongoing revenues and operating expenses, it is possible that in the case of dedicated revenue streams and certain types of structured financings, other types of special purpose financial statements, project operating statements or reports may be used to reflect the financial position of the credit source for the financing. However, if audited financial statements are prepared, then when and if available, such audited financial statements will be subject to the undertaking and must be submitted to the repositories.[106] Thus, as suggested by a number of commenters, the undertaking must include audited financial statements only in those cases where they otherwise are prepared.

The amendments adopt the proposed requirement that the undertaking specify the accounting principles pursuant to which the financial information provided as part of the annual financial information will be prepared.[107] As discussed in the Proposing Release, it is important that financial information be prepared on a consistent basis to enable market participants to evaluate results and perform year to year comparisons.[108] The undertaking also must specify whether audited financial statements will be provided as part of the annual financial information.[109]

The amendments do not establish a standardized format for presentation of financial information, or any specification of the content of the information, other than by reference to the final official statement. The annual financial information may be presented through any disclosure document or set of documents, whatever their form or principal purpose, that include the necessary information. The amendments, as adopted, contemplate that sequential final official statements prepared by frequent issuers may meet the standards of the rule. As in the case of final official statements, annual financial information submitted to a repository also may reference other information already submitted to repositories or the MSRB, or filed with the Commission.[110]

(3) *Operating data.* The Proposed Amendments[111] would have required that the undertaking call for pertinent operating information, and that the parties specify the pertinent operating information to be provided on an annual basis. The basic concern of commenters regarding this provision, in addition to issues of specification of form and content discussed above, was that the use of the term "pertinent" did not provide sufficient guidance as to who would determine what was pertinent and what independent obligations Participating Underwriters would have with respect to such evaluation.[112]

The amendments have been modified to respond to these comments. The phrase "pertinent" has been deleted from the reference to operating information and the word "data" is used to emphasize the intended quantitative nature of the information. Operating data is included as a subset of annual financial information, and the operating data to be provided annually also is determined by reference to the type of operating data presented in the final official statement. Thus, the parties will determine at the outset, presumably with the assistance of applicable industry guidelines, what operating data will be provided both initially and on an ongoing basis. For example, in a conduit health care financing, under current industry practice, an official statement typically provides information relating to the obligated party—the hospital—in an appendix. In addition to a discussion describing the hospital, its administration and management, economic base and service area, and capital plan, operating statistics such as bed utilization, admissions and type, patient days, and payor utilization often is provided. Under the amendments, in this type of transaction, parties at the outset of a transaction will determine which operating data will be included in the hospital appendix; such information, in turn, will be the type of "operating data" to be provided annually.

Some commenters expressed concern that the Proposed Amendments were not sufficiently flexible to permit parties to address changing conditions because the undertaking would have to describe the financial and pertinent operating information to be provided in the future.[113] Nonetheless, the requirement that the undertaking specify in reasonable detail the type of data that will be provided on an ongoing basis, including the identity of the persons (or category of persons) about which the information will relate has been retained. As is the case with financial information, the intent of the amendments is to give investors and market participants the ability to evaluate the security through comparisons of the quantitative operating data provided. Contrary to the suggestion of some commenters, the undertaking would be meaningless if issuers and obligated persons could unilaterally determine that certain types of information were no longer necessary or meaningful to investors.

Because the amendments require that the undertaking specify only the general type of information to be supplied, there should be sufficient flexibility to accommodate subsequent developments that may require adjustments in the financial information and operating data that should be provided annually. Of course, nothing in the undertaking will prevent a party from providing additional information, particularly where such disclosure may be necessary to avoid liability under the antifraud provisions of the federal securities laws. Similarly, the amendments make specific provision for adjusting the persons about which information is provided. As required in the case of pooled financings, parties may identify the persons covered by reference to objective selection criteria that will be applied on a consistent basis between the offering statements and with regard to annual financial information. Moreover, the party providing the undertaking need not continue to provide information concerning persons that are no longer obligated persons with respect to the municipal securities.

A new provision has been added to the amendments which permits the written agreement or contract to have a

[106] *See* Rule 15c2-12(b)(5)(i)(B).

[107] *See* Rule 15c2-12(b)(5)(ii)(B).

[108] *See* Proposing Release. A number of commenters responded to the request for comment on specification of the use of generally accepted accounting principles ("GAAP") and generally accepted auditing standards ("GAAS"). *See, e.g.*, Letter of Comptroller of the State of California; Letter of Government Accounting Standards Board ("GASB"); Letter of NAST; Letter of National State Auditors Association; Letter of Prudential Investment Corp. The amendments as adopted do not mandate the use of either GAAP or GAAS.

[109] *See* Rule 15c2-12(b)(5)(ii)(B).

[110] Of course, any required information must be the subject of an undertaking, and if the information cross referenced has not been submitted to a repository or the MSRB, or filed with the Commission, the undertaking will not have been complied with.

[111] Paragraph (b)(5)(i)(A) of the Proposed Amendments.

[112] *See, e.g.*, Letter of APPA; Letter of Fidelity Management and Research Company; Letter of Hawkins Delafield & Wood.

[113] *See, e.g.*, Letter of Chapman and Cutler; Joint Response; Letter of Kutak Rock.

termination provision with respect to any obligated person that is no longer directly or indirectly liable for repayment of any of the obligations on the municipal securities.[114] Once an obligated person no longer has any liability for repayment of the municipal securities, whether through termination or expiration of its commitment to support payment, or as a result of a defeasance of the municipal securities with no remaining liability, then the obligation to provide annual financial information and notices of events may terminate.

2. Notice of Material Events

Commenters generally agreed that issuers and obligors should be subject to an undertaking to provide event information to the market.[115] Brokers, dealers and municipal securities dealers supported these provisions of the Proposed Amendments, because the use of a list provides guidance as to what events should be covered.[116] Other commenters, however, felt that the list should be deleted from the rule and that the concept of materiality should be relied upon to determine what events should be the subject of notices.[117] Some commenters believed that the list of eleven events should be expanded to include a provision that would cover any other event that might reasonably be expected to have a material adverse effect on the holders of the bonds.[118]

The list of eleven events has been retained in the amendments.[119] As indicated in the Proposing Release, the list of eleven events was proposed in response to requests for guidance to issuers and other participants in the municipal securities markets as to those events that normally would reflect on the credit supporting the municipal securities, as well as on the terms of the securities that they issue, and thus normally would be considered material. Under the amendments, only the occurrence of one of the specified events will, if material, create an obligation to send a notice to the repository.

The determination of whether other events also should be the subject of notification pursuant to the information undertaking is left to the parties. For example, some commenters requested that the list of events be expanded to address circumstances when the notified events have been cured or rectified, as well as other favorable developments.[120] The parties would be free to add such matters to the undertaking. Issuers also may wish to send information regarding material developments to the repositories, to ensure equal access to that information by all investors and participants in the market, regardless of whether the particular development is subject to the undertaking.[121]

Some commenters were concerned that permitting issuers and obligors to send any notices or information they wished would flood the repositories. Given the fact that event notices generally are short, it appears that the repositories would be able to handle the flow of notices. The Commission will, however, monitor developments in this area.

Some commenters expressed concern that the event described as "matters affecting collateral" was too broad.[122] In response to such observations, that reference has been revised to reflect more clearly the types of events relating to collateral that could affect the creditworthiness of the security being offered. For instance, the item was not intended to require disclosure in the event of a drop in revenues or receipts securing payment. Rather, as more clearly indicated in the revised amendments, it is intended to encompass the release, substitution, or sale of property securing repayment of the securities being offered.[123]

Commenters also questioned whether the event relating to adverse tax opinions or events affecting the tax-exempt status of the security would include events not specific to an issuer, such as tax law changes which may affect a multitude of issuances and which are broadly reported.[124] They argued that there is no need for each issuer to make that disclosure, which may overwhelm the repositories. The amendments do not include a uniform requirement for notification of events having widespread impact that are widely reported. Frequently, individual issuer disclosure may not affect the total "mix" of information available to investors, for example where Congress amends tax rates or alternative minimum tax rules that could affect an investor's yield. On the other hand, it may not be clear, absent individual disclosure, which classes of outstanding securities are affected by the general events, for example, where the tax law change affects a particular type of municipal security or financing structure.

It is possible that an "event" affecting the tax-exempt status of the security may include the commencement of litigation and other legal proceedings, including an audit by the Internal Revenue Service, when an issuer determines, based on the status of the proceedings and their likely impact on holders of the municipal securities, among other things, that such events may be material to investors.

Commenters expressed concern that the party providing the undertaking may not have knowledge of the occurrence of events affecting other parties that might be called for by the provisions of the rule.[125] This concern should be addressed by the revised approach of enabling the parties to the transaction to determine who will provide the undertakings. For example, in the conduit context, the covenant could be provided by the person that is committed by contract or other arrangement to support payment of debt service, rather than the conduit issuer.

[114] *See* Rule 15c2-12(b)(5)(iii).

[115] *See* paragraph (b)(5)(i)(B) of the Proposed Amendments. *See also*, Letter of A.G. Edwards; Letter of Chemical Securities; Letter of J.J. Kenny Co., Inc. ("J.J. Kenny Co."); Letter of MSRB.

[116] *See, e.g.*, Letter of Chemical Securities; Letter of Goldman Sachs; Letter of George K. Baum; Letter of PSA.

[117] *See, e.g.*, Letter of CDFA; Letter of Gust & Rosenfeld; Joint Response; Letter of Municipal Treasurers Association; Letter of Rauscher Pierce Refsnes, Inc.; Letter of Standish Ayer & Wood, Inc.

[118] *See, e.g.*, Letter of Chemical Securities; Letter of Edward D. Jones & Co.; Letter of Finance Authority of Maine; Letter of Ferris Baker Watts; Letter of Norwest Investment Services, Inc.; Letter of Prudential Investment Corp.

[119] The introduction to the list also has been clarified to indicate that the events relate specifically to the securities being offered. *See* Rule 15c2-12(b)(5)(i)(C).

[120] *See, e.g.*, Letter of NAST; Letter of the Treasurer of State of California.

[121] Several commenters have expressed concern that statements by various elected officials made in a political context relating to an issuer must now be included in information provided to a repository. The amendments contain no such requirement. Moreover, these concerns appear to be based upon a misunderstanding of the reminder to issuers in the Interpretive Release that investors may rely on a variety of formal and informal sources for continuing information on municipal issuers, including public statements and press releases concerning an entity's fiscal affairs made by municipal officials, particularly in the absence of a more standardized mechanism for disseminating information about the municipal issuer to the market as a whole. The caution contained in the Interpretive Release that the antifraud provisions may apply to releases of information to the public reasonably expected to reach investors and the trading market does not mean, as some commenters inferred, that such statements are *per se* material; nor do the amendments require that such statements, even where material, be provided to the repositories.

[122] *See, e.g.*, Letter of ABA Business Law Section; Letter of ABA Urban Law Section; Letter of NABL; Letter of NCHFFA; Letter of New York State Housing Finance Agency; Letter of Orrick Herrington.

[123] *See* Rule 15c2-12(b)(5)(i)(C)(10).

[124] *See, e.g.*, Letter of ABA Urban Law Section; Letter of Kutak Rock; Letter of Orrick Herrington.

[125] *See, e.g.*, Letter of First Southwest Company; Letter of New York Dormitory Authority; Letter of the Treasurer of the State of North Carolina; Letter of City of Pullman, Washington.

The timing for providing the notification has not been changed from the Proposed Amendments, which required that the notice be provided on a "timely" basis. The amendments do not establish a specific time frame as "timely," because of the wide variety of events and issuer circumstances. In general, this determination must take into consideration the time needed to discover the occurrence of the event, assess its materiality, and prepare and disseminate the notice.

A new paragraph has been added to the amendments[126] that would require a Participating Underwriter to reasonably determine that the undertaking includes an agreement to notify the appropriate repository if the annual financial information is not provided in the stated time frame. Given the expressed concerns of some commenters regarding the difficulty that they would face in determining whether an issuer or other person was in compliance with any of its undertakings,[127] this provision will help inform market participants if annual financial information for such persons has not been made available in the agreed upon time frame.

3. Location of Undertaking in a Written Agreement or Contract

The Proposed Amendments called for the undertaking to be contained in a written agreement or contract for the benefit of holders of municipal securities. Commenters provided a variety of views as to where the undertakings should be memorialized, who should be parties to such undertakings, and the need for flexibility to modify undertakings in the future. Commenters suggested, for instance, that the undertakings could be included in the trust indenture, bond resolution, ordinance, or other legislation, a separate written agreement, or the underwriting agreement or bond purchase agreement.

As discussed in the Proposing Release, many offerings of municipal securities are issued pursuant to a trust indenture setting out the covenants of the issuer for the benefit of the holders of the municipal securities. If there is no trust indenture as part of an offering, as is the case with general obligation and certain other types of bonds, there may be a bond resolution, ordinance, or other legislation. Most commenters addressing this issue considered the trust indenture, bond resolution, ordinance, or other legislation to be appropriate for undertakings to provide secondary market disclosure, because they would create a direct obligation by issuers to bondholders.[128] Commenters also suggested the use of a separate written agreement between the issuer and the trustee as an appropriate method of memorializing undertakings.[129]

Several commenters suggested that the inclusion of the undertakings in an underwriting agreement or bond purchase agreement would be sufficient for purposes of Rule 15c2–12,[130] though another commenter suggested that a promise running to the benefit of the underwriter, whether in a bond purchase agreement or in a separate agreement, would be enforceable by existing and future bondholders only on the basis of a third party beneficiary theory, the availability of which may vary from state to state.[131]

Because commenters were supportive of leaving the determination of the location of the undertaking to the parties, the relevant language of the Proposed Amendments, requiring a Participating Underwriter to look to "undertakings in a written agreement or contract for the benefit of holders of such securities" has been adopted as proposed. Therefore, undertakings may be included in a trust indenture, bond resolution or other legislation, or a separate written agreement. Undertakings also may be included in the bond form itself. This general requirement will create a direct obligation to bondholders, yet will be flexible to address variations in state law, as well as the wide variety of types and structures of offerings in the municipal securities market.

The Commission also recognizes that an issuer's ability to contract may be limited under state law. To the extent that issuers are restricted by statute from entering into long-term contractual arrangements, the undertaking may include a qualifier to its obligation, such as that it is subject to appropriation.[132]

Commenters generally took the view that, while a statement in the final official statement describing any undertakings to provide secondary market disclosure would be an important addition to undertakings in a written agreement or contract, in order to make clear that the undertaking is an obligation of the issuer or obligated person that is enforceable on behalf of bondholders, the undertaking should be in a writing signed by the issuer or obligated person.[133] Statements regarding an issuer's or obligated person's provision of secondary market disclosure made exclusively in an official statement would not satisfy the terms of Rule 15c2–12(b)(5) because they would not create a contract enforceable on behalf of bondholders.

Commenters addressing the inclusion of undertakings in various documents were concerned that the failure to provide continuing disclosure pursuant to the undertakings could be deemed a potential event of default on the securities.[134] Though a failure to comply with the undertaking would be a breach of contract, the rule does not specify the consequences of an issuer's breach of its undertakings to provide secondary market disclosure. As called for by the Joint Response, as well as other commenters, remedies for breach of any undertaking under applicable state law are a subject for negotiation between the parties to the Offering. To avoid uncertainties of enforcement, the parties

[126] *See* Rule 15c2–12(b)(5)(i)(D).

[127] *See, e.g.*, Letter of Gust & Rosenfeld.

[128] *See, e.g.*, Letter of Merrill Lynch. Certain commenters considered that undertakings in a trust indenture could prove inflexible, as well as difficult to modify if they became inappropriate in the future. Letter of ABA Business Law Section. Other commenters considered that the issue of flexibility could be addressed through careful drafting. Letter of Morgan Stanley; Letter of Rauscher, Pierce, Refsnes, Inc.

[129] *See* Letter of Chapman and Cutler (suggesting that an agreement could be made between an issuer and a trustee or between the issuer and a NRMSIR); Letter of Rauscher, Pierce, Refsnes, Inc. These commenters noted that such agreements provide flexibility for the future modification of the type, timing, or presentation of secondary market disclosure, as well as remedies in the event of a breach of the agreement.

[130] *See e.g.*, Letter of Mudge Rose.

[131] *See* Letter of Morgan Stanley. Morgan Stanley also suggested that an underwriting agreement was an unsatisfactory vehicle for undertakings to provide secondary market disclosure because an underwriter of a specific bond issue should not be the recipient of a long-term contract of this type. *See* Letter of Morgan Stanley. Other commenters agreed that undertakings should be for the benefit of holders of municipal securities, and that there should be no requirement that undertakings be made for the benefit of Participating Underwriters. *See, e.g.*, Letter of Merrill Lynch (noting that "the holders of the securities have the greatest interest in enforcing the covenant to provide information and are in the best position to evaluate whether affirmative efforts to enforce the covenant should be undertaken").

[132] Some commenters were concerned that in some jurisdictions, an issuer's ability to agree to provide information beyond a one year period might be restricted by state law. To address such concerns, inclusion of a condition subsequent in the covenant, such as subject to appropriation, might be appropriate. It is anticipated, however, that should funds that would enable the issuer to provide the agreed upon information not be appropriated, disclosure of such fact would be made by notice to the repositories pursuant to Rule 15c2–12(b)(5)(i)(D).

[133] *See, e.g.*, Letter of Chemical Securities; Letter of Dain Bosworth, Inc.; Letter of Dillon, Read & Co., Inc.

[134] Commenters argued that an issuer's failure to comply with undertakings to provide secondary market disclosure should not result in an event of default. *See, e.g.*, Letter of ABA Urban Law Section; Letter of State of Washington, Office of the Treasurer; Letter of Colorado Municipal Bond Supervision Advisory Board.

to a transaction are encouraged to enumerate the consequences in the undertaking, including the available remedies, for breach of the information undertaking.

B. Recommendation of Transactions in Municipal Securities

The Proposed Amendments would have prohibited any broker, dealer, or municipal securities dealer from recommending the purchase or sale of a municipal security unless it had specifically reviewed the information the issuer of such municipal security had undertaken to provide.[135] The purpose of this provision of the Proposed Amendments was to assist dealers in satisfying their obligation to have a reasonable basis to recommend municipal securities by requiring them to consider the most current information before making a recommendation.

In view of the importance of secondary market liquidity in municipal issues, the Commission requested comment on whether the Proposed Amendments would have a substantial or long-lasting effect on market liquidity. This request for comment was based on concerns raised about whether municipal securities dealers would be willing to effect secondary market transactions in a broad range of municipal securities if review was required on a recommendation by recommendation basis.

Many commenters strongly criticized this provision of the Proposed Amendments. The majority of commenters responded that requiring the review of information prior to making a recommendation on the purchase or sale of a municipal security would create substantial compliance burdens for dealers.[136] Commenters also noted that the specific requirement to review information either would impel dealers to hire larger research and analysis staffs,[137] or, more likely, would cause dealers to restrict the issuers whose municipal securities they would trade to a smaller number of large and frequent issuers.[138] Commenters predicted that, as a result, liquidity for all but the largest and most frequent issuers would be reduced.[139]

Commenters proposed alternatives to the recommendation prohibition, including basing the type of review of a municipal security, and disclosure about such review, on whether the investor was an institutional or retail investor,[140] or on the type of municipal security recommended.[141] Other commenters suggested the continued reliance on the reasonable basis standard inherent in the MSRB's suitability rule, G–19, and the antifraud provisions, as discussed by the Commission in the 1988 and 1989 Releases proposing and adopting Rule 15c2–12, as well as the Interpretive Release.[142]

As adopted, this provision has been modified in a number of respects to respond to concerns expressed by commenters. In particular, the amendments replace the proposed review standard with a requirement that dealers have procedures in place that provide reasonable assurance that they will receive promptly any notices of material events regarding the securities that they recommend. The events are any of the eleven events disclosed as described in Rule 15c2–12(b)(5)(i)(C), or the notice of failure to provide annual financial information in accordance with an undertaking as described in Rule 15c2–12(b)(5)(i)(D) with respect to that security. Many dealers currently subscribe to electronic reporting systems that give notice of significant events made public by municipal issuers. To comply with the rule's requirement, these dealers should make certain that these systems receive, directly or indirectly, material event notices for issues the dealer recommends. In addition, dealers should develop procedures to ensure that notices of such events will be available to the staff responsible for making recommendations.

In the Commission's view, the recommendation provision, as modified, should substantially reduce the concerns of commenters with respect to compliance burdens and effects on liquidity. It also will help ensure that dealers will consider the material event notices that issuers produce, thus enabling them to have an adequate basis on which to recommend[143] municipal securities.

Moreover, even though the amendments do not require that dealers directly review an issuer's ongoing disclosure before making each recommendation, the Commission agrees with those commenters that said that additional information made available by issuers will be taken into account by dealers making recommendations regarding that security, under the MSRB's fair dealing and suitability rules, and the antifraud provisions.[144] In addition to the Commission's past interpretations of the responsibilities of dealers to have a reasonable basis for their recommendations, the MSRB repeatedly has emphasized that secondary market disclosure information publicized by issuers must be taken into account by dealers to meet the investor protection standards imposed by its investor protection rules. Specifically, MSRB rule G–17 requires dealers to disclose material facts of a transaction to the customer; MSRB rule G–19 requires dealers to ensure that any transaction recommended to the customer is suitable for that customer; and MSRB rule G–30 requires dealers to ensure that the prices set for customer transactions are fair and reasonable. In its comment letter, the MSRB noted that "[i]f a dealer is not aware of major financial and other material developments affecting an issuer's securities, it is difficult or impossible for the dealer to comply with these requirements."[145]

For example, if a dealer reviews an electronic reporting system for material events relating to a security, and finds that an issuer has submitted a notice that it has failed to provide annual financial information on or before the date specified in the written agreement or contract,[146] that fact would be a

[135] *See* paragraph (c) of the Proposed Amendments.

[136] *See* Letter of PSA (noting that paragraph (c) would require dealers to create records showing that they had reviewed municipal securities).

[137] *See, e.g.*, Letter of Chapman and Cutler (brokers with fewer analysts will be at a competitive disadvantage); Letter of Morgan Stanley (noting that in order to comply with paragraph (c) as proposed, reliance on third-party service providers for information analysis would be required).

[138] *See, e.g.*, Joint Response; Letter of PSA; Letter of Gabriel, Hueglin & Cashman.

[139] *See, e.g.*, Joint Response; Letter of PSA.

[140] Letter of Investment Company Institute ("ICI"). *See also* Letter of MSRB; Letter of NABL. NABL suggested disclosure by dealers as to whether a party has committed to provide secondary market disclosure, and if not, the consequences of investing in the securities.

[141] *See, e.g.*, Letter of Edward D. Jones & Co. (suggesting application of the Proposed Amendments only to non-rated or special assessment bonds); Letter of NABL (suggesting exemptions from the amendments to Rule 15c2–12 for issuers that obtain and maintain an investment grade rating, and for general obligation bonds and revenue bonds issued to finance essential government purposes).

[142] *See, e.g.*, Letter of PSA; Letter of A.G. Edwards & Sons, Inc. (reviewing issuer's disclosure is not the only way to form the basis for a recommendation).

[143] As noted in the Proposing Release, most situations in which a dealer brings a municipal security to the attention of a customer involve an implicit recommendation of the security to the customer.

[144] *See, e.g.*, Letter of MSRB (emphasizing that, in the Board's view, dealers would be responsible for continuing disclosure information available in NRMSIRs even without the specific "review" requirement); Letter of Paine Webber.

[145] Letter of MSRB (noting the requirements of the MSRB's rules in commenting that the Proposed Amendment's requirement to review periodic information is not a practical option for dealers).

[146] *See* Rule 15c2–12(b)(5)(i)(D).

significant factor to be taken into account when the dealer formulates the basis for a recommendation of such securities. While the dealer would not be prohibited *per se* from recommending such municipal securities, notice that the issuer has failed to provide annual financial information would be the type of material information required to be disclosed to the customer pursuant to MSRB rule G–17.[147] Such a notice also would trigger a further inquiry by the dealer to assure itself that it is cognizant of the condition of the issuer or obligated persons, despite the absence of promised information. This also would be true if a dealer attempts to obtain an issuer's annual financial information, finds that it has not been submitted to any repository, and the dealer had no record of the issuer submitting a notice to this effect. In such cases, further research may be necessary or advisable prior to making a recommendation in the issuer's securities.

C. Information Repositories

1. Background

Under Rule 15c2–12, as adopted in 1989, NRMSIRs essentially serve the function of disseminators of official statements on behalf of Participating Underwriters.[148] The option of Participating Underwriters to transfer their final official statement delivery obligations to NRMSIRs has encouraged the development of NRMSIRs.[149] The three existing NRMSIRs are private vendors that gather and disseminate final official statements pursuant to Rule 15c2–12. In addition, although not required under existing provisions of the rule, they provide other current information about municipal issuers to the primary and secondary municipal securities markets.[150]

As a result of the amendments, NRMSIRs will play an expanded role in the collection and dissemination of secondary market information. In addition to the collection and dissemination of final official statements, they will collect and disseminate annual financial information, as well as notices of material events. The Commission is sensitive to the need of NRMSIRs for flexibility, especially with respect to the timing requirements for the dissemination of notices of material events. The Commission will monitor developments in the municipal securities market as participants adapt to the changes in Rule 15c2–12, and fully expects that the current and potential NRMSIRs are capable of adjusting to their expanded role. The Commission is of the view that NRMSIRs, as private information vendors, will have sufficient economic incentives to serve their expanded functions resulting from the amendments to Rule 15c2–12, even in the absence of the more specific review requirement of the recommendation prohibition of the Proposed Amendments.[151]

2. Definition of Nationally Recognized Municipal Securities Information Repository

The Commission requested comment on whether the term "NRMSIR" should be defined in Rule 15c2–12, and whether specific standards should be established for NRMSIRs. If standards were to be established in the rule, the Commission requested comment on whether proposed standards set forth in the release were adequate.[152] The majority of state-based information gatherers and disseminators, and other NRMSIRs that addressed the issue of defining the term "NRMSIR" supported maintaining the guidelines already established by the Commission in the 1989 Release.[153] After reviewing the comment letters, the Commission has determined that the guidance established in the 1989 Release for NRMSIRs should be modified only as necessary to reflect the amendments to Rule 15c2–12. In determining whether a particular entity is a NRMSIR the Commission will now consider, among other things, whether the repository:

(1) Is national in scope;

[147] *See* MSRB Manual (CCH) ¶ 3581.30 (interpreting MSRB rule G–17 to require that a dealer disclose, at or prior to a sale, all material facts concerning the transaction, including a complete description of the security). *See also* 1988 Release at n. 50 and accompanying text.

[148] Under Rule 15c2–12(b)(4), underwriters must deliver final official statements to potential customers for a 90 day period after the close of the underwriting period. The underwriters' 90 day delivery obligation is shortened to 25 days if the final official statement can be obtained from a NRMSIR.

[149] Since the Commission adopted Rule 15c2–12, the Division of Market Regulation issued three no-action letters recognizing national information vendors as NRMSIRS, based on the standards set out in the July 1989 Release. *See* Letters from Richard G. Ketchum, Director, Division of Market Regulation to: Joseph V. Riccobono, Executive Vice-President, American Banker-Bond Buyer (Jan. 4, 1990); J. Kevin Kenny, President, Chief Executive Officer, J.J. Kenny Co. (Jan. 4, 1990); and Michael R. Bloomberg, President, Bloomberg, L.P. (Jan. 11, 1990). Recently, the Commission has received inquiries from additional information vendors desiring to be recognized as NRMSIRs.

[150] NRMSIRs are not the only source of information in the municipal market. The MSRB has developed its Municipal Securities Information Library ("MSIL") system, which presently collects information and disseminates it to market participants and information vendors. The Official Statement and Advance Refunding Document-Paper Submission System ("OS/ARD") of the MSIL collects and makes available on magnetic tape and on paper official statements and advance refunding notices. Securities Exchange Act Release No. 29298 (June 13, 1991), 56 FR 28194. As a part of the MSIL system, the MSRB commenced operation of its Continuing Disclosure Information ("CDI") pilot system in January, 1993. The CDI system is a central repository for voluntarily submitted official continuing disclosure documents relating to outstanding municipal securities issues. Securities Exchange Act Release No. 30556 (April 6, 1992) 57 FR 12534. Neither the MSIL OS/ARD system nor the CDI system is a NRMSIR; the Commission has previously indicated that it would consider the competitive implications of a MSRB request for NRMSIR status. *See* Securities Exchange Act Release No. 28081 (June 1, 1990), 55 FR 23333, 23337 n.26.

[151] *See, e.g.*, Letter of PSA (noting that the suggestion made by some market participants that municipal securities dealers will not utilize information they have long sought is implausible), Letter of Ferris Baker Watts (information will be used if it is available).

[152] The Commission suggested that NRMSIRs (a) maintain current, accurate information about municipal securities, including final official statements, the issuer's annual final information, and issuer's notices of material events; (b) have effective systems for the timely collection, indexing, storage and retrieval of these documents; and (c) be capable of national dissemination of final official statements, annual financial information, and notices of material events through electronic dissemination systems, in response to telephone inquiries, and hard copy delivery via facsimile, by mail and by messenger service. The Commission also stressed the importance of timely public availability upon receipt of information by a NRMSIR.

[153] *See, e.g.*, Letter of Bloomberg L.P.; Letter of Cypress Capital Corp. (a dealer chosen by the Louisiana Municipal Association to assist it in developing a repository to collect and disseminate information on Louisiana issuers of municipal securities). In discussing NRMSIRs in the 1989 Release, the Commission noted that in determining whether a particular entity is a NRMSIR, it would look, among other things, at whether the repository: (1) is national in scope; (2) maintains current, accurate information about municipal offerings in the form of official statements; (3) has effective retrieval and dissemination systems; (4) places no limit on the issuers from which it will accept official statements or related information; (5) provides access to the documents deposited with it to anyone willing and able to pay the applicable fees; and (6) charges reasonable fees. *See* 1989 Release at n. 65.

(2) Maintains[154] current, accurate[155] information about municipal offerings in the form of official statements, and annual financial information, notices of material events, and notices of a failure to provide annual financial information undertaken to be provided in accordance with Rule 15c2–12;

(3) Has effective retrieval and dissemination systems;

(4) Places no limits on the persons from which it will accept official statements, and annual financial information, notices of material events, and notices of a failure to provide annual financial information undertaken to be provided in accordance with Rule 15c2–12;

(5) Provides access to the documents deposited with it to anyone willing and able to pay the applicable fees; and

(6) Charges reasonable fees.

While NRMSIRs may charge reasonable fees[156] for the dissemination of information, they may not charge issuers for accepting information provided by issuers in accordance with Rule 15c2–12.[157] In response to concerns raised by commenters, the Commission also notes that giving preferential treatment to certain brokers, dealers, and municipal securities dealers by giving them market information before it is made available to all customers would be wholly inconsistent with recognition as a NRMSIR.[158]

Comment also was requested on the ability and willingness of both potential NRMSIRs, and those presently operating under no-action letters, to meet the dissemination standards discussed in the Proposing Release. NRMSIRs responded that they can meet these standards.[159] In order to implement these standards, the Commission has determined that existing NRMSIRs should reapply for recognition from the Commission under the revised criteria to continue to function as NRMSIRs.

3. State Information Depositories

The Commission also requested comment on whether a state-based depository could serve as an effective means to disseminate information to the market for a nationally traded security, thus enabling the appropriate parties to fulfill their disclosure obligations using a state-based depository. Commenters expressed divergent views on this issue.[160] No state responded directly in response to the Commission's request for comment on whether states are willing to make the necessary financial commitment to create a state-based system. The Comptroller of the State of New York pointed out, however, that his office already collects financial data from local governments, and that there "is an appropriate and important function which the states may perform in the secondary market disclosure process."[161] A number of third party state-based information collectors also stated that they were in the process of creating state-based repositories.[162] Other such third party state-based information collectors pointed out that they already had working depositories in place.[163]

Based on these comments, and in light of existing disclosure mechanisms and recent legislation in several states designed to enhance secondary market disclosure,[164] it appears that states can play a beneficial role in enhancing disclosure in the municipal securities market.[165] State-based depositories will be in a special relationship with filers of disclosure information to provide for convenient and efficient dissemination. The Commission therefore encourages states to develop state-based depositories.

To encourage the development of state-based depositories, the Commission has amended Rule 15c2–12 to require that Participating Underwriters reasonably determine that the information undertaken to be provided, in addition to being submitted to the NRMSIRs, or, in some cases, to the MSRB, will be submitted to a state information depository ("SID"), if an appropriate SID has been established in that state. Further, as discussed below,[166] an exemption conditioned on making annual financial information available upon request or to a SID, and providing notices of material events to each NRMSIR or the MSRB, and to a SID, has been adopted. An appropriate SID would be a depository operated or designated[167] by the state that receives information from all issuers within the state, and makes this information available promptly to the public on a contemporaneous basis.[168] The Commission staff is prepared to provide guidance in particular instances regarding a SID's qualification for purposes of the rule.

4. Information Delivery Requirements

The Proposing Release asked to whom the required information should be

[154] In the past, the Division of Market Regulation has required that each NRMSIR maintain copies of all disclosure documents. In view of recent requests from information collectors and disseminators, the Division of Market Regulation will review, on a case by case basis, NRMSIR proposals to satisfy the requirement to maintain copies of disclosure documents through a contract with another entity (including the MSRB) that will maintain copies. *See* Letters from Laurence M. Landau, Vice President, Dow Jones Telerate, to Elizabeth MacGregor, Division of Market Regulation, SEC, (July 18, 1994) and to Gautam S. Gujral, Division of Market Regulation, SEC (August 4, 1994). *See also* Letter of Storch & Brenner (on behalf of R.R. Donnelly Financial). This flexible approach, requested by industry participants, may allow NRMSIRs to reduce the cost at which they can collect and disseminate disclosure information to broker-dealers and investors.

[155] It should be noted that NRMSIRs are not being required to verify the accuracy of the information provided them. NRMSIRs are required to accurately convey the information provided to them.

[156] *See* 1989 Release.

[157] *See, e.g.*, Letter of Maine Municipal Bond Bank; Letter of National Association of Independent Public Financial Advisers (NRMSIR users, not issuers, should pay the NRMSIR costs).

[158] *See, e.g.*, Letter of Colonial Management Associates, Inc.

[159] Letter of Bloomberg L.P.; Letter of J.J. Kenny Co.; Letter of The Bond Buyer.

[160] With one notable exception, national information vendors generally did not see a need for state-based repositories and argued that state-based repositories would indeed add to the complexity of collecting and disseminating information. *See, e.g.*, Letter of J.J. Kenny Co. Some state-based information gatherers and disseminators, however, argued that they already had created mechanisms for the collection and dissemination of information, and their systems are working well. The National Association of State Auditors, Comptrollers and Treasurers ("NASACT") pointed out that issuers and other obligors will probably file with state-based repositories, with whom they are accustomed to working and with whom they typically must file in any event for regulatory purposes unrelated to secondary market disclosure. NASACT argued that while the state repositories do not wish to compete with NRMSIRs, state-based repositories can serve an important role in enhancing the accessibility of disclosure information for repackaging by the NRMSIRs. *See* Letter of NASACT.

[161] *See* Letter of the Office of the State Comptroller, State of New York.

[162] *See, e.g.*, Letter of Cypress Capital Corporation (Louisiana Municipal Security Disclosure Board "intends to be in a position to comply with the standards developed by the Commission for NRMSIRs").

[163] *See* Letter of Municipal Advisory Council of Texas; Letter of Ohio Municipal Advisory Council.

[164] South Carolina recently enacted legislation requiring issuers to agree in a bond indenture to file an annual independent audit within a specified number of days of the issuer's receipt thereof and certain event information with a central repository. South Carolina Senate Bill 1182, (effective September 1, 1994) to be codified in S.C. Code Ann. Chapter 1, Title 11, Section 11–1–85 (1976). Similarly, Tennessee recently adopted legislation authorizing the adoption of rules to facilitate secondary market disclosure by any public entity, including the form and content of that disclosure. Tenn. Code Ann. Sec. 9–21–151 (a) and (b)(2).

[165] *See, e.g.*, Letter of the Office of the State Comptroller, State of New York.

[166] *See* Section II.D.1. *infra*.

[167] There is no requirement that SIDs be instrumentalities of a state. A number of private organizations already function as state-based repositories, at times at no cost to the taxpayer. The Commission defers to each state's determination whether to have a private or public entity be its SID.

[168] As with NRMSIRs, for a SID to give preferential treatment to a NRMSIR by giving it market information before it is made available to other NRMSIRs would be wholly inconsistent with functioning as a SID.

delivered. It also requested comment on the feasibility of requiring NRMSIRs to inform the MSRB when they receive disclosure information from issuers, and whether such information also should be required to be placed with the MSRB, in addition to or in lieu of a NRMSIR. The NRMSIRs did not address the issue of requiring them to inform the MSRB whenever they received disclosure information from an issuer, although one commenter argued that designating the MSRB as a repository only would add an unnecessary layer to the dissemination process.[169] Other commenters suggested designating a single central repository.[170] Similarly, some commenters suggested imposing a requirement that disclosure information be delivered to all NRMSIRs,[171] while others suggested that NRMSIRs be required to share the information received with other NRMSIRs,[172] and a third group preferred the establishment of a central index.[173] State-based information gatherers and disemminators had diverging views on this issue.[174]

Based on these comments, the Commission has determined to require that annual financial information undertaken to be provided be deposited with each NRMSIR and the appropriate SID in the issuer's state. Any audited financial statements submitted in accordance with the undertakings also must be delivered to each NRMSIR and to the SID in the issuer's state, if such a depository has been established. The requirement to have annual financial information and audited financial statements delivered to all NRMSIRs and the appropriate SID is a modification of the Proposed Amendments. This modification will ensure that all NRMSIRs receive disclosure information directly. It also permits the Commission to adopt the amendments without a delay for the creation of a central index or a system of information sharing among NRMSIRs.[175] The requirement to send information to all NRMSIRs rather than a single NRMSIR of the issuer's or obligated person's choice, should not impose significant burdens or costs, other than duplication and mailing costs. Furthermore, this requirement to deliver disclosure to the NRMSIRs and the appropriate SID also allays the anti-competitive concerns raised by the creation of a single NRMSIR.

In contrast to annual financial information, under the amendments, notices of material events, as well as notices of a failure by an issuer or other obligated person to provide annual financial information must be delivered to each NRMSIR or the MSRB, and the appropriate SID. The Commission is of the view that permitting issuers and obligated persons to file such notices either with each NRMSIR or with the MSRB (as well as the appropriate SID) will facilitate prompt and wide disclosure. The amendments reflect the preference of some commenters for filing such notices in one central place, such as the MSRB, rather than having to file with multiple NRMSIRs. The Commission expects that if notices are filed with the MSRB, the MSRB will make these notices available to all NRMSIRs on a prompt and contemporaneous basis.

5. Timing of Dissemination

Due to the time sensitive nature of notices of material event and failures to provide annual financial statements, it is important that such notices are disseminated quickly. These market requirements will dictate that disseminators have a system in place by which information vendors can make such notices available to broker-dealers and investors quickly and contemporaneously.

NRMSIRs and other information vendors have indicated in their comment letters that under certain circumstances a 15 minute turnaround[176] time for notices of material events, and a 24 hour turnaround period for annual financial information may be feasible, and, in some instances, already is in place.[177] Nonetheless, because the ultimate scope of the information undertakings was not known to the existing and potential NRMSIRs at the time they submitted their comments, the Commission intends to discuss with the NRMSIRs during the recognition process appropriate and practicable turnaround standards for information re-dissemination. Because SIDs are alternative sources of information for every type of disclosure, the Commission does not intend to impose strict turnaround times for SIDs. Instead, SIDs should provide the Commission and users with a clear statement of turnaround times that they will meet consistently.

6. Technological Considerations

The Commission also received many suggestions from information gatherers and vendors on streamlining the filing of disclosure information. These suggestions included requiring electronic filing of disclosure information, providing filings on computer disks and providing information to NRMSIRs as images of original source documents rather than exclusively as coded text.[178] Rather than dictate standards, the Commission encourages municipal securities market participants to coordinate their requirements and preferences on an industry-wide basis.

D. Exemptions

The Proposed Amendments contained two new exemptions, which are being

[169] Letter of Bloomberg L.P.

[170] *See, e.g.*, Artemis Capital Group, Ltd. (proposing that the Commission designate the MSRB's MSIL system as the single central repository); Letter of Chapman and Cutler (there should be one central source of information).

[171] *See, e.g.*, Letter of J.J. Kenny Co.; Letter of National Association of Independent Public Financial Advisers.

[172] *See, e.g.*, Letter of MSRB; Letter of Richard A. Ciccarone.

[173] Letter of Storch & Brenner (on behalf of R.R. Donnelly Financial); Letter of The Bond Buyer.

[174] The Ohio Municipal Advisory Council stated that it is feasible to require repositories to inform the MSRB as to which issuers have released information to it. Under Cypress Capital Corporation's proposal, the indexing party would receive descriptions of all materials received by the Louisiana Repository. *But see*, Letter of NASACT (requirement that a repository be required to notify a central index each time an item of information is received by the repository is unduly burdensome and unnecessary).

[175] Some commenters expressed an interest in creating a central index and an information sharing system. Letter of Storch & Brenner (on behalf of R.R. Donnelly Financial); Letter of Dow Jones Telerate, Inc. The Commission is prepared to review such mechanisms for centralized collection and dissemination if requested to do so.

[176] The Commission considers "turnaround time" or "turnaround period" to mean the time between which a NRMSIR initially receives information, and the time when such information is made available to the public. NRMSIRs will be required to make available the full text of notices of material events, and post the receipt and availability of other documents within the designated turnaround time period.

[177] The Bond Buyer stated that it broadcasts, through its Munifacts News product, material events and time critical announcements within 15 minutes of their receipt to municipal market participants throughout the country. It stated that it also posts documents within 24 hours of a document's receipt to the Bond Buyer's On-line Index which is updated throughout the day. Letter of The Bond Buyer. Similarly, Dow Jones Telerate stated that electronic dissemination will allow the turnaround time of 24 hours for an official statement and 15 minutes for secondary disclosure documents on material events to be feasible. Letter of Dow Jones Telerate. Material information is electronically disseminated on a "real time" basis by Bloomberg L.P. Letter of Bloomberg L.P.

[178] J.J. Kenny Co. requested that documents be required to be filed as images of original source documents rather than exclusively as coded text. Dow Jones Telerate requested that Official statements be filed along with one electronic disk copy of the original Word Processing/Desktop publishing file with the label marked as to which software and version was used. For secondary market disclosure documents, Telerate advises using the NFMA proposed worksheets. The Bond Buyer stated that "collection would be most efficient if documents were in ASCII and a common word processing or publishing format"

adopted with certain modifications. A third new exemption from the annual financial information requirement, for short-term securities, also is being adopted. In addition, Rule 15c2–12's limitation to primary offerings of municipal securities with an aggregate principal amount of $1,000,000 or more, and its existing exemptions, also apply to the amendments.[179]

1. Small Issuer Exemption

The Proposed Amendments would have exempted from the provisions of the undertaking and recommendation prohibitions of the rule municipal securities issued in Offerings by issuers that had (i) less than $10,000,000 in principal amount of securities outstanding, including the offered securities and (ii) issued less than $3,000,000 in aggregate amount of municipal securities in the most recent 48 months preceding the offering.

A number of commenters discussed the appropriateness of the proposed dollar exemption, with comments ranging from a call for increased thresholds to no thresholds at all.[180] Some commenters believed that the thresholds should be increased, because many small municipalities would exceed these thresholds if they delay their financings in order to issue a greater amount of bonds at one time. The commenters argued that these are small, infrequent issuers with limited trading in the secondary market and the cost of compliance would outweigh the benefits received from improved secondary market disclosure.[181]

Other commenters took exception to the proposed thresholds because they were too high. These commenters argued that the exemption as proposed would exclude from coverage of the rule the types of issuers who have historically had deficient disclosure practices and disproportionate numbers of defaults.[182] A number of commenters also argued that the $3 million/48 month component of the threshold was too complex.[183]

As adopted,[184] the exemption retains the aggregate $10,000,000 limitation, but eliminates the $3,000,000 threshold. Instead, in addition to falling under the $10,000,000 in outstanding securities threshold, the exemption is conditioned upon an issuer or obligated person providing a limited disclosure undertaking. Under this undertaking, financial information and operating data concerning each obligor for which financial information or operating data is presented in the final official statement, must be provided upon request to any person, or be provided at least annually to the appropriate SID. The undertaking would specify the type of financial information and operating data that will be made available annually, which must include financial information and operating data that is customarily prepared by the obligated person and is publicly available. The final official statement must describe where and how the financial information and operating data can be obtained.

Financial information and operating data of governmental issuers generally are subject to freedom of information laws, and thus would be publicly available for purposes of this condition of the exemption. Conduit borrowers generally provide annual financial information to trustees, credit enhancers, or the financing agency that issued the municipal securities, and thus would have no difficulty complying with this standard if that information is made publicly available. To the extent that an obligated person does not currently publicly disclose that information, they are free to specify the type of information they are undertaking to provide on an ongoing basis, but they must agree to provide some information. That information need not be the same type of information presented in the official statement. Nor would these exempt persons have to release their audited financial statements, unless they otherwise customarily prepare and make their audited financial statements publicly available. Moreover, the limited disclosure undertaking need only cover those obligors for which financial information or operating data is provided in the official statement.

In addition to providing financial information and operating data annually, notices of material events must be sent to each NRMSIR or to the MSRB, and the appropriate SID. This public information condition has been adopted in response to comments highlighting the need for information regarding small issuers accessing the public debt market.[185]

The threshold of $10,000,000 has been retained, notwithstanding comments that it was too high or too low. According to statistics provided by one commenter,[186] in 1993, 71% of the approximately 52,000 municipal issuers had under $10,000,000 in outstanding municipal securities. Accordingly, the amendments as proposed already provided significant exemptive relief for small issuers. Indeed, the fact that a majority of issuers fall below that threshold supports conditioning the exemption on a commitment to provide a limited amount of secondary market information from exempt issuers. Even with that condition, a significant percentage of offerings would remain totally exempt from the amendments as adopted, because over 20% of the total issuances in 1993 were under $1,000,000.[187] As these statistics demonstrate, the exemption should exclude a large percentage of small infrequent issuers.

Commenters also questioned how the aggregate thresholds were measured, including whose securities would be included and whether the exemption applied only to outstanding securities that were sold in Offerings subject to the rule.[188] Many commenters indicated that the thresholds should be separately applied to each issuer of municipal securities and each underlying obligor.[189] Thus, in the case of conduit issuers that have no liability on the municipal securities, commenters argued that the thresholds should be determined by reference to the persons who are the beneficiaries of the

[179] Former paragraph (c) of Rule 15c2–12 was proposed to be, and has been redesignated as paragraph (d)(1). This paragraph exempts primary offerings of municipal securities in authorized denominations of $100,000 or more, if such securities: (1) are sold to no more than 35 investors, each of whom the underwriter reasonably believes is capable of evaluating the investment and who is not purchasing with a view to distribution; (2) have a maturity of nine months or less or; (3) at the option of the holder may be tendered to an issuer at least as frequently as every nine months.

[180] *See, e.g.* Letter of ALHFA; Letter of CDFA; Letter of NFMA; Letter of National Association of Independent Public Finance Advisors; Letter of Prudential Investment Corp.; Letter of PSA; Letter of Washington State Auditor.

[181] *See, e.g.*, Letter of NAST; Letter of SIA.

[182] *See, e.g.* Letter of Chemical Securities; Letter of Eaton Vance Management; Letter of Edward D. Jones & Co.; Letter of Morgan Stanley; Letter of National Association of Independent Public Finance Advisors; Letter of Norwest Investment Services.

[183] *See, e.g.*, Letter of APPA; Letter of The Bank of New York; Joint Response.

[184] *See* Rule 15c2–12(d)(2).

[185] *See* Joint Response. A number of other commenters expressed concern about the lack of information on issuers in market segments in which the higher proportion of defaults have occurred. *See* note 182, *supra* and accompanying text. The effective date for this information undertaking condition on the small issuer exemption will be delayed until January 1, 1996. *See* Section II.E., *infra*.

[186] *See* Letter of The Bond Buyer.

[187] *See* Letter of The Bond Buyer. The requirements of Rule 15c2–12, as amended, may not be avoided by breaking up an offering into several offerings of less than $1,000,000, where the offerings are of the same class of securities and are for the same purpose.

[188] *See, e.g.*, Letter of ABA Urban Law Section; Letter of CIFA; Letter of Colorado Municipal Bond Supervision Advisory Board.

[189] *See, e.g.*, Letter of ALHFA; Letter of CDFA; Letter of Hawkins Delafield & Wood.

financing.[190] Some commenters argued that those issuers that had different types of financings that relied on separate revenue streams for repayment, such as dedicated tax revenues, should not be foreclosed from relying on the small issuer exemption for each financing.[191]

To address the first of these concerns, the amendments have been revised to clarify that the availability of the exemption turns on the amount of outstanding municipal securities for which an issuer or obligated person also is an obligated person. An issuer of municipal securities would need to satisfy the threshold only if it were an obligated person with respect to the security being offered. Under this approach, if a financing agency that is offering obligations that have some recourse to the agency, only those outstanding securities of the agency that likewise are recourse would count toward the threshold. If the financing agency does not issue recourse securities, the exemption will be unavailable only if a conduit borrower obligated on the municipal securities being offered is an obligated person with respect to more than $10,000,000 in outstanding municipal securities. If any one obligated person in an Offering exceeds the threshold, then the entire Offering, including all obligated persons, will be subject to the rule. Subsequent non-recourse offerings by the financing agency would not be affected, but would be subject to a similar test.

With respect to the second concern, however, the amendments require that an obligated person aggregate all its outstanding obligations, even if some are payable from separate dedicated revenue sources. For example, a city or county that issues securities for a number of different purposes could not qualify as a small and infrequent issuer merely because its outstanding securities are payable from separate revenue streams. Thus, while a governmental issuer's outstanding obligations need not be aggregated with that of non-governmental obligated persons, a governmental issuer could not avoid aggregation of its securities by restricting repayment to separate revenue streams.[192]

Commenters also discussed a related issue of what securities would be included in the calculation. Commenters contended that only publicly offered securities should be included in the calculation. Other commenters questioned how short term obligations such as bond anticipation notes, refunded bonds and installment/lease purchase agreements would be treated. Several commenters suggested that the threshold should be measured only against publicly offered, long-term bonds.[193]

The amendments have been clarified in this respect to exclude from the threshold calculation securities that were offered in transactions exempt from Rule 15c2–12 because they were otherwise exempt as private placements and short term financings. In addition, to the extent that an issuer or obligated person is no longer liable for repayment on bonds, as with certain defeased bonds, then such bonds would not be included in the calculation of the threshold for such issuer or obligated person.

A number of commenters indicated that an exemption should be available based on the number of holders of the municipal securities.[194] However, in accordance with concerns voiced by other commenters regarding the difficulty in ascertaining the number of holders due to the fact that most municipal securities are held in street name through a very limited number of depositories,[195] the amendments do not adopt any exemption based on the number of holders of the municipal securities.

A variety of other comments were raised relating to exemptions, and a number of alternative exemptions were proposed, including exemptions based on the type of issuer or the existence of an investment grade rating.[196] Commenters also believed that an exemption should be available for securities covered by bond insurance or other credit enhancement, such as bank letters of credit.[197] Except as described above, the exemptions have not been revised to adopt these suggestions. Commenters, including some bond insurance providers,[198] expressed the view that the existence of credit enhancement does not necessarily eliminate the need for information regarding the underlying credit.

A number of commenters also argued that new exemptions should be added that would mirror exemptions under the Securities Act.[199] Some commenters argued that exemptions should be included for non-profit entities that would have their own exemption from registration under the Securities Act.[200] The Commission is not including any exclusion in the amendments for any such issuers. Issuers accessing the tax-exempt public securities markets have obligations to promote the integrity and efficiency of those markets. As the Commission noted in the Interpretive Release, the high level of defaults in sectors such as healthcare, lifecare, retirement homes and multifamily housing, relative to other market sectors,[201] and the past problems with the sufficiency of information in many of these sectors, weighs heavily against adopting such exclusions

2. Exemption from the Annual Financial Information Requirement for Short-term Securities

A new exemption has been added to exempt from the requirement for an undertaking calling for annual financial information, Offerings of securities with an 18 month or shorter maturity.[202] The new exemption is in response to comments suggesting that the rule not

[190] *See, e.g.*, Letter of Alaska Municipal Bond Bank; Letter of Bose, McKinney & Evans; Letter of CDFA; Letter of Oregon Economic Development Department.

[191] *See, e.g.*, Letter of ABA Business Law Section; Letter of Chapman and Cutler; Letter of NABL.

[192] Significant indicia of whether an issuer in a revenue-type financing is in fact a part of a larger municipality would be whether the issuer's accounts are reflected in the municipality's financial statements and whether the municipality's officials or personnel manage the separate financing programs.

[193] *See, e.g.*, Letter of ABA Business Law Section; Letter of Day Berry & Howard; Joint Response; Letter of Kutak Rock; Letter of the Treasurer of the State of North Carolina.

[194] *See, e.g.*, Letter of ABA Business Law Section; Letter of Kutak Rock; Letter of Mudge Rose; Letter of National League of Cities.

[195] *See, e.g.*, Letter of Bank One Corporation; Letter of Reliance Trust Company.

[196] *See, e.g.*, Letter of ICI; Letter of McDonald & Company Securities; Letter of NABL; Letter of National League of Cities; Letter of NFMA; Letter of New York Dormitory Authority; Letter of Putnam Investment Management; Letter of State of Utah, Office of the State Treasurer; Letter of State of Washington, Office of the State Treasurer.

[197] *See, e.g.*, Letter of Delaware County Industrial Development Authority; Letter of Financial Security Assurance; Letter of McNair & Sanford; Letter of Smith, Gambrell & Russell.

[198] As some commenters indicated, the existence of credit enhancement or other programmatic enhancement features does not eliminate the need for information on underlying obligated persons, particularly where there is a long term guarantee, because of the potential impact of a default on the pricing of the securities. *See* Letter of Kutak Rock on behalf of Financial Guaranty Insurers; Letter of FGIC; Letter of Prudential Investment Corp. *See also* Securities and Exchange Commission, *Report by the Securities and Exchange Commission on the Financial Guaranty Market: The Use of the Exemption In Section 3(a)(2) of the Securities Act for Securities Guaranteed by Banks and the Use of Insurance Policies to Guarantee Debt Securities* (August 28, 1987).

[199] *See, e.g.*, Letter of ABA Business Law Section; Letter of Goldman Sachs; Letter of Morgan Stanley; Letter of Mudge Rose; Letter of Thacher Proffitt & Wood.

[200] *See, e.g.*, Letter of Morgan Stanley; Letter of Mudge Rose; Letter of New York Dormitory Authority.

[201] Interpretive Release at Section III.D. *See also* Letter of The Bond Buyer.

[202] Rule 15c2–12(d)(3).

require annual financial information in situations where the securities would mature shortly after, or possibly even before, the annual financial information would be due.[203] The provisions of the amended rule relating to notices of material events, however, would apply to these Offerings absent some other Rule 15c2–12 exemption.

3. Exemptions from the Recommendation Prohibition

The Proposed Amendments also included a new exemption,[204] which would have permitted the recommendation in the secondary market of securities that were not subject to the underwriting prohibition, either because they were sold in a primary offering[205] of municipal securities with an aggregate principal amount of less than $1,000,000, or came within the existing exemptions for limited placements, short-term securities, and securities with demand features,[206] or within the new exemption for small, infrequent issuers.[207] This exemption has been adopted as proposed,[208] with the exception that securities sold in an exempt Offering that is subject to the limited undertaking condition,[209] are not exempt from the application of the recommendation prohibition. Pursuant to this element of the small issuer exemption, dealers must have in place procedures to receive notices of material events.[210]

4. Transactional Exemption

The existing Rule 15c2–12 transactional exemption[211] permits the Commission to exempt any Participating Underwriter from any requirement of the rule. Because Rule 15c2–12, as amended, places requirements on brokers, dealers, and municipal securities dealers in the secondary market, the transactional exemption has been amended to clarify that the Commission has exemptive authority with respect to both Participating Underwriters, in connection with Offerings, and with respect to brokers, dealers, and municipal securities dealers recommending transactions in the secondary market.[212]

E. Transitional Provision

The rule as amended contains a transitional provision for the amendments to Rule 15c2–12.[213] The underwriting prohibition applies to a Participating Underwriter that has contractually committed to act as an underwriter in an Offering on or after the effective date of the rule, July 3, 1995; provided that issuers need not undertake to provide annual financial information for fiscal years ending prior to January 1, 1996. The recommendation prohibition will become effective on January 1, 1996. The Commission is of the view that this delay of six months beyond the effective date of the amendment relating to the underwriting of municipal securities is sufficient to permit participants in the municipal securities market to design procedures for compliance with the provisions of Rule 15c2–12. Brokers, dealers and municipal securities dealers must, therefore, have procedures in place to comply with the recommendation prohibition on or before January 1, 1996. Finally, the limited undertaking condition to the small issuer exemption need not be satisfied for offerings commencing prior to January 1, 1996.

III. Effects on Competition and Regulatory Flexibility Act Considerations

Section 23(a)(2) of the Exchange Act[214] requires the Commission, in adopting rules under the Act, to consider the anticompetitive effects of those rules, if any, and to balance that impact against the regulatory benefits gained in terms of furthering the purposes of the Exchange Act. The Commission has considered the amendments to Rule 15c2–12 in light of the standard cited in Section 23(a)(2) and believes the adoption of the amendments will not impose any burden on competition not necessary or appropriate in furtherance of the Exchange Act.

In addition, the Commission has prepared a final regulatory flexibility analysis ("FRFA"), pursuant to the requirements of the Regulatory Flexibility Act[215] regarding the proposed amendments to Rule 15c2–12. The Commission requested comment on the extent to which current practice deviates from the requirements of the proposed amendments, and the extent to which additional costs may be imposed on small issuers, brokers, dealers, and municipal securities dealers if the amendments are adopted as proposed. The FRFA indicates that the amendments to the rule could impose some additional costs on small broker-dealers and municipal issuers. Nonetheless, the Commission is of the view that many of the substantive requirements of the amendments already are observed, absent access to the continuing information provided by the amendments, by issuers, brokers, dealers, and municipal securities dealers as a matter of business practice, or to fulfill their existing obligations under the antifraud provisions of the federal securities laws. To the extent that the Proposed Amendments would have imposed additional costs on small issuers, brokers, dealers, and municipal securities dealers, in response to commenters' concerns, the Commission has modified the amendments as described.

A copy of the FRFA may be obtained from Janet W. Russell-Hunter, Attorney, Office of Chief Counsel, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street NW., Mail Stop 7–10, Washington, DC 20549, (202) 942–0073.

List of Subjects in 17 CFR Part 240

Reporting and recordkeeping requirements; Securities.

Text of Amendments to Rule 15c2–12

In accordance with the foregoing, Title 17, Chapter II of Title 17 of the Code of Federal Regulations is amended as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for part 240 continues to read in part as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78i, 78j, 78*l*, 78*m*, 78*n*, 78*o*, 78*p*, 78*q*, 78*s*, 78*w*, 78*x*, 78*ll*(d), 79q, 79t, 80a–20, 80a–

[203] *See, e.g.*, Letter of ABA Urban Law Section; Letter of Chemical Securities; Letter of Day, Berry & Howard; Letter of Kutak Rock; Letter of Maryland Department of Economic and Employment Development.

[204] *See* paragraph (d)(3) of the Proposed Amendments.

[205] This exemption has been modified to clarify that the recommendation prohibition will not apply to primary or secondary market trading where municipal securities are exempt at the time of their original issuance. Several commenters noted that the inclusion of the term "a primary offering of" created confusion, based on the stated purpose of the exemption in the Proposing Release. *See, e.g.*, Letter of Kutak Rock; Letter of ABA Urban Law Section; Letter of Colorado Municipal Bond Supervision Advisory Board; Letter of Day, Berry & Howard. The exemption has been modified to delete that term, thus giving the exemption its intended meaning.

[206] *See* paragraph (d)(1) of the Proposed Amendments.

[207] *See* paragraph (d)(2) of the Proposed Amendments.

[208] Rule 15c2–12(d)(4).

[209] *See* Rule 15c2–12(d)(2).

[210] *See* Rule 15c2–12(b)(5)(i)(C).

[211] Former paragraph (d) of Rule 15c2–12.

[212] The transactional exemption also has been redesignated as paragraph (e) of Rule 15c2–12.

[213] *See* Rule 15c2–12(g).

[214] 15 U.S.C. 78w(a)(2).

[215] 5 U.S.C. 604.

23, 80a–29, 80a–27, 80b–3, 80b–4 and 80b–11, unless otherwise noted.

* * * * *

2. Section 240.15c2–12 is amended by adding a Preliminary Note preceding paragraph (a); revising paragraph (a); adding paragraph (b)(5); redesignating paragraph (c) through paragraph (f) as paragraph (d) through paragraph (g); adding paragraph (c); revising newly designated paragraph (d), paragraph (e), and paragraph (f)(3); adding paragraph (f)(9) and paragraph (f)(10); and adding four sentences to the end of newly designated paragraph (g) to read as follows:

§ 240.15c2–12 Municipal securities disclosure.

Preliminary Note: For a discussion of disclosure obligations relating to municipal securities, issuers, brokers, dealers, and municipal securities dealers should refer to Securities Act Release No. 7049, Securities Exchange Act Release No. 33741, FR–42 (March 9, 1994). For a discussion of the obligations of underwriters to have a reasonable basis for recommending municipal securities, brokers, dealers, and municipal securities dealers should refer to Securities Exchange Act Release No. 26100 (Sept. 22, 1988) and Securities Exchange Act Release No. 26985 (June 28, 1989).

(a) *General.* As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for any broker, dealer, or municipal securities dealer (a "Participating Underwriter" when used in connection with an Offering) to act as an underwriter in a primary offering of municipal securities with an aggregate principal amount of $1,000,000 or more (an "Offering") unless the Participating Underwriter complies with the requirements of this section or is exempted from the provisions of this section.

* * * * *

(b) *Requirements.* * * *

(5)(i) A Participating Underwriter shall not purchase or sell municipal securities in connection with an Offering unless the Participating Underwriter has reasonably determined that an issuer of municipal securities, or an obligated person for whom financial or operating data is presented in the final official statement has undertaken, either individually or in combination with other issuers of such municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such securities, to provide, either directly or indirectly through an indenture trustee or a designated agent:

(A) To each nationally recognized municipal securities information repository and to the appropriate state information depository, if any, annual financial information for each obligated person for whom financial information or operating data is presented in the final official statement, or, for each obligated person meeting the objective criteria specified in the undertaking and used to select the obligated persons for whom financial information or operating data is presented in the final official statement, except that, in the case of pooled obligations, the undertaking shall specify such objective criteria;

(B) If not submitted as part of the annual financial information, then when and if available, to each nationally recognized municipal securities information repository and to the appropriate state information depository, audited financial statements for each obligated person covered by paragraph (b)(5)(i)(A) of this section;

(C) In a timely manner, to each nationally recognized municipal securities information repository or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any, notice of any of the following events with respect to the securities being offered in the Offering, if material:

(*1*) Principal and interest payment delinquencies;

(*2*) Non-payment related defaults;

(*3*) Unscheduled draws on debt service reserves reflecting financial difficulties;

(*4*) Unscheduled draws on credit enhancements reflecting financial difficulties;

(*5*) Substitution of credit or liquidity providers, or their failure to perform;

(*6*) Adverse tax opinions or events affecting the tax-exempt status of the security;

(*7*) Modifications to rights of security holders;

(*8*) Bond calls;

(*9*) Defeasances;

(*10*) Release, substitution, or sale of property securing repayment of the securities;

(*11*) Rating changes; and

(D) In a timely manner, to each nationally recognized municipal securities information repository or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any, notice of a failure of any person specified in paragraph (b)(5)(i)(A) of this section to provide required annual financial information, on or before the date specified in the written agreement or contract.

(ii) The written agreement or contract for the benefit of holders of such securities also shall identify each person for whom annual financial information and notices of material events will be provided, either by name or by the objective criteria used to select such persons, and, for each such person shall:

(A) Specify, in reasonable detail, the type of financial information and operating data to be provided as part of annual financial information;

(B) Specify, in reasonable detail, the accounting principles pursuant to which financial statements will be prepared, and whether the financial statements will be audited; and

(C) Specify the date on which the annual financial information for the preceding fiscal year will be provided, and to whom it will be provided.

(iii) Such written agreement or contract for the benefit of holders of such securities also may provide that the continuing obligation to provide annual financial information and notices of events may be terminated with respect to any obligated person, if and when such obligated person no longer remains an obligated person with respect to such municipal securities.

(c) *Recommendations.* As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for any broker, dealer, or municipal securities dealer to recommend the purchase or sale of a municipal security unless such broker, dealer, or municipal securities dealer has procedures in place that provide reasonable assurance that it will receive prompt notice of any event disclosed pursuant to paragraph (b)(5)(i)(C), paragraph (b)(5)(i)(D), and paragraph (d)(2)(ii)(B) of this section with respect to that security.

(d) *Exemptions.* (1) This section shall not apply to a primary offering of municipal securities in authorized denominations of $100,000 or more, if such securities:

(i) Are sold to no more than thirty-five persons each of whom the Participating Underwriter reasonably believes:

(A) Has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of the prospective investment; and

(B) Is not purchasing for more than one account or with a view to distributing the securities; or

(ii) Have a maturity of nine months or less; or

(iii) At the option of the holder thereof may be tendered to an issuer of such securities or its designated agent for redemption or purchase at par value or more at least as frequently as every nine months until maturity, earlier redemption, or purchase by an issuer or its designated agent.

(2) Paragraph (b)(5) of this section shall not apply to an Offering of municipal securities if, at such time as an issuer of such municipal securities delivers the securities to the Participating Underwriters:

(i) No obligated person will be an obligated person with respect to more than $10,000,000 in aggregate amount of outstanding municipal securities, including the offered securities and excluding municipal securities that were offered in a transaction exempt from this section pursuant to paragraph (d)(1) of this section;

(ii) An issuer of municipal securities or obligated person has undertaken, either individually or in combination with other issuers of municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such municipal securities, to provide:

(A) Upon request to any person or at least annually to the appropriate state information depository, if any, financial information or operating data regarding each obligated person for which financial information or operating data is presented in the final official statement, as specified in the undertaking, which financial information and operating data shall include, at a minimum, that financial information and operating data which is customarily prepared by such obligated person and is publicly available; and

(B) In a timely manner, to each nationally recognized municipal securities information repository or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any, notice of events specified in paragraph (b)(5)(i)(C) of this section with respect to the securities that are the subject of the Offering, if material; and

(iii) the final official statement identifies by name, address, and telephone number the persons from which the foregoing information, data, and notices can be obtained.

(3) The provisions of paragraph (b)(5) of this section, other than paragraph (b)(5)(i)(C) of this section, shall not apply to an Offering of municipal securities, if such municipal securities have a stated maturity of 18 months or less.

(4) The provisions of paragraph (c) of this section shall not apply to municipal securities:

(i) Sold in an Offering to which paragraph (b)(5) of this section did not apply, other than Offerings exempt under paragraph (d)(2)(ii) of this section; or

(ii) Sold in an Offering exempt from this section under paragraph (d)(1) of this section.

(e) *Exemptive Authority.* The Commission, upon written request, or upon its own motion, may exempt any broker, dealer, or municipal securities dealer, whether acting in the capacity of a Participating Underwriter or otherwise, that is a participant in a transaction or class of transactions from any requirement of this section, either unconditionally or on specified terms and conditions, if the Commission determines that such an exemption is consistent with the public interest and the protection of investors.

(f) *Definitions.* * * *

(3) The term *final official statement* means a document or set of documents prepared by an issuer of municipal securities or its representatives that is complete as of the date delivered to the Participating Underwriter(s) and that sets forth information concerning the terms of the proposed issue of securities; information, including financial information or operating data, concerning such issuers of municipal securities and those other entities, enterprises, funds, accounts, and other persons material to an evaluation of the Offering; and a description of the undertakings to be provided pursuant to paragraph (b)(5)(i), paragraph (d)(2)(ii), and paragraph (d)(2)(iii) of this section, if applicable, and of any instances in the previous five years in which each person specified pursuant to paragraph (b)(5)(ii) of this section failed to comply, in all material respects, with any previous undertakings in a written contract or agreement specified in paragraph (b)(5)(i) of this section. Financial information or operating data may be set forth in the document or set of documents, or may be included by specific reference to documents previously provided to each nationally recognized municipal securities information repository, and to a state information depository, if any, or filed with the Commission. If the document is a final official statement, it must be available from the Municipal Securities Rulemaking Board.

* * * * *

(9) The term *annual financial information* means financial information or operating data, provided at least annually, of the type included in the final official statement with respect to an obligated person, or in the case where no financial information or operating data was provided in the final official statement with respect to such obligated person, of the type included in the final official statement with respect to those obligated persons that meet the objective criteria applied to select the persons for which financial information or operating data will be provided on an annual basis. Financial information or operating data may be set forth in the document or set of documents, or may be included by specific reference to documents previously provided to each nationally recognized municipal securities information repository, and to a state information depository, if any, or filed with the Commission. If the document is a final official statement, it must be available from the Municipal Securities Rulemaking Board.

(10) The term *obligated person* means any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support payment of all, or part of the obligations on the municipal securities to be sold in the Offering (other than providers of municipal bond insurance, letters of credit, or other liquidity facilities).

* * * * *

(g) *Transitional Provision.* * * * Paragraph (b)(5) of this section shall not apply to a Participating Underwriter that has contractually committed to act as an underwriter in an Offering of municipal securities before July 3, 1995; *except that* paragraph (b)(5)(i)(A) and paragraph (b)(5)(i)(B) shall not apply with respect to fiscal years ending prior to January 1, 1996. Paragraph (c) shall become effective on January 1, 1996. Paragraph (d)(2)(ii) and paragraph (d)(2)(iii) of this section shall not apply to an Offering of municipal securities commencing prior to January 1, 1996.

Dated: November 10, 1994.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 94-28448 Filed 11-16-94; 8:45 am]

BILLING CODE 8010-01-P

NASD NOTICE TO MEMBERS 95-24

SEC Approves Recordkeeping And Reporting Requirements For Trading Systems Operated By Broker/Dealers

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

Effective June 1, 1995, the Securities and Exchange Commission (SEC) is adopting Rule 17a-23 and Form 17A-23 under the Securities Exchange Act of 1934. The Rule requires broker/dealers that operate automated trading systems to maintain participant, volume, and transaction records, and to report system activity to the SEC and, in certain circumstances, to their designated examining authority (DEA). Broker/dealers currently operating automated trading systems subject to the Rule must file their initial operation reports **no later than July 1, 1995.**

Background

Currently, firms that operate automated trading systems must be registered broker/dealers and keep records relating to general brokerage activity, but are not required to keep records that separately identify transactions effected through their systems. These firms need not provide readily accessible summaries of system volume, identify the securities trading on their systems, or describe how their systems operate.

In 1989, the SEC attempted to formalize its oversight of automated trading systems by proposing Rule 15c2-10. That Rule was directed at certain securities trading and information systems, referred to as proprietary trading systems, that were not operated as facilities of a registered national securities exchange or association. This proposal was withdrawn in February 1994.

In the interim, many firms sponsoring screen-based, broker/dealer trading systems (BDTSs) have been operating according to no-action letters obtained from the SEC. Generally, these letters provide relief from registration as a national securities exchange or association, and require supplemental recordkeeping and reporting by the sponsor.

In January 1994, the SEC published its *Market 2000: An Examination of Current Equity Market Developments*, a study that recommended close monitoring of BDTSs to understand the implications of integrating these systems into existing market structures. The SEC proposed Rule 17a-23 shortly after publishing the study and recently determined to adopt the Rule with certain modifications.

SEC Rule 17a-23

As adopted, the Rule requires a broker/dealer that sponsors a BDTS to make and keep current specified records and to file reports with the SEC and its DEA on Form 17A-23.

Broker/Dealer Trading Systems

In finalizing the rule, the SEC modified the definition of BDTS to mean any system that provides a mechanism, automated in full or in part, for:

• collecting or disseminating system orders; and

• matching, crossing, or executing system orders, or otherwise facilitating agreement to the basic terms of a purchase or sale of a security between system participants, or between a system participant and the system sponsor, through use of the system or through the system sponsor. Members should note that a system must meet both criteria to be considered a BDTS.

Recordkeeping Requirements

System sponsors are required to keep and make available to the SEC, upon request, these records:

• daily summaries of trading in the system;

• identities of system participants (including any affiliations between those participants and the sponsor); and

• time-sequenced records of each transaction effected through the system.

These records must be kept for three years, the first two years in an easily accessible place.

Members should note that the Rule does not dictate a format for maintaining information nor require that such information be maintained separately from other records, provided the sponsor can retrieve promptly the information upon request in the format and for the time periods specified in the Rule.

Reporting Requirements

The Rule requires a BDTS sponsor to file specified reports using Form 17A-23, which contains three parts:

• Part I—Operation Reports, including the initial operation report that must be filed at least 20 calendar days before the operation of the system and subsequent reports that must be filed at least 20 calendar days before implementing any material change to the operation of the system.

• Part II—Quarterly Reports, which must be filed within 30 calendar days after the end of the calendar quarter.

• Part III—Final Report, which must be filed within 10 calendar days after a sponsor ceases to operate the trading system.

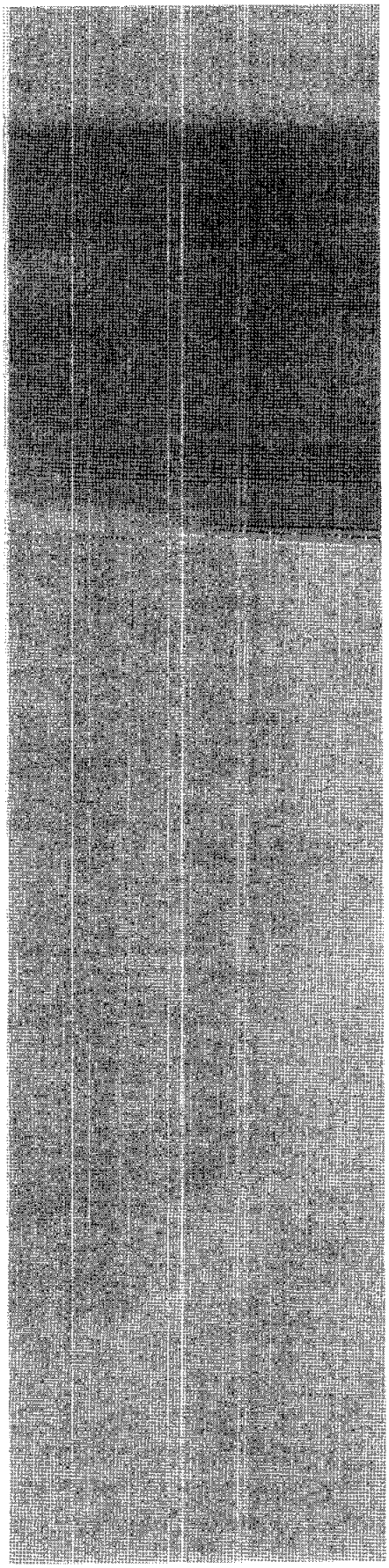
Parts I and III of the form must be filed with the SEC and the sponsor's DEA. Part II is filed with the SEC only; however, the sponsor must make the reports available to its DEA upon request. **Members for whom the NASD is the DEA should submit their required reports to the NASD Market Surveillance Department, 9513 Key West Avenue, 4th Floor, Rockville, MD 20850-3389.**

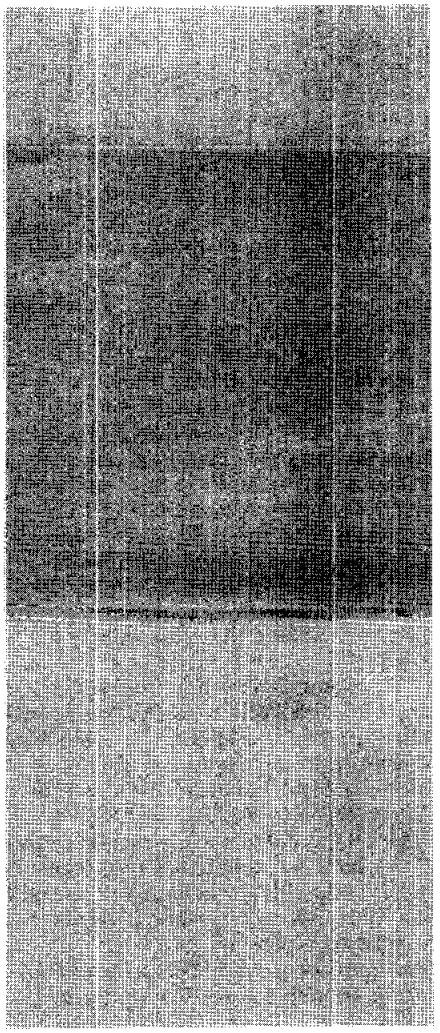
Implementation Dates

Rule 17a-23 is effective on June 1, 1995. Sponsors of systems currently in operation must submit the information required by Part I of Form 17A-23 **no later than July 1, 1995.**

* * *

Members operating automated trading systems are urged to review the SEC release concerning Rule 17a-23 in its entirety. The release, which appeared in the December 28, 1994, *Federal Register*, follows this Notice. Questions concerning this Notice may be directed to James Bohlin, Assistant Director, NASD Market Surveillance, at (301) 590-6789.





17 CFR Parts 240 and 249

[Release No. 34-35124; File No. S7-3-94]

RIN 3235-AG03

Recordkeeping and Reporting Requirements for Trading Systems Operated by Brokers and Dealers

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Securities and Exchange Commission is adopting Rule 17a-23 ("Rule") and Form 17A-23 under the Securities Exchange Act of 1934 to establish recordkeeping and reporting requirements for brokers and dealers that operate automated trading systems. Under the Rule, registered broker-dealers that sponsor these systems would be required to maintain participant, volume, and transaction records, and to report system activity to the Commission and, in certain circumstances, to an appropriate self-regulatory organization.

EFFECTIVE DATE: June 1, 1995.

FOR FURTHER INFORMATION CONTACT: Kristen N. Geyer, Senior Counsel, 202/942-0799, Office of Automation and International Markets, Division of Market Regulation, Securities and Exchange Commission (Mail Stop 5-1), 450 Fifth Street, N.W., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION:

I. Introduction and Summary

On February 9, 1994, the Securities and Exchange Commission ("Commission") proposed for comment Rule 17a-23 ("Proposed Rule")[1] and Form 17A-23 ("Proposed Form")[2] under the Securities Exchange Act of 1934 ("Act").[3] The Proposed Rule would have required specific recordkeeping and reporting by registered broker-dealer sponsors of certain automated trading systems (as defined in the Rule, "Broker-Dealer Trading System," or "BDTS"). The Proposed Form specified the information to be included in each filing required by the Proposed Rule.

The Commission received ten comment letters in response to the Proposing Release. Commenters generally supported the Proposed Rule's goal of standardizing recordkeeping and reporting for BDTSs.[4] The majority of

[1] 17 CFR 240.17a-23.

[2] 17 CFR 249.636.

[3] 15 U.S.C. 78a *et seq.* *See* Securities Exchange Act Release No. 33605 (Feb. 9, 1994), 59 FR 8368 ("Proposing Release").

[4] The comment letters and a summary of comments prepared by the Division of Market Regulation have been placed in Public File No. S7-3-94, which is available for inspection in the Commission's Public Reference Room. Commenters consisted of two industry associations, two self-regulatory organizations, four sponsors of automated proprietary trading systems, and two automated broker-dealers. *See* letters from: John F Olson, Chair, Committee on Federal Regulation of Securities, and Roger D. Blanc, Chair, Subcommittee on Market Regulation, the Business Law Section of the American Bar Association, dated May 10, 1994 ("ABA"); Robert A. McTamaney, Attorney, Carter, Ledyard & Milburn (representing RMJ Securities Corporation, RMJ Options Trading Corporation, and RMJ Special Brokerage, Inc.), dated April 15, 1994 ("CLM/RMJ"); John E. Herzog, Chairman & CEO, Herzog, Heine, Geduld, dated April 12, 1994 ("HHG"); Charles R. Hood, Senior Vice President & General Counsel, Instinet Corporation, dated April 25, 1994 ("Instinet"); Alan D. Rudolph, Vice President, Intervest Financial Services, Inc. and President, CrossCom Trading Network, Inc., dated March 15, 1994 ("Intervest"); Raymond L. Killian, Jr., President & CEO, Investment Technology Group, Inc. (sponsor of Portfolio System for Institutional Trading ("POSIT")), dated May 18, 1994 ("ITG"); Leonard Mayer, Vice President, Mayer & Schweitzer, Inc., dated July 11, 1994 ("M&S"); Joseph R. Hardiman, President, National Association of Securities Dealers, Inc., dated May 27, 1994 ("NASD"); John E. Buck, Senior Vice President & Secretary, New York Stock Exchange, dated June 30, 1994 ("NYSE"); and Mark T Commander, Chairman of

commenters recommended specific modifications to the Proposed Rule. Two commenters, the National Association of Securities Dealers ("NASD") and the New York Stock Exchange ("NYSE"), objected to the Commission's overall regulatory treatment of certain BDTSs and the competitive implications of such regulatory treatment.[5]

After considering the comments, the Commission is adopting the Rule and Form, with certain modifications. The Commission does not believe that these modifications materially alter the scope of the Proposed Rule or the entities to which it applies. The recordkeeping and reporting approach adopted in the Rule will provide the Commission with information necessary to effectively monitor, evaluate, and examine such systems.

II. Basis and Purpose of the Rule

In January 1994, the Commission's Division of Market Regulation ("Division") published its *Market 2000 Study*,[6] which reviewed, among other things, the Commission's existing oversight of automated trading systems. The Study recognized that the activities of such systems differ from the activities of traditional broker-dealers, and recommended that the Commission closely monitor the effects of proliferation of such systems.[7] The Commission proposed Rule 17a–23 immediately following publication of the *Market 2000 Study*.[8]

The majority of commenters supported the concept of a recordkeeping and reporting rule and recognized the importance of ongoing monitoring and evaluation of technological advances in the securities industry.[9] Several commenters, however, questioned the necessity for applying the Proposed Rule to specific types of systems. In particular, two commenters suggested that the Proposed Rule should not apply to systems that allow a dealer's customers and other dealers to execute orders against the sponsoring dealer's bid or offer (*i.e.*, "hit" the sponsor's quotations) through automated means ("automated dealer systems").[10] Another commenter objected to application of the Proposed Rule to non-equity systems.[11]

In the Proposing Release, the Commission noted that, although automated systems have proliferated in the securities industry, the Commission receives little information about such systems.[12] The Commission concluded that its efforts to gauge the effect of automation on the U.S. markets and to regulate broker-dealers that operate such systems appropriately are being hindered by a lack of critical information regarding the activity of BDTSs.

The Commission identified three ways in which additional information about BDTSs would assist in evaluating, monitoring, and examining such systems. First, the Rule will allow the Commission to evaluate BDTSs with regard to national market system goals.[13] The Commission noted in the Proposing Release that BDTSs have the potential to significantly affect trading patterns, market transparency, and the distribution of trading activity among different markets; consequently, access to uniform, reliable information about BDTSs is critical to the Commission's evaluation of these issues.[14] This is true regardless of whether such systems automate the market-making function, automate an order-interaction function, or automate trading of illiquid or non-equity securities.

Second, the information will help the Commission to monitor the competitive effects of these systems and to ascertain whether broker-dealer regulation remains appropriate for the operation of BDTSs.[15] As is clear from the comments, the ongoing debate regarding the competitive consequences of the Commission's regulation of BDTSs remains vigorous.[16] Finally, the Rule will help the Commission identify areas where monitoring of such systems may be improved and where self-regulatory organization ("SRO") surveillance may be more appropriately tailored to the detection of fraudulent, deceptive, and manipulative practices in an automated environment.[17]

Notwithstanding the views of commenters that the risks posed by automated market-maker systems are sufficiently addressed by existing broker-dealer regulations[18] or that automated systems are less susceptible to manipulation than traditional broker-dealers,[19] the Commission believes that the evolution of both automated broker systems and automated dealer systems present new challenges in maintaining

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Self-Regulation & Supervisory Practices Committee, Securities Industry Association, dated June 17, 1994 ("SIA").

[5] *See* letters from NASD and NYSE. The NASD expressly opposed adoption of the Proposed Rule.

[6] Division of Market Regulation, *Market 2000: An Examination of Current Equity Market Developments* (January 1994) ("*Market 2000 Study*").

[7] *Id.* at 26–27

[8] *See* Proposing Release, *supra* note 3. Concurrently with the publication of the Proposed Rule, the Commission withdrew a previous rule proposal (Rule 15c2–10) which would have required certain BDTSs to seek Commission approval prior to operation of a proprietary trading system and imposed additional conditions on the operation of such systems. The Commission concluded that, based on its experience since 1989 in overseeing BDTSs, including the proposal of Rule 17a–23, a separate regulatory structure governing proprietary trading systems was not necessary at this time. *See* Securities Exchange Act Release No. 33621 (Feb. 14, 1994), 59 FR 8379.

[9] *See, e.g.*, Letter of ABA, at 1; Letter of HHG, at 1; Letter of ITG, at 1; and Letter of M&S, at 2.

[10] *See* Letter of ABA, at 3; Letter of NASD, at 6.

[11] *See* Letter of CLM/RMJ, at 3.

[12] The extent of information currently accessible to the Commission, the history of the Commission's oversight of such systems, and other background information can be found in the Proposing Release *See* Proposing Release, *supra* note 3, 59 FR at 8369–71. Currently, BDTSs are subject to Commission oversight through broker-dealer registration, recordkeeping, and reporting requirements in the Act. In addition, sponsors of a number of BDTSs have obtained no-action assurances from the Division that it will not recommend enforcement action if the systems operate without registering as exchanges. These staff no-action letters require supplemental recordkeeping and reporting by the sponsor as a condition of the no-action position. *See* Proposing Release, *supra* note 3, 59 FR at 8369. The Rule does not address the issue of whether a particular trading system may be required to register as a national securities exchange, clearing agency, or other self-regulatory organization. Sponsors of BDTSs seeking relief from exchange, clearing agency, and other registration requirements may continue to request no-action positions from the Division.

[13] *See* Proposing Release, *supra* note 3, 59 FR at 8369–70.

[14] For example, in its *Market 2000 Study*, the Division advocated improving transparency for limit orders and after-hours trading, order-exposure rules, disclosure of broker-dealer order-handling practices, assessment of market quality by users of automated routing systems, and surveillance of third market trading. *Market 2000 Study*, *supra*, note 6, at 16–32. The Commission's consideration of each of these issues is directly affected by its understanding of different trading mechanisms, including BDTSs. In particular, the Commission must examine how, and the extent to which, order flow is directed to different trading mechanisms, the extent to which orders entered into different trading mechanisms are integrated into national quotation and trade reporting systems, the extent to which various trading mechanisms offer price improvement, and the order handling and execution practices of different trading mechanisms. Information reported pursuant to the Rule will assist the Commission in understanding how BDTSs operate and how they interact, and are integrated, with other market participants and mechanisms, and consequently will assist the Commission in evaluating these issues.

[15] *See* Proposing Release, *supra* note 3, 59 FR at 8370.

[16] Three commenters discussed the competitive implications of the Commission's adoption of a recordkeeping and reporting rule applicable to BDTSs. *See* Letter of ABA, at 2; Letter of NASD, at 5; and Letter of NYSE, at 2–4. Two of these commenters, the NASD and NYSE, opposed the Commission's determination not to adopt previously proposed Rule 15c2–10, which would have subjected sponsors to a number of procedural and substantive requirements. *Cf.* Securities Exchange Act Release No. 26708 (April 13, 1989), 54 FR 15429; Proposing Release, *supra* note 3, 59 FR at 8369.

[17] *See* Proposing Release, *supra* note 3, 59 FR at 8370–71.

[18] See Letter of ABA, at 2; Letter of NASD, at 5.

[19] See Letter of Instinet, at 2–4.

market quality and customer protection. BDTSs contribute to the concentration of order flow among a few, large, automated broker-dealers, execute trades at a more rapid rate than traditional services, and make execution of the customers' orders dependent on the reliability of the automated system rather than individual traders.

The Commission believes that the Rule as adopted will provide important information to assist it in accomplishing these goals, without imposing unnecessary or overly burdensome requirements that do not relate to the purposes of the Rule.

III. Discussion

As adopted, the Rule requires a registered broker-dealer who acts as the sponsor[20] of a "broker-dealer trading system" to make and keep current specified records, and file reports with the Commission (and, in certain circumstances, with the appropriate SRO) on Form 17A–23.

A. Scope of the Rule and Application to Specific Types of Systems

The Rule as proposed and adopted would apply to registered brokers or dealers[21] that sponsor a "broker-dealer trading system." Commenters requested clarification of which automated systems would be considered "broker-dealer trading systems" as defined in the Proposed Rule.[22] Several commenters suggested narrowing the definition of BDTS to exempt certain systems. In particular, two commenters questioned the inclusion of automated dealer systems that allow a dealer's customers and other dealers to execute against the sponsoring dealer's bids and offers.[23] One commenter also recommended that the Commission exempt non-equity trading systems from application of the Proposed Rule.[24] In view of the comments, the Commission has simplified the definition of BDTS and clarified the Rule's application to various systems, as discussed below, but has not materially altered the scope of the Rule.

The definition of "broker-dealer trading system" has been modified in the Rule to mean any system that meets the following criteria: the system must provide a mechanism, automated in full or in part, for (1) collecting or disseminating system orders and (2) matching, crossing, or executing system orders, or otherwise facilitating agreement to the basic terms of a purchase or sale of a security between system participants, or between a system participant and the system sponsor, through use of the system. As made clear in the Rule, the term "broker-dealer trading system" does not include any system that does not meet both of these requirements.

The modified definition of BDTS captures the essential features of the types of systems that the Proposed Rule was intended to encompass. The Proposed Rule also described several types of systems that were excluded from the definition of BDTS.[25] As discussed below, the Commission believes that those systems continue to be excluded from the Rule as adopted, because they do not meet the required characteristics of a BDTS as defined.[26]

1. System Automation

As adopted, the Rule applies to systems that may be only partially automated, as well as to fully automated systems. Some systems may automate the collection and dissemination of orders through a screen available for viewing by participants, but require participants to contact the sponsor by telephone in order to finalize a trade based on such orders. Other systems may collect orders via telephone contact with customers, and enter those orders into a system that automates the matching of such orders. Although neither of these systems are "fully" automated, both are BDTSs under the Rule as adopted. The lack of complete automation does not alter the potential market effects of automated execution systems, nor does it alter the need to tailor oversight of the sponsor to reflect the distinctive characteristics of automated systems. The Commission notes in particular that it is not necessary for participants to have the ability to enter orders electronically through a system terminal or screen in order for the system to be subject to the Rule. Some systems permit customers to participate in the system's matching, crossing, or other features by communicating orders to the sponsor by telephone, to be entered into the system by the sponsor's trading personnel.[27]

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[20] The Rule defines a sponsor as "any entity that organizes, operates, administers, or otherwise directly controls a broker-dealer trading system." In addition, the Rule includes within this term any registered broker-dealer that regularly executes transactions on behalf of participants of a system operated by a non-registered entity. See Proposing Release, supra note 3, 59 FR at 8371.

[21] As noted in the Proposing Release, absent an exemption from or exception to the broker-dealer registration provisions of the Act, the types of activities conducted by BDTSs can be lawfully conducted only by a broker-dealer registered with the Commission pursuant to the Act. See Proposing Release, supra note 3, 59 FR at 8371. The Commission notes that the term "registered broker or dealer" is defined in Section 3(a)(48) of the Act, and includes the majority of broker-dealers. The term does not include government securities brokers or government securities dealers registered under Section 15C of the Act, which are required to comply with the recordkeeping and reporting requirements promulgated by the Department of the Treasury, 17 CFR 400 et seq., under the Government Securities Act of 1986, 15 U.S.C. 78o-5. Accordingly, the Rule would not apply to systems sponsored by broker-dealers registered solely under Section 15C of the Act. In addition, the Rule would not apply to operators of systems that do not involve activities requiring broker-dealer registration. See Letters regarding Farmland Industries, Inc. (Aug. 26, 1991); Troy Capital Services, Inc. (May 1, 1990); Real Estate Financing Partnership (May 1, 1990); Ivestex Investment Exchange, Inc. (April 9, 1990); and Petroleum Information Corporation (Nov. 28, 1989). Cf. Securities Exchange Act Release No. 27017 (July 11, 1989), 54 FR 30013, text accompanying n.66.

[22] See, e.g., Letter of NASD, at 7. The Proposed Rule defined "broker-dealer trading system" as:

(i) any system that automates the execution of orders to buy or sell securities based on quotations of the system sponsor or its affiliates (whether such quotations are disseminated through the system, a quotation consolidation system operated pursuant to a plan approved by the Commission under Section 11A of the Act, an electronic interdealer quotation system operated by a registered national securities association, or otherwise); or

(ii) any system that both automates the dissemination or collection of quotations, orders to buy or sell securities, or indications by any person announcing a general interest in buying or selling a security, submitted by entities other than the system sponsor and its affiliates, and provides a mechanism for matching or crossing, or for otherwise facilitating agreement between participants to the basic terms of a purchase or sale of a security through use of the system.

See Proposing Release, *supra* note 3, 59 FR at 8374.

[23] *See* Letter of ABA, at 3; Letter of NASD, at 6.

[24] See Letter of CLM/RMJ, at 3.

[25] One commenter noted that the Proposing Release discussed other systems that the Proposed Rule would not encompass, but that were not expressly excluded from the definition of BDTS. The commenter requested that the Commission reconcile the Rule with the excluded systems described in the Proposing Release. *See* Letter of ABA, at 3–4. Given the ongoing evolution of automated trading systems, however, the Commission believes it would be impractical to attempt to enumerate all types of systems that would not be considered "broker-dealer trading systems" under the Rule. In view of this, the Rule as adopted does not contain express exclusions.

[26] The Proposed Rule excluded certain order routing systems. *See* Proposing Release, *supra* note 3, 59 FR at 8372 (Sections (b)(2)(ii)(A) and (B) of the Proposed Rule). These systems do not meet the requirements of the Rule as adopted, and therefore are not subject to the Rule. Specifically, systems that only allow participants to post trading interest, or only route orders to the execution facilities of established markets or other broker-dealers do not effect the purchase or sale of a security between system participants or between a system participant and the system sponsor through the system.

[27] The Commission also notes in this context that transactions resulting from orders entered into the system through the sponsor's trading personnel would be considered to be executed through the system to the same extent as trades entered directly by system participants. One commenter noted that certain systems may permit the system sponsor to execute trades manually and to enter the matched trade into the system for reporting and other execution related activities. *See* Letter of M&S, at 2. The commenter suggested that system sponsors should not be required to segregate out such trades

This lack of automated access to a system does not exempt such a system from application of the Rule.

2. System Execution Mechanism

The Rule applies only to those automated trading systems that offer users the ability to effect securities transactions through their use of the system, either with other participants or with the system sponsor. Numerous automated systems have developed that facilitate securities trading, but do not create opportunities to effect transactions apart from the facilities of established markets. These systems range from purely informational "bulletin board" systems that allow participants to announce their trading interest (typically by posting quotation or order information and participant telephone numbers on the system's screen)[28] to "routing" systems that direct order flow to an exchange or other established market or dealer but do not otherwise interact with such order flow. Bulletin boards, routing systems, and other similar systems essentially disperse information; they do not allow users to effect securities transactions with other system participants or with the system sponsor through the system. Accordingly, such systems are not subject to the Rule. In the Commission's view, these "non-execution" systems do not create the same potential for market effects and correspondingly create less need for ongoing monitoring and evaluation by the Commission than systems that fall within the definition of broker-dealer trading system.[29]

for purposes of the recordkeeping and reporting requirements of the Rule. Neither the Rule nor Form 17A–23 requires a system sponsor to segregate transaction records or reports based on the method by which the order was accepted into the system (*i.e.*, telephone, computer terminal, etc.). System sponsors would not be required, therefore, to segregate out manually handled trades. The Commission expects, however, that a system's ability to process manually handled orders would be described in the system sponsor's filings pursuant to Part I of Form 17A–23.

[28] The Commission uses the term "bulletin board systems" in this context to mean only those systems that allow participants to announce their trading interest, but do not provide further opportunity to interact with the system or the system sponsor to execute transactions. Such systems do not allow participants to agree to the terms of a transaction "through use of the system"; participants must contact each other outside of system facilities or the system sponsor to conclude a transaction. Therefore, such systems do not meet the definition of a BDTS under the Rule, and the Rule would not apply to these systems.

[29] Although the Commission requested comment on whether the Proposed Rule should apply to "non-execution" systems, no commenter suggested that such systems be subject to the Rule. *See* Proposing Release, *supra* note 3, at 8373.

3. Application of the Rule to Automated Dealer Systems

Two commenters argued that the Proposed Rule only should apply to systems that offer a "locked-in trade" between or among customers or other dealers as part of an interactive system.[30] These commenters questioned the Commission's rationale for applying the Proposed Rule to automated dealer systems, arguing that automated dealer systems "do no more than what any market-maker has done since the enactment of the 1934 Act," other than providing fuller automation of the market-maker function.[31] One commenter supported inclusion of automated dealer systems in the Proposed Rule.[32]

The Commission has concluded that the Rule should apply to automated dealer systems as well as other BDTSs. Systems that automate execution functions make it possible for a broker-dealer to concentrate a significant volume of securities transactions. This is true whether such an "execution" system allows participants to interact directly with each other, or whether the system allows participants to interact with a single dealer. As discussed above and in the Proposing Release, this potential concentration of volume outside of national market systems may have significant market effects. The Commission believes that in today's highly complex, integrated trading environment, it must fully consider the effect of technological advances on the broker-dealer's role in both auction market and dealer market trading.[33]

4. Application of Rule to Non-Equity Systems

The Rule as adopted applies both to systems trading equity and systems trading non-equity securities. One commenter objected to application of the Proposed Rule to systems that deal exclusively with non-equity instruments.[34] That commenter noted that "[t]he nature of and detail imposed by these recordkeeping and reporting requirements suggest that the real intention behind the Proposed Rule is to enable the SEC to gather and evaluate information on BDTSs dealing in equity instruments only."[35]

The need for uniform, reliable information as discussed above and in the Proposing Release is equally applicable to systems trading non-equity securities. It is probable that sponsors will continue to create BDTSs to facilitate transactions in products that do not trade in organized markets, including various debt and derivative products. Systems that trade these non-equity, and typically less liquid, securities are especially opaque under existing regulations; they are not integrated into market quotation and reporting mechanisms to the same degree as systems that trade equity products. Some of these "niche" systems may provide the only readily identifiable source of trading in a particular instrument. The Rule will help alleviate the difficulty of obtaining accurate information on a regular basis about trading in these instruments.

The Commission recognizes that information that is relevant to equity security trading may not be relevant to non-equity security trading. Accordingly, the Rule and Form direct the sponsor of a non-equity trading system to provide information relevant to such non-equity securities (such as number of bonds, contracts, etc.).[36]

B. Regulation of Certain BDTSs

Three commenters urged the Commission to reconsider its regulatory approach to BDTSs, or in the alternative to reconsider its regulation of traditional markets.[37] Specifically, both the NYSE and the NASD identified concerns regarding the competitive implications of the Commission's adoption of a recordkeeping and reporting rule governing BDTSs in light of the regulatory structures that apply to registered exchanges and interdealer

[30] *See* Letter of ABA, at 3; Letter of NASD, at 5–6.

[31] *See* Letter of NASD, at 6.

[32] *See* Letter of NYSE, at 2.

[33] The NASD in its comment letter suggested that market-maker execution systems should be distinguished from other BDTSs because the executions provided by a market-maker are based on the market-maker's own quotes, subject to its best execution obligations and affect the market-maker's own inventory. According to the NASD, other BDTSs permit the direct interaction of customer orders or provide for the quotations of multiple market-makers and are thus more akin to the functions performed by traditional markets. *See* Letter from NASD, at 6. The Commission is not persuaded that this difference in operation is a sufficient basis on which to exclude market-maker systems from the Rule. A broker-dealer firm sometimes trades for its own account as dealer and sometimes for the account of its customers as broker; in either case, the broker-dealer uses its facilities to bring together buyers and sellers with the intent of effecting a securities transaction. *See* Securities Exchange Act Release No. 27611 (Jan. 12, 1990), 55 FR 1890, 1898.

[34] *See* Letter of CML/RMJ, at 3–5.

[35] *Id.* In addition to CML/RMJ, one other sponsor of a system trading non-equity securities commented on the Proposed Rule. *See* Letter of Intervest.

[36] *See* 17 CFR 240.17a23(c)(1)(ii)(B) and 249.636, Form 17A–23, Part II, 1.

[37] *See* Letter of ABA, at 5–6; Letter of NASD, at 1–7; Letter of NYSE, at 1–2, 4.

quotation systems.[38] The Commission does not believe it is necessary at this time to adopt regulations governing BDTSs beyond those existing requirements applicable to the broker-dealer sponsors of such systems and the enhanced recordkeeping and reporting that will be provided pursuant to the Rule. The Commission is not precluded from reconsidering the issues raised by the commenters concerning the Commission's regulatory approach to BDTSs at a later time, should circumstances warrant such reconsideration.

These commenters also urged the Commission to reconsider its regulation of trading services provided by registered exchanges and securities associations. In particular, commenters recommended that the Commission streamline its requirements governing the filing of SRO rule proposals, and that SROs be allowed to develop trading systems under the same regulatory requirements applicable to BDTSs.[39] In that regard, the Commission notes that today it has adopted amendments to the Commission's rules governing the SRO rule filing process.[40] The Commission also notes that the regulation of SRO trading services is largely dictated by statutory requirements. Consequently, SRO operation of trading systems outside of existing SRO regulations would require a careful, case-by-case analysis under the Act. BDTSs are governed by the regulatory structure applicable to other registered broker-dealers. The Commission has not created a separate regulatory structure for BDTS trading; it has adopted enhanced recordkeeping and reporting for such systems.

C. Recordkeeping Requirements

Under the Rule, system sponsors are required to keep and make available to the Commission, upon request, records of: (1) daily summaries of trading in the system; (2) the identities of system participants (including any affiliations between those participants and the sponsor); and (3) time-sequenced records of each transaction effected through the system. The sponsor is required to keep these records, as well as any notices provided by the sponsor to participants, for three years (the first two years in an easily accessible place). The Commission has modified some of the proposed recordkeeping requirements in response to comments as discussed below.

1. Duplicative Recordkeeping

The Commission requested comment on whether the Proposed Rule's requirements would be duplicative or burdensome. Commenters suggested that the recordkeeping requirements appear to be duplicative of those already required under other rules promulgated under Section 17, and questioned the justification for such duplication.[41] Two commenters expressed reservations that the Proposed Rule would penalize broker-dealers that use automation to become more efficient, and would thus deter further automation.[42] Only one commenter stated that the Proposed Rule would impose undue financial burden on BDTS sponsors.[43] No commenter provided information sufficient to quantify the extent to which BDTSs would be financially burdened by the Proposed Rule.

While existing regulations require registered broker-dealers to maintain much of the information required under the Rule, they do not require broker-dealers to keep records that present BDTS activity separately from other brokerage activity.[44] Consequently, the Commission does not have ready access to system-specific information. The Commission's ability, and the ability of SROs,[45] to adequately evaluate, monitor, and examine these systems is correspondingly limited.[46] Although the Rule may result in changes to some existing BDTS sponsors' recordkeeping practices, the Commission believes that it has made sufficient provision in the Rule to minimize the need for BDTS sponsors to keep duplicative records. The Rule does not dictate a format for maintaining information and does not require BDTS sponsors to maintain such information separately from its other records, so long as the sponsor can promptly retrieve such information upon request in the format, and for the time periods, specified in the Rule.

2. Records Regarding Applicants Denied Participation on the System.

Commenters questioned the need to retain information regarding specific applicants denied participation in the system, and indicated that quantifying such information would be difficult.[47] In view of the comments, the Commission has deleted this requirement from the Rule. Sponsors, however, are required to describe, in filings under Part I and IA of Form 17A-23, the factors relied upon by the sponsor in granting participation in the system.

3. Daily Trading Summaries

The Proposed Rule required sponsors to retain daily summaries of, among other things, securities trading in the system. The Proposed Rule also would have required sponsors to retain daily summaries identifying the number of "quotations" and "orders" placed in the system, expressed separately for limit and market orders and other relevant order specifications. This requirement was intended to provide the Commission with a basis for comparing potential system trading interest with trading volume. Commenters expressed concern that the configuration of specific systems would make it difficult to determine what would constitute a single "quotation" or "order."[48] Commenters also noted that, depending upon system configuration, identifying the number of quotations or orders may not provide the Commission with useful information regarding system trading interest.[49]

The Commission has modified the Rule in view of these commenter concerns regarding the terms "quotations" and "orders."[50] As adopted, the Rule requires sponsors to identify the number of "system

[38] *See* Letter of NASD, at 1–4; Letter of NYSE, at 1–2, 4. *See also*, Letter of ABA, at 5–6.

[39] *See* Letter of ABA, at 5–6; Letter of NASD, at 5; Letter of NYSE, at 4.

[40] *See* Securities Exchange Act Release No. 35123 (December 20, 1994). The amendments expand the category of proposed rule changes that may become effective upon filing under Section 19(b)(3)(A) of the Act to include certain changes to existing systems and other noncontroversial filings.

[41] *See* Letter of NASD, at 7 *Cf* Letter of SIA, at 2.

[42] *See* Letter of ABA, at 3 and Letter of NASD, at 6.

[43] *See* Letter of CLM/RMJ, at 3–4.

[44] *See* Proposing Release, *supra* note 3, 59 FR at 8368–69.

[45] Staff of the Division met with representatives of the NASD to discuss its use of the information provided by the records maintained pursuant to the Rule and the reports filed pursuant to Form 17A-23. The Commission expects that the NASD and other SROs that have the responsibility to examine and otherwise oversee BDTSs will use such information to tailor their oversight of BDTSs to reflect the distinctive features of automated broker-dealers.

[46] *See* Proposing Release, supra note 3, 59 FR at 8370–71.

[47] *See* Letter of ABA, at 5; Letter of CLM/RMJ, at 5; Letter of HHG, at 3–4; Letter of Instinet, at 6–7; Letter of ITG, at 2; Letter of NASD, at 7–8; and Letter of SIA, at 3.

[48] *See* Letter of ABA, at 4; Letter of HHG, at 3; and Letter of Instinet, at 8–9.

[49] *See* Letter of ABA, at 4 and Letter of Instinet, at 8–9. One commenter questioned the use of the term "quotations" in the Proposed Rule to refer to trading interest entered into an automated system, noting that its system users place "orders," not "quotations." *See* Letter of Instinet, at 8. The Commission does not believe that such distinctions between the terms "order" and "quotation" are relevant for purposes of this Rule.

[50] A corresponding requirement in Form 17A-23, Part II, has been modified as well, for the reasons discussed above with regard to modification of the recordkeeping requirement in the Rule.

orders,"[51] or any other identifiable indicator that accurately reflects participant trading interest, as appropriate in light of system configuration. If applicable in light of system configuration, sponsors must express such number separately for priced and unpriced orders. In modifying this requirement, the Commission relies on the sponsor's knowledge of its system configuration to determine which statistics would provide the most accurate assessment of participant trading interest, and to retain those statistics accordingly.[52]

The Commission also has modified the Rule, in response to one commenter's concern, to clarify that a sponsor must be able to identify on a daily basis only those securities for which transactions have been executed through the system.[53]

4. Participant Notices

Three commenters requested clarification of the extent to which communications to individual participants or non-written communications must be preserved as notices to participants under paragraph (c)(2)(ii) of the Proposed Rule.[54] The Rule as adopted requires sponsors to preserve only those notices that are disseminated (whether through written or other means) generally to all participants, or to one or more classes of participants. The Rule does not require the sponsor to preserve communications directed solely to an individual participant.

D. Reporting Requirements

Under the Rule as adopted, a BDTS sponsor is required to file reports with the Commission (and, in certain circumstances, with the appropriate SRO), in accordance with Form 17A–23. Form 17A–23 contains three parts: (1) operation reports, including initial operation reports filed at least 20 calendar days prior to the operation of the system and subsequent operation reports filed as necessary prior to implementing material system changes; (2) quarterly reports filed within 30 calendar days after the end of the calendar quarter;[55] and (3) a final report filed within 10 calendar days after a sponsor ceases to operate the trading system. The operation reports would describe the system, its procedures for reviewing capacity, security and contingency planning, and protecting participant funds and securities (if an entity other than the sponsor will hold or safeguard participant funds or securities on a regular basis). It also would identify an appropriate system contact. The quarterly reports would contain summary trading information. The report notifying the Commission of cessation of operations would contain, in addition to the notification, a final transaction summary.

1. Filing Reports Prior to Operation or Implementation of a Material Change

The Rule requires initial operation reports to be filed at least 20 days prior to operation, and subsequent operation reports regarding material changes to be filed at least 20 days prior to implementing such material change, or, where it is commercially impracticable to do so, as soon as possible after the sponsor determines that it will implement such material change and in any event no later than 10 days following the implementation of such change.

The Commission notes that the Rule does not require system sponsors that alter the operation of their BDTS subsequent to filing an initial operation report to file additional or amended operation reports prior to beginning operation. In the Commission's experience, it is not uncommon for automated systems to be altered routinely to respond to participant comments or concerns, incorporate technological advances, or otherwise upgrade a system's operation. Accordingly, sponsors that file initial operation reports with the Commission might alter the operation of their BDTS subsequent to such filing, but prior to beginning operation. If a sponsor materially changes system operation subsequent to filing an initial operation report, but prior to beginning operation, the sponsor should contact the Division to apprise them of such material change.

The Commission also notes that currently, material changes to automated systems generally require significant planning and development prior to implementation. Accordingly, the Commission believes that most sponsors will be able to notify the Commission at least 20 days prior to implementing a material change. Nonetheless, if a sponsor is able to implement a material system change on a greatly expedited basis, the Commission recognizes that it may not be commercially feasible to notify the Commission 20 days prior to implementation without delaying implementation. In such circumstances, the Rule allows a sponsor to notify the Commission as soon as possible after it determines to implement a material change, but in any event no later than 10 days following the implementation of such change.

2. Availability of Reports to SROs

As adopted, the Rule requires sponsors to file Parts I and III of Form 17A–23 with both the Commission and the SRO that is its designated examining authority. The quarterly reports covered by Part II of Form 17A–23 are required to be filed only with the Commission; however, the sponsor must make such reports available to the appropriate SRO upon request.[56] Two commenters expressed concern that SRO access to information contained in reports filed pursuant to the Proposed Rule might adversely affect a BDTS's competitive position.[57] One commenter recommended that the Commission require SROs to adopt procedures to restrict access to BDTS reports to the SRO's surveillance personnel, or, in the alternative, dispense with the reporting obligation.[58]

The Commission recognizes that the activities of SROs as both market operators and market regulators may create tension between the SROs and SRO members. For example, documents obtained in the conduct of an SRO's regulatory duties may contain competitively sensitive information. Notwithstanding this, SROs must have access to relevant member information in order to fulfill their self-regulatory

[51] The Rule defines "system order" as any order or other communication or indication submitted by any system participant for entry into the system announcing an interest in purchasing or selling a security. The Rule also clarifies that the term "system order" does not include inquiries or indications of interest that are not entered into the system. 17 CFR 240.17a23(b)(4).

[52] The Commission expects sponsors that intend to fulfill this requirement by retaining and reporting statistics other than system orders will contact staff of the Division to discuss which statistics the sponsor wishes to retain and report instead.

[53] *See* Letter of ITG, at 2.

[54] See Letter of ABA, at 4; Letter of Instinet, at 10; and Letter of ITG, at 2.

[55] In the Proposing Release, the Commission solicited comments on the appropriate interval at which sponsors should file reports. See Proposing Release, supra note 3, 59 FR at 8373. No commenter addressed this issue. One commenter, however, requested that the Commission extend the time period for filing quarterly reports from 20 calendar days to 30 calendar days after the calendar quarter. See Letter of Instinet, at 11. The Rule has been modified accordingly.

[56] The Commission has determined that summary trading information filed pursuant to Part II of Form 17A–23 are not critical to the SROs' routine oversight of BDTSs, although such information is useful for the Commission for the reasons discussed herein and may be useful to SROs for non-routine oversight of BDTS sponsors. Accordingly, the Commission has revised the Rule to require BDTS sponsors to file reports pursuant to Part II of Form 17A–23 routinely with the Commission and to make such reports available to the appropriate SRO upon request.

[57] See Letter of ABA, at 4–5 and Letter of Instinet, at 12–13.

[58] See Letter of ABA, at 4–5.

obligations.[59] The Commission believes that information contained in reports filed pursuant to the Rule will be critical to appropriately tailoring SRO examination and oversight of BDTS sponsors to reflect the distinctive characteristics and concerns of automated trading systems. Accordingly, the Rule continues to make such information available to SROs designated as a BDTS's examining authority. In order to address potential competitive issues, the Rule provides for filing of Rule 17a–23 reports directly with surveillance personnel designated by the examining SRO. The Commission notes that access to information made available to an SRO in its regulatory capacity should be rigorously restricted to those personnel who require it for surveillance and regulatory oversight purposes only. The Commission strongly urges SROs to carefully assess, and revise where necessary, their internal policies and procedures for protecting the confidentiality of sensitive information obtained in the course of fulfilling SRO regulatory responsibilities.

3. Confidentiality of Reports

Two commenters requested that the Commission discuss whether reports filed pursuant to the Proposed Rule may be exempt from public disclosure under the Freedom of Information Act.[60] The Commission notes that reports filed pursuant to the Rule will be deemed to be confidential. The Commission considers such reports to be exempt from disclosure under the Freedom of Information Act ("FOIA").[61] The Commission will protect the confidentiality of reports filed pursuant to the Rule accordingly.[62]

E. Form 17A–23

Proposed Form 17A–23 would have required sponsors to report "lists of securities trading in the system," and to state whether it offers services that allow system participants to trade with entities outside of the United States. Commenters requested clarification that sponsors may comply with the Form by identifying the categories of securities that have actually traded in the system during the period covered by the report.[63] After reviewing the comments, the Commission believes that the information required pursuant to Part I of Form 17A–23 is sufficient to provide summary information regarding the categories of securities trading, and that submission of lists identifying individual securities in the quarterly filings under Part II of Form 17A–23 would not be useful. Accordingly, the Commission has deleted this requirement from the Form. The Commission also has modified Parts I and II of Form 17A–23 to clarify that sponsors must report whether entities located outside of the United States have access to the system, and describe the nature of such access and foreign participation in the system in reports filed pursuant to Part I of the Form. Finally, the Commission has modified Part I of the Form and paragraph (d)(1) of the Rule to require system sponsors to update the information filed in Part I of the Form at least 20 days prior to implementing a material change to system operation, or, where it is commercially impracticable to do so, as soon as possible thereafter when the sponsor determines that it will implement such material change (and in any event no later than 10 calendar days following the implementation of such change).

IV. Implementation Date

The Rule will become effective on June 1, 1995. The Commission has modified the Rule to allow sponsors of systems currently operating to submit the information required by Part I of Form 17A–23 no later than July 1, 1995 (one month following the effective date), to provide sponsors of existing systems adequate time to prepare this filing.[64]

As discussed above, certain BDTS sponsors are subject to staff no-action letters that require those sponsors to provide operation and trading information to the Division that is comparable to that required in Form 17A–23.[65] These staff no-action letters do not affect the obligation of any BDTS sponsor to comply with the Rule. Prior to effectiveness of the Rule, the Division will revise the conditions of no-action in each letter granted to a sponsor of an operating system that would be subject to the Rule, to eliminate duplicative reporting requirements. Sponsors of BDTSs subject to no-action letters that have further questions on complying with the Rule and conditions of no-action should contact the Division.

V. Competition Findings

Section 23(a)(2) of the Act[66] requires the Commission, in adopting rules under the Act, to consider the anti-competitive effects of such rules, if any, and to balance any impact against the regulatory benefits gained in terms of furthering the purposes of the Act. As discussed above, several commenters raised concerns regarding the competitive implications of the Proposed Rule. The Commission has considered the Rule in light of the comments and the standard cited in Section 23(a)(2). The Rule's establishment of reporting and recordkeeping requirements will not impose a significant burden on competition. All BDTSs will be subject to the same requirements, and the reporting and recordkeeping requirements, which are similar to those currently imposed on registered brokers and dealers, should not be unduly burdensome. In addition, the Commission has specifically considered competitive concerns relating to SRO access to such information.[67] For the reasons discussed above, the Commission believes that adoption of the Rule will not impose any burden on competition not necessary or appropriate in furtherance of the Act.

VI. Summary of Final Regulatory Flexibility Analysis and Paperwork Reduction Act

The Commission has prepared a Final Regulatory Flexibility Analysis ("FRFA") regarding Rule 17a–23, in accordance with 5 U.S.C. § 604. No public comment was received in response to the initial regulatory flexibility analysis. The FRFA notes the potential costs of operation and procedural changes that may be necessary to comply with the Rule. As more fully explained above, however, the Commission has determined that the proliferation of broker-dealer automated trading systems requires increased oversight to promote investor protection and to assess the impact of these systems on the securities markets. The Commission finds that the benefits of Rule 17a–23 outweigh the costs incurred by industry participants in complying with the Rule. A copy of the FRFA may be obtained by contacting Elaine M. Darroch, Attorney-Advisor, Office of Automation and International

[59] See, e.g., Exchange Act Section 15A(b), 15 U.S.C. 78o–3(b).

[60] See Letter of ABA, at 4; Letter of M&S, at 3.

[61] Such reports constitute examination, operating or condition reports of a financial institution, and, as such, are exempt from disclosure under FOIA pursuant to 5 U.S.C. § 552(b)(8).

[62] In addition, other exemptions from FOIA may be available, including the exemption provided by Section 552(b)(4) for trade secrets and commercial or financial information obtained from a person and privileged or confidential. The availability of this exemption depends upon a factual analysis which may require substantiation by the sponsor of the reporting BDTS.

[63] See Letter of Instinet, at 11 and Letter of ITG, at 2.

[64] Sponsors of existing BDTSs must submit a system description that is current as of the date of filing.

[65] See note 12, *supra*.

[66] 15 U.S.C. 78w(a)(2).

[67] See Availability of Reports to SROs, *supra*.

Markets, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, N.W. (Mail Stop 5–1), Washington, D.C. 20549.

No public comment was received in response to proposed Rule 17a–23 with respect to the Paperwork Reduction Act of 1980, 44 U.S.C. §§ 3501 et seq.

VII. Statutory Basis

The rules and regulations of the Commission are amended as follows, pursuant to the Securities Exchange Act of 1934 and particularly Sections 2, 3, 11A, 15(c), 17, and 23(a) thereof, 15 U.S.C. §§ 78b, 78c, 78k–1, 78o(c), 78q, and 78w(a).

List of Subjects in 17 CFR Parts 240 and 249

Reporting and recordkeeping requirements, Securities.

Text of Amendments

In accordance with the foregoing, Title 17, Chapter II of the Code of Federal Regulations is amended as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 is amended by adding the following citation:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78i, 78j, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78w, 78x, 78*ll*(d), 79q, 79t, 80a–20, 80a–23, 80a–29, 80a–37, 80b–3, 80b–4 and 80b–11, unless otherwise noted.

* * * * *

Section 240.17a–23 also issued under 15 U.S.C. 78b, 78c, 78o, 78q, and 78w(a);

* * * * *

2. Section 240.17a–23 is added to read as follows:

§ 240.17a–23 Recordkeeping and Reporting Requirements relating to Broker-Dealer Trading Systems.

(a) *Scope of section.* This section shall apply to any registered broker or dealer that acts as the sponsor of a broker-dealer trading system.

(b) *Definitions.* For purposes of this section:

(1) The term *registered broker or dealer* shall have the meaning ascribed to it in Section 3(a)(48) of the Act.

(2) The term *broker-dealer trading system* means any facility that provides a mechanism, automated in full or in part, for:

(i) Collecting, receiving, disseminating, or displaying system orders; and

(ii) Matching, crossing, or executing system orders, or otherwise facilitating agreement to the basic terms of a purchase or sale of a security between system participants, or between a system participant and the system sponsor, through use of the system or through the system sponsor.

(3) The term *sponsor* means any entity that organizes, operates, administers, or otherwise directly controls a broker-dealer trading system; and, if the system operator of such broker-dealer trading system is not a registered broker or dealer, any registered broker or dealer that, pursuant to contract, affiliation, or other agreement with the system operator, is involved materially on a regular basis with executing transactions in connection with use of the broker-dealer trading system, other than solely for its own account or as a participant in the broker-dealer trading system.

(4) The term *system order* means any order or other communication or indication submitted by any system participant for entry into a trading system announcing an interest in purchasing or selling a security. The term "system order" does not include inquiries or indications of interest that are not entered into a trading system.

(5) The term *system participant* means any person that is provided access to a trading system (whether through computer terminal, access codes, or other means) by a system sponsor for the purpose of effecting the purchase or sale of securities through use of such system.

(c) *Recordkeeping.* Every registered broker or dealer subject to this section pursuant to paragraph (a) of this section shall:

(1) Make and keep current the following records relating to the broker-dealer trading system:

(i) A record of participants in the broker-dealer trading system (identifying any affiliations between system participants and the system sponsor);

(ii) Daily summaries of trading in the broker-dealer trading system, including:

(A) Securities for which transactions have been executed through use of such system;

(B) Transaction volume (separately stated for trading occurring during hours when consolidated trade reporting facilities are and are not in operation), expressed with respect to stock in trades, shares and in dollar value, and expressed with respect to other securities in trades, number of units of securities and in par value, dollar value, or other appropriate commonly used measure of value of such securities; and

(C) Number of system orders, or other identifiable indicator that accurately reflects participant trading interest, as appropriate in light of configuration of the broker-dealer trading system (expressed separately for priced and unpriced orders, if applicable in light of system configuration);

(iii) Time-sequenced records of each transaction effected through the broker-dealer trading system, including date and time executed, price, size, security traded, counterparty identification information, and method of execution (if broker-dealer trading system allows alternative means or locations for execution, such as routing to another market, matching with limit orders, or executing against the system sponsor's quotations); and

(2) Preserve, for a period of not less than three years, the first two years in an easily accessible place, the following records relating to the broker-dealer trading system:

(i) All records required to be made pursuant to paragraph (c)(1) of this section; and

(ii) All notices provided by the system sponsor to system participants generally (or to one or more classes of system participant), whether written or communicated through the broker-dealer trading system or other automated means, including, but not limited to, notices addressing hours of system operations, system malfunctions, changes to system procedures, maintenance of hardware and software, instructions pertaining to access to the broker-dealer trading system.

(d) *Reporting.* (1) Every registered broker or dealer subject to this section pursuant to paragraph (a) of this section shall:

(i) File the information required by Part I of Form 17A–23 (§ 249.636 of this chapter) at least 20 calendar days prior to operating a broker-dealer trading system, or, if the sponsor is operating the broker-dealer trading system on June 1, 1995, no later than July 1, 1995;

(ii) During the operation of a broker-dealer trading system of which the broker or dealer is the sponsor, file the information described in Part IA of Form 17A–23 (§ 249.636 of this chapter) regarding a material change to operation of the broker-dealer trading system as described in any filing previously made with the Commission pursuant to paragraph (d)(1)(i) of this section, at least 20 calendar days prior to implementing such material change, or, where it is commercially impracticable to do so, as soon as possible thereafter when the sponsor determines that it will implement such material change, and in any event no later than 10 calendar days

following the implementation of such change;

(iii) During the operation of a broker-dealer trading system of which the broker or dealer is the sponsor, file the information described in Part II of Form 17A–23 (§ 249.636 of this chapter) within 30 calendar days after the end of each calendar quarter in which the broker-dealer trading system has operated after July 1, 1995; and

(iv) Within 10 calendar days after a broker-dealer trading system of which the broker or dealer is the sponsor ceases to operate, file the notice described in Part III of Form 17A–23 (§ 249.636 of this chapter).

(2) The reports provided for in paragraph (d) of this section shall be considered filed upon receipt at the Commission's principal office in Washington, DC. Duplicate originals of the reports provided for in paragraphs (d)(1)(i), (ii), and (iv) of this section must be filed with surveillance personnel designated as such by the self-regulatory organization that is the designated examining authority for the broker or dealer pursuant to § 240.17d-1 simultaneously with filing with the Commission. Duplicates of the reports required by paragraphs (d)(1)(iii) of this section must be provided to such surveillance personnel of such self-regulatory authority upon request. All reports filed pursuant to this paragraph (d) shall be deemed to be confidential.

(e) *Maintenance of records in alternative form.* The records required to be maintained and preserved pursuant to this section may be produced, reproduced and maintained pursuant to the provisions of § 240.17a-4(f).

(f) *Compliance with other recordkeeping and reporting rules.* Nothing in this section obviates the need for any broker or dealer to comply with any other applicable recordkeeping or reporting requirement in the Act and the rules and regulations thereunder. If the information in a record required to be made pursuant to this section is preserved in a record made pursuant to § 240.17a-3 or § 240.17a-4, or otherwise preserved by the sponsor (whether in summary or other form), paragraph (c) of this section shall not require the sponsor to maintain such information in a separate file, provided that the sponsor can promptly sort and retrieve the information as if it had been kept in a separate file as a record made pursuant to this section, and preserves the information in accordance with the time periods specified in paragraph (c)(2) of this section.

(g) *Maintenance of records by others.* The records required to be maintained and preserved pursuant to this section may be prepared or maintained by a service bureau, depository, or other recordkeeping service on behalf of the sponsor of a broker-dealer trading system, provided such entity complies with the provisions of § 240.17a-4(i). Agreement with such an entity shall not relieve the sponsor of a broker-dealer trading system from the responsibility to prepare and maintain records as specified in this section.

(h) *Furnishing copies of records.* Every broker or dealer subject to this section pursuant to paragraph (a) of this section shall furnish to any representative of the Commission promptly upon request, legible, true and complete copies of those records of the sponsor that are required to be preserved under this section.

(i) *Exemption from this section.* The Commission, by rule or order, may exempt any sponsor of a broker-dealer trading system from all or any of the provisions of this section, either unconditionally or on specified terms and conditions, if the Commission determines that such exemption is consistent with the public interest or the protection of investors.

PART 249—FORMS, SECURITIES EXCHANGE ACT OF 1934

3. The authority citation for Part 249 continues to read in part as follows:

Authority: 15 U.S.C. 78a, *et seq.*, unless otherwise noted;

* * * * *

4. Section 249.636 and Form 17A–23 are added to read as follows:

Note: The text of Form 17A–23 appears as Appendix A to this document and will not appear in the Code of Federal Regulations.

§ 249.636 Form 17A–23, information required of certain broker and dealer sponsors of broker-dealer trading systems pursuant to section 17 of the Securities Exchange Act of 1934 and § 240.17a–23 of this chapter.

This form shall be used by every registered broker and dealer that is required to file reports under § 240.17a–23 of this chapter.

By the Commission.

Dated: December 20, 1994.

Margaret H. McFarland,

Deputy Secretary.

BILLING CODE 8010–01–P

Official Use Only

APPENDIX A

OMB Approval
OMB No.: 3235-0442
Expires: 4-30-97

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 17A-23

Information Required of Registered Broker or Dealer Sponsor of Broker-Dealer Trading System Pursuant to Section 17 of the Securities Exchange Act of 1934 and Rule 17a-23 Thereunder

READ ALL INSTRUCTIONS PRIOR TO COMPLETING FORM

FORM 17A-23 Page 1	Indicate if this Report is submitted pursuant to: Part I _____ Part IA _____ Part II _____ Part III _____ If submitted pursuant to Part II or Part III, state period covered by Report: _____ through _____ mm/dd/yy mm/dd/yy

SPONSOR INFORMATION

NAME OF BROKER-DEALER TRADIN ; SYSTEM:

NAME OF REGISTERED BROKER OR DEALER SPONSOR OF SYSTEM:
FIRM CRD NO. _____

NAME OF SYSTEM OPERATOR:
(If different from Registered Broker or Dealer Sponsor of System)

ADDRESS OF PRINCIPAL PLACE OF BUSINESS OF REGISTERED BROKER OR DEALER SPONSOR:
(Do not use P.O. Box No.)

(No. and Street)

(City) (State) (Zip Code)

NAME AND TELEPHONE NUMBER OF PERSON TO CONTACT WITH REGARD TO THIS REPORT:

EXECUTION

The registered broker or dealer sponsor submitting this form and the executing official hereby represent that all the information contained herein is true, correct and complete.

Manual signature of Official responsible for form:	Title:
Name of Official responsible for form:	Date executed (Month/Day/Year):

FORM 17A-23 Page 2	READ ALL INSTRUCTIONS PRIOR TO COMPLETING FORM

PART I: INITIAL OPERATION REPORT
(To be filed at least 20 calender days prior to operation)

Provide the following information:

1. State the date the sponsor (or system operator, if other than sponsor) intends to begin operating the system.

2. State the securities or types of securities eligible for trading on or through the facilities of the system including whether securities of foreign private issuers will be eligible for trading on or through the system.

3. State the name and address of any entity that will be involved in the operation of the system, or will execute, clear or settle transactions on behalf of the sponsor or system participants in connection with operation of the system (other than system sponsor). Briefly describe the nature of such involvement and the responsibilities of such entity with respect to operation of the system and/or execution, clearance, or settlement of transactions in connection with operation of the system.

4. Briefly describe the sponsor's criteria for granting access to the system, and the manner of operation of the system, including the procedures governing entry of quotations and orders into the system; access to the system; execution, reporting, clearance and settlement of transactions in connection with the system; and procedures for ensuring participant compliance with system usage guidelines. Attach copy of system user's manual, if available.

5. Briefly describe the sponsor's procedures for reviewing system capacity, and security and contingency planning procedures.

6. If any entity other than the sponsor will hold or safeguard participant funds or securities on a regular basis, briefly describe the controls that will be implemented to ensure the safety of those funds and securities.

7. State whether entities located outside the United States will have access to the system. If so, describe the nature of such access and the extent to which such entities may participate in the system.

PART IA: MATERIAL CHANGE TO OPERATION OF SYSTEM
(To be filed at least 20 calendar days prior to implementation of a material change to system operation, if commercially practicabl

Describe any material changes to the information previously filed by sponsor with the Commission pursuant to Part I of this Form.

PART II: QUARTERLY REPORT
(To be filed within 30 calendar days after end of calendar quarter)

Provide the following information:

1. Total volume and average daily volume of transactions effected through the system during the period covered by this report and year-to-date aggregates of these numbers, expressed in (a) number of units of securities (for transactions in stock, number of shares); (b) number of transactions; and (c) monetary value (for transactions in stock, dollar value; for transactions in securities other than stock, dollar value or other appropriate commonly used measure of value of such securities). Provide separate unit, transaction, and monetary volume and average daily volume information for the period covered by the report reflecting: (a) system activity in securities listed on a registered national securities exchange, if applicable; (b) system activity in securities quoted on the National Association of Securities Dealers' Nasdaq service, if applicable; (c) system activity occuring during regular trading hours of the primary market for type of securities trading on system (for stock, the New York Stock Exchange), and (d) system activity occurring outside regular trading hours of the primary market for type of securities trading on system (for stock, the New York Stock Exchange). Identify the primary market and hours for items (c) and (d).

2. Total number of system orders, or other identifiable indicator that accurately reflects participant trading interest, as appropriate in light of system configuration (expressed separately for priced and unpriced orders, if applicable in light of system configuration).

PART III: REPORT OF CEASING TO OPERATE OR SPONSOR SYSTEM
(To be filed within 10 calendar days after sponsor ceases to operate or sponsor System)

Provide the following information:

1. State the date the sponsor ceased to operate or sponsor the system. State whether another entity will continue to operate or sponsor the system, and provide the name, address, and telephone number of such entity, if available.

2. Provide information requested in Part II for the period beginning on the day after the period covered by the most recent Form 17A-23, Part II filing, and ending on the date stated in item 1 of this Part (date sponsor ceased to operate or sponsor the system).

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

INSTRUCTIONS FOR COMPLETING FORM 17A–23

I. Terms

Unless the context clearly indicates otherwise, terms used in this Form have the meaning ascribed to them in the Securities Exchange Act of 1934 and Rule 17a–23 thereunder.

II. Who Must File; When to File

Rule 17a–23 requires that every registered broker or dealer that acts as the sponsor of a broker–dealer trading system: file Part I of Form 17A–23 at least 20 calendar days prior to operating or sponsoring a broker–dealer trading system; file Part IA of Form 17A–23 regarding regarding a material change to operation of the system as described in any filing previously made with the Commission pursuant to Part I of Form 17A–23 at least 20 calendar days prior to implementing such material change, or, where it is commercially impracticable, as soon as possible thereafter when the sponsor determines that it will implement such material change (but in any event, no later than 10 calendar days following the implementation of such change); file Part II of Form 17A–23 within 20 calendar days after the end of each calendar quarter during which the sponsor operates or sponsors a broker–dealer trading system; and file Part III of Form 17A–23 within 10 calendar days after the sponsor ceases to operate or sponsor a broker–dealer trading system.

III. Number of Copies; How and Where to File

File the original and one copy of each Form 17A–23 filing with the SEC at Office of Automation and International Markets, Division of Market Regulation, 450 5th Street, N.W., Washington, DC 20549. Simultaneously with the filing of the original with the SEC, file one duplicate copy of each Part I, Part IA, and Part III Form 17A–23 filing with surveillance personnel designated by the self–regulatory organization that is the designated examining authority for the sponsor pursuant to Rule 17d–1. The sponsor must keep an exact copy of the filing for its records. All copies must be legible. The filing date of any Form 17A–23 filing is the date of its actual receipt by the SEC, provided that the filing complies with applicable requirements.

IV. Format of Filing

A sponsor may use the printed Form 17A–23 or a reproduction of it. In either case, complete page 1 of Form 17A–23 in the format provided. Number each page following page 1 consecutively, give the name of the broker–dealer trading system and the date at the top of each page, and identify the Part to which the information on that page relates.

V. Completing Form

If the sponsor of a broker–dealer trading system has not previously filed a Form 17A–23 with respect to the system, complete page 1 and Part I. If the sponsor has previously completed Part I in a Form 17A–23 filed with respect to the system, and continues to operate or sponsor the system: complete page 1 and Part IA only, if filing Form 17A–23 as required prior to implementing a material change to system operation; complete page 1 and Part II only, if filing Form 17A–23 as required quarterly. If the sponsor has ceased to operate or sponsor the system, complete page 1 and Part III only. Provide information required by each Part of the Form by typing or printing the text of each item followed by the response thereto. Numerical information required by Parts II and III (item 2) may be provided in chart form. For numerical responses, clearly indicate the information each number represents and the item number in the Form which requests such information. Print or type all items and responses. If sponsor intends to provide a number other than the number of system orders in response to Item 2, Part II, contact the Office of Automation and International Markets, Division of Market Regulation, prior to filing. If the information requested by any item is available in printed form, the printed material may be attached as an exhibit and referenced in the response to the item.

VI. Sponsors that Operate More Than One Broker–Dealer Trading System

Sponsors that operate more that one broker–dealer trading system may file reports on Form 17A–23 relating to one or more systems. In each filing of Form 17A–23 that relates to more than one system operated by the sponsor, provide the required information separately for each system.

[FR Doc. 94–31656 Filed 12–27–94; 8:45 am]
BILLING CODE 8010–01–C

NASD NOTICE TO MEMBERS 95-25

SEC Approves NASD And Options Exchanges' Proposals Regarding Information Storage

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 Securities and Exchange Commission has approved proposals by each of the five registered national options exchanges and the National Association of Securities Dealers, Inc. (the SROs) that provide member firms with more flexibility in how they store account statements and other information for options customers (options account information) for supervisory purposes. This circular describing the rule change has been prepared by the SROs acting jointly as members of the Options Self-Regulatory Council (OSRC).[1]

Discussion

SRO rules uniformly require the branch office servicing an options customer's account and the principal supervisory office having jurisdiction over that branch office retain account statements and other financial and background information for the account for supervisory purposes. With the advances in data storage and retrieval systems, such as optical disks, fax machines, computers, and microfiche, and with the increased expenses of storing records on-site in major financial centers such as New York City, member firms increasingly have been storing their records away from their principal supervisory offices. Because of the record retention requirements for options accounts, these arrangements have necessitated action by the OSRC. Specifically, on a case-by-case basis, member firms have obtained no-action positions from the OSRC providing that such off-site storage arrangements are consistent with the record retention requirement rules so long as the documents are readily accessible and promptly retrievable.

To ensure that all member firms are aware of the OSRC's position with respect to the storage of options account information off-site, the SROs proposed to incorporate the OSRC's no-action position into their respective rules. Specifically, with the Rule change, member firms are permitted to satisfy their record retention requirements for options accounts by storing required options account information in locations other than the respective principal supervisory office for the options accounts, provided such account information is readily accessible and promptly retrievable.[2]

Even though the rule change affords member firms the opportunity to store options account information in a more cost-effective manner in off-site locations, member firms are reminded that they are still obligated to discharge their supervisory responsibilities with respect to their options accounts. In this connection, to ensure that off-site document storage arrangements will not jeopardize or constrain members' supervisory activities, members must have procedures and mechanisms in place to assure that options account information is readily accessible and promptly

[1] The OSRC is a committee comprised of representatives from each of the options exchanges and the NASD that was created pursuant to the plan submitted by the options exchanges and the NASD under Rule 17d-2 of the Act (17d-2 Plan). The 17d-2 Plan was adopted to reduce regulatory duplication relative to options-related sales practice matters for a large number of firms that are currently members of two or more SROs. The purpose of the OSRC is to administer the 17d-2 Plan and to address options-related sales practice matters in a common forum. See also NYSE Information Memo 95-7 (February 16, 1995).

[2] See American Stock Exchange Rule 922; Chicago Board Options Exchange Rule 9.8; Section 33(b)(20) of the NASD Rules of Fair Practice; New York Stock Exchange Rule 722; Pacific Stock Exchange Rule 9.18; and Philadelphia Stock Exchange Rule 1025.

retrievable. For purposes of this Rule, a document will be deemed to be readily accessible and promptly retrievable if it is retrievable by noon of the next business day. In addition, member firms are reminded that this rule change does not modify the record retention requirement with respect to branch offices—copies of options account information must still be retained at branch offices.

Questions regarding the rule change may be directed to these SRO representatives:

AMEX:
Roland Wyatt
(212) 306-1506

CBOE:
Larry Bresnahan
(312) 786-7713

NASD:
Tom Gira
(202) 728-8957

NYSE:
Patricia Dorilio
(212) 656-2744

PHLX:
Dianne Anderson
(215) 496-5184

PSE:
Dave Semak
(415) 393-7948

Text Of Amendments To Section 33(b) Of The NASD Rules Of Fair Practice

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

Section 33 Of NASD By-Laws

* * *

Section 33(b)(17) Maintenance of Records

(A) No change.

(B) Background and financial information of customers who have been approved for options trading shall be maintained at both the branch office servicing the customer's account and the principal supervisory office having jurisdiction over that branch office. Copies of account statements of options customers shall also be maintained at both the branch office supervising the accounts and the principal supervisory office having jurisdiction over that branch for the most recent six-month period. With respect solely to the above-noted record retention requirements applicable to principal supervisory offices, however, the customer information and account statements may be maintained at a location other than the principal supervisory office if such documents and information are readily accessible and promptly retrievable. Other records necessary to the proper supervision of accounts shall be maintained at a place easily accessible both to the branch office servicing the customer's account and to the principal supervisory office having jurisdiction over that branch office.

Section 33(b)(18) and Section 33(b)(19) No change.

Section 33(b)(20) Supervision of Accounts

(A) through (C) No change.

(D) Headquarter's Review of Accounts. Each member shall maintain at the principal supervisory office having jurisdiction over the office servicing customer accounts, or have readily accessible and promptly retrievable, information to permit review of each customer's options account on a timely basis to determine (i) the compatibility of options transactions with investment objectives and with the types of transactions for which the account was approved; (ii) the size and frequency of options transactions; (iii) commission activity in the account; (iv) profit or loss in the account; (v) undue concentration in any options class or classes; and (vi) compliance with the provisions of Regulation T of the Federal Reserve Board.

NASD NOTICE TO MEMBERS 95-26

Conversion To T+3 Settlement, Reg. T, And SEC Rule 15c3-3(m), And Ex-Dividend 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

Executive Summary

Securities and Exchange Commission (SEC) Rule 15c6-1, which establishes three business days as the standard time period for settling transactions in most securities (T+3), is effective June 7, 1995. The conversion to a T+3 settlement period takes place in two steps, using two double settlement days. The T+3 changeover also affects the time periods within which members may request extensions of time pursuant to Regulation T (Reg. T) of the Board of Governors of the Federal Reserve System (Fed) and Rule 15c3-3(m) of the Securities and Exchange Act of 1934 [SEC Rule 15c3-3(m)].

Reg. T

Pursuant to Section 220.8(b)(1) and (4) of Reg. T, a broker/dealer must promptly cancel or otherwise liquidate a customer purchase transaction in a cash account if full payment is not received within a specified time period from the date of purchase or, pursuant to Section 220.8(d)(1), make application to extend the time period specified. Late last year, the Fed amended Reg. T to eliminate any conflicts with T+3 settlement.

Reg. T now requires payment within one payment period of trade date; payment period is the number of business days in the standard U.S. securities settlement cycle (SEC Rule 15c6-1) plus two business days. Effective June 7, 1995, requests for extensions of time are due five business days after trade date.

In the Trade Date-Settlement Date Schedule, the date by which members must take action is shown in the column entitled "Reg. T Date."

SEC Rule 15c3-3(m)

Unless they request an extension, Paragraph (m) of SEC Rule 15c3-3 requires broker/dealers to buy-in any securities sold by a customer (other than a short sale) if they have not received the securities within 10 business days after settlement date. Effective June 7, 1995, requests for extensions of time for "regular way" trades are due 13 business days after trade date.

In the Trade Date-Settlement Date Schedule, the date by which members must take action is shown in the column titled "SEC Rule 15c3-3(m) Date."

Note: Members may refer to the *Member Firm Quick Reference Guide* to determine the current time periods provided in requests for extensions of time and the limits as to the number of extensions permitted by reason code and by customer. A revised version of the Guide will be available to members soon.

T+3 Implementation: Trade Date-Settlement Date Schedule

The following schedule represents the implementation of the conversion from a five business day settlement cycle to three business days. The Nasdaq Stock Market℠ and the securities exchanges will settle "regular way" transactions on the business days noted below. Wednesday, June 7, 1995, will be the first trade date for the three business day settlement period.

Trade Date	Settlement Date	Reg. T Date	SEC Rule 15c3-3(m) Date
May 31	June 7	June 9	June 21
June 1	8	12	22
2	9	13	23
5	9	13	23
6	12	14	26
7	12	14	26
8	13	15	27

Note: Transactions made on June 5 will settle in four business days and will be combined with transactions made on the previous business day, June 2, for settlement on June 9. Transactions made on June 6 will settle in four business days and will be combined with transactions made on the next business day, June 7, for settlement on June 12.

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.

Ex-Dividend Dates

Effective June 7, 1995 the procedure for establishing ex-dividend dates will change from four business days before record date to two business days. Additionally, the standard due-bill redemption date for securities quoted ex-dividend after the payable date will be three business days after the payable date instead of five business days. To accommodate the conversion to T+3 settlement, special ex-dividend dates have been established and are reflected in the following schedule.

Record Date	Ex-Dividend Date
June 2	May 26
5	30
6	31
7	June 1
8	2
9	6
12	8

Note: There will be no ex-dividends on June 5 and June 7.

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. Questions regarding the submission of extension requests through the ARRS System may be directed to NASD Regulatory Systems at (800) 321-6273, or your local NASD District Office.

NASD NOTICE TO MEMBERS 95-27

NASD Introduces Revised Free-Riding Questionnaire And Form FR-1

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

As a result of recent amendments to the Free-Riding and Withholding Interpretation of the NASD Board of Governors under Article III, Section 1 of the NASD Rules of Fair Practice, the NASD revised the questionnaire that is used to review whether an offering was distributed according to the Interpretation. Revisions also were made to NASD Form FR-1, which may be used by members in their dealings with non-U.S. broker/dealers or banks. Copies of the revised forms follow this Notice.

Background

The NASD adopted the Interpretation based on the premise that members are obligated to make a bona fide public distribution at the public offering price of securities of a public offering that trade at a premium in the secondary market whenever such secondary market begins (a hot issue), regardless of whether such securities are acquired by the member as an underwriter, as a selling group member, from a member participating in the distribution as an underwriter or a selling group member, or otherwise. The Interpretation includes specific prohibitions and restrictions as a guide for members participating in an offering of hot-issue securities.

On December 7, 1994, the Securities and Exchange Commission (SEC) approved several amendments to the Interpretation. *Notice to Members 95-7* describes the amendments in detail. These changes necessitated revisions to the questionnaire used by the NASD in reviewing offerings for compliance with the Interpretation and to NASD Form FR-1, which may be used by members to obtain assurances from non-U.S. broker/dealers or banks that no sales will be made by them in contravention of the Interpretation.

Free-Riding Questionnaire

In its review for compliance with the Interpretation, the NASD issued a questionnaire to the managing underwriter and to members participating in the distribution of the hot issues. Members must complete the questionnaire and forward it to the appropriate NASD District Office. The revised questionnaire is divided into four sections:

• Section I, overall figure from the managing underwriter;

• Section II, overall figures from all other underwriters, selling group members, and participants in the distribution;

• Section III, breakdown of the distribution by the participant; and

• section IV, detailed information on sales to restricted accounts.

Sections I And II

In the first two sections, a member must indicate the total number of securities that have been confirmed by the firm. For this questionnaire, "confirmed" means the number of hot-issue securities allocated to the firm for distribution and for which the firm has issued a confirmation/comparison reflecting the full details of such sales to retail customers, institutional accounts, or other broker/dealers. When participating in a distribution of hot-issue securities, broker/dealers are responsible for ensuring compliance with the Free-Riding and Withholding Interpretation for all securities allocated and confirmed by that broker/dealer, including shares billed and delivered on behalf of others, such as designated orders, group

sales, and directed sales.

A member completes Section I **or** Section II of the questionnaire. Section I is completed by the managing underwriter **only**. Section II is completed by all underwriters, selling group members, and other participants in the distribution, except for the managing underwriter.

Section III

All members must complete Section III. In this section, a member indicates the total number of securities distributed in each of 10 categories. The categories are addressed in the questionnaire in the same basic order in which they are addressed in the Interpretation. Unless otherwise noted, a member must provide detailed information on these sales in Section IV.

The figures reported in Section III are final figures after a member makes any cancellations and reallocations. Members should note that the total figure in Section III should equal the total number of securities confirmed in Section I or Section II.

Section IV

Section IV requires a member to provide detailed information on sales that were made to restricted accounts. The Interpretation includes specific circumstances in which it is permissible to sell to a restricted account, provided the member demonstrates compliance with the applicable provisions of the Interpretation.

NASD Form FR-1

For sales to a non-U.S. broker/dealer or bank, which is not participating in the distribution as an underwriter, the selling member must make an affirmative inquiry regarding the ultimate purchasers and comply with certain recordkeeping requirements. However, the Interpretation provides that a member may fulfill these obligations by having the non-U.S. broker/dealer or bank execute Form FR-1, or a reasonable facsimile of it.

In completing Form FR-1, the non-U.S. broker/dealer or bank gives the selling member a blanket assurance that no sales will be made in contravention of the provisions of the Interpretation. This form, which also was revised to conform with the recent amendments, is reprinted following this Notice. Members may reproduce copies of it or, as provided in the Interpretation, obtain other written assurance from the non-U.S. broker/dealer or bank.

* * *

Questions about the amendments to, or other provisions of, the Interpretation, should be directed to the NASD Office of General Counsel at (202) 728-8953. Questions regarding the Free-Riding Questionnaire or NASD Form FR-1 may be directed to Erin Gilligan, District Coordinator, Compliance Department, at (202) 728-8946.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

DATE

KEYBOARD()

RE: KEYBOARD() **Offering Date:** KEYBOARD()

INSTRUCTIONS: *Each member is required to complete either Section I or Section II based upon the capacity in which they acted in the distribution of the new issue. Sections III and IV must be completed by all firms for their "confirmed"* securities. It is the executing broker/dealer's responsibility to ensure that securities were distributed in compliance with the Free-Riding and Withholding Interpretation.*

SECTION I. TO BE COMPLETED BY THE MANAGING UNDERWRITER ONLY

A. Total number of securities offered for public distribution: (Include any additional shares received from the issuer as part of any over-allotment provision.) _____

B. Total number of securities allocated to other underwriters and selling group members: _____

C. Total number of securities confirmed* by your firm to retail and institutional customers, including all shares billed and delivered on behalf of others, designated orders, group sales, directed sales, etc.: _____

SECTION II. TO BE COMPLETED BY ALL UNDERWRITERS, SELLING GROUP MEMBERS AND OTHER PARTICIPANTS IN THE DISTRIBUTION

A. Total number of securities confirmed* by your firm to retail and institutional customers. (Do not include shares billed and delivered on your behalf by the managing underwriter, designated orders, group sales, directed sales, etc.): _____

B. Indicate capacity in which your firm participated in the offering:

- ☐ Underwriter
- ☐ Selling group
- ☐ Other (define) _____

* For purposes of this questionnaire, "confirmed" means the number of new issue securities allocated to the firm for distribution purposes and for which the firm has issued a confirmation/comparison reflecting the full details of such sale to retail customers, institutional accounts or other broker/dealers. When participating in a distribution of new issue securities, broker/dealers are responsible for ensuring compliance with the Free-Riding and Withholding Interpretation for all securities allocated and confirmed by that broker/dealer.

SECTION III. BREAKDOWN OF SECURITIES DISTRIBUTED BY YOUR FIRM

INSTRUCTIONS: *Indicate total number of securities distributed in each category and, unless otherwise noted, provide detailed information in Section IV, "Sales to Restricted Accounts". This breakdown should contain the final figures after giving effect to all cancellations and reallocations. For additional information regarding categories, please refer to the Board of Governors Interpretation "Free-Riding and Withholding" under Article III, Section 1, of the Rules of Fair Practice.*

1. Securities held in a firm account. _____

2. Sales to any officer, director, general partner, employee or agent of the member or any other broker/dealer, or to persons associated with the member or with any other broker/dealer, or to a member of the immediate family of such person. _____

Indicate the number of shares/units that were sold pursuant to the following provisions:

(A) Sales to persons associated with broker/dealers whose business is limited to investment company/variable contract securities or direct participation programs.
Number of shares/units _____

(B) Sales to a member of the immediate family of a person associated with a member who is not supported directly or indirectly by that person if the sale is by a broker/dealer other than that employing the restricted person and the restricted person has no ability to control the allocation of the hot issue.
Number of shares/units _____

It is not necessary to complete Section IV for items 2(A) and (B).

3. Sales to a person who is a finder with respect to the public offering or to any person acting in a fiduciary capacity to the managing underwriter, including among others, attorneys, accountants and financial consultants, or to any other person who is supported directly or indirectly, to a material extent, by any person specified in this paragraph. _____

4. Sales to any senior officer of a bank, savings and loan institution, insurance company, investment company, investment advisory firm or any other institutional type account, (including, but not limited to hedge funds, investment partnerships, investment corporations, or investment clubs) domestic or foreign, or to any person in the securities department of, or to any employee or any other person who may influence or whose activities directly or indirectly involve or are related to the function of buying and selling securities for any bank, savings and loan institution, _____

insurance company, investment company, investment advisory firm, or other institutional type account, domestic or foreign, or to any other person who is supported directly or indirectly, to a material extent, by any person specified in this paragraph.

5. Sales to any account in which any person specified under paragraphs (1), (2), (3), or (4) has a beneficial interest. _____

6. Sales to other domestic broker/dealers for bona fide public customers, other than those enumerated in paragraphs (1)(2)(3)(4) or (5) above. _____

Name of Broker/Dealer	No. of Shares/Units	Written Representation Received (pursuant to paragraph 6)	
_____	_____	Yes	No
_____	_____	Yes	No
_____	_____	Yes	No

It is not necessary to complete Section IV for item 6.

7. Sales to any domestic bank, domestic branch of a foreign bank, trust company or other conduit for an undisclosed principal. _____

(A) Indicate the number of shares/units that were sold based upon assurances obtained that ultimate purchasers were not restricted persons.
Number of shares/units _____

It is not necessary to complete Section IV for item 7 (A).

8. Sales to a foreign broker/dealer or bank. _____

Indicate the number of shares/units that were sold pursuant to the following conditions.

(A) Sales by a foreign broker/dealer or bank participating in the distribution as an underwriter were made in accordance with provisions of underwriting agreement.

Number of shares/units _____

(B) Affirmative inquiry was obtained that ultimate purchasers were not restricted persons.
Number of shares/units _____

It is not necessary to complete Section IV for items 8(A) and (B).

9. Sales to an investment partnership or corporation, domestic or foreign (except companies registered under the Investment Company Act of 1940) including but not limited to hedge funds, investment clubs, and other like accounts. _____

Indicate the number of shares/units that were sold pursuant to the following conditions:

(A) "Carve out" mechanism was utilized.
Number of shares/units _____

(B) Determination was made based upon file containing information on all persons having a beneficial interest or the opinion of counsel or accountant was obtained.
Number of shares/units _____

It is not necessary to complete Section IV for items 9 (A) and (B).

10. Sales to public customers. _____

It is not necessary to complete Section IV for item 10.

TOTAL (1 through 10) _____
Please note that the total should be equal to total securities confirmed by your firm as noted in Section I or II.

Indicate the number of shares/units that were originally sold to a restricted account and were subsequently cancelled prior to the end of the first business day after the date on which secondary market trading begins and were reallocated to an unrestricted account. _____ ☐ Not applicable

_____ _____
Signature of Principal Title

NOTE: *Questionnaires should be returned to your District Office by the date specified.*

SECTION IV. SALES TO RESTRICTED ACCOUNTS

PLEASE NOTE THAT IN CERTAIN CIRCUMSTANCES AS SET FORTH IN THE INTERPRETATION, IT IS PERMISSIBLE TO SELL TO A RESTRICTED ACCOUNT. HOWEVER, IT IS THE OBLIGATION OF THE MEMBER TO DEMONSTRATE COMPLIANCE WITH THE APPLICABLE PROVISIONS OF THE INTERPRETATION.

REPORTING MEMBER_____

ISSUE:_____

DATE OF PUBLIC OFFERING:_____

NUMBER OF SHARES /UNITS	NAME OF PURCHASER	NAME OF REGISTERED REPRESENTATIVE (HANDLING A/C)	CATEGORY REPORTED IN SECTION III	INDICATE EMPLOYMENT CLASSIFI-CATION, FAMILY MEMBER RELATIONSHIP, ETC. OF PURCHASER 1/	INDICATE WHETHER ISSUER -DIRECTED SALES, STAND-BY ARRANGEMENT SALES, OR SALES TO VENTURE CAPITAL INVESTORS 2/

1/ SALES ARE PERMITTED TO MEMBERS OF THE IMMEDIATE FAMILY PROVIDED THAT SUCH PERSONS DO NOT CONTRIBUTE DIRECTLY OR INDIRECTLY TO THE SUPPORT OF SUCH MEMBER OF THE IMMEDIATE FAMILY; SECURITIES WERE SOLD TO SUCH PERSONS IN ACCORDANCE WITH THEIR NORMAL INVESTMENT PRACTICE AND THAT THE AGGREGATE OF THE SECURITIES SO SOLD IS INSUBSTANTIAL AND NOT DISPROPORTIONATE. TO DEMONSTRATE INVESTMENT HISTORY AT YOUR FIRM OR ANOTHER BROKER/DEALER, PLEASE SUBMIT A TRANSCRIPT OR OTHER EVIDENCE FOR EACH ACCOUNT. TRANSCRIPT SHOULD INCLUDE ACCOUNT'S PRACTICE PRIOR TO OFFERING (I.E., 1 YEAR).

2/ SALES OF ISSUER-DIRECTED SECURITIES, SALES PURCHASED PURSUANT TO A STAND-BY ARRANGEMENT AND SALES TO VENTURE CAPITAL INVESTORS, ARE NOT SUBJECT TO PROVISIONS OF THE INTERPRETATION PROVIDED THE CONDITIONS STIPULATED IN THE INTERPRETATION ARE MET.

NASD FORM FR-1

Representation from Non-United States Broker/Dealers or Banks regarding NASD Board of Governors Interpretation with respect to "Free-Riding and Withholding" under Article III, Section I, of the Rules of Fair Practice.

Date _____

Name of Non-United States Broker/Dealer or Bank _____
Address _____

Pursuant to the obligations imposed upon members in their dealings with Non-United States broker/dealers or banks under paragraph 8 (b) of the Interpretation, this form gives assurances to (selling member name) _____ that no sales will be made in contravention of the provisions of this Interpretation.

It is our understanding that the securities falling within the scope of the Interpretation are those of an issue which trade at a premium in the secondary market whenever such secondary market begins. We further understand that the Interpretation prohibits:

1. Sales to any broker/dealer, including a member of the National Association of Securities Dealers, Inc. (NASD); provided, however, a purchasing firm may sell all or part of the securities acquired as described above to another member broker/dealer upon receipt from the latter, written assurance that such a purchase would be made to fill orders from bona fide public customers, other than those enumerated in paragraphs (2), (3), (4) or (5) below, at the public offering as an accommodation to them and without compensation for such.

2. Sales to any officer, director, general partner, employee or agent of the member or any other broker/dealer, or to persons associated with the member or with any other broker/dealer, or to a member of the immediate family of any such person. This provision does not apply to:

1. Sales to persons associated with broker/dealers whose business is limited to the purchase or sale of either investment company/variable contract securities or direct participation programs.
2. Sales to a member of the immediate family of a person associated with a member who is not supported directly or indirectly to a material extent by such person if the sale is by the broker/dealer other than that employing the restricted person and the restricted person has no ability to control the allocation of the hot issue.

3. Sales to a person who is a finder with respect to the public offering or to any person acting in a fiduciary capacity to the managing underwriter, including among others, attorneys, accountants and financial consultants, or to any other person who is supported directly or indirectly, to a material extent, by any person specified in this paragraph.

4. Sales to any senior officer of a bank, savings and loan institution, insurance company, investment company, investment advisory firm or any other institutional type account, (including, but not limited to hedge funds, investment partnerships, investment corporations, or investment clubs) domestic or foreign, or to any person in the securities department of, or to any employee or any other person who may influence or whose activities directly or indirectly involve or are related to the function of buying and selling securities for any bank, savings and loan institution, insurance company, investment company, investment advisory firm, or other institutional type account, domestic or foreign, or to any other person who is supported directly or indirectly, to a material extent, by any person specified in this paragraph.

5. Sales to any account in which any person specified under paragraphs (1), (2), (3), or (4) has a beneficial interest provided that:
   1. Sales to members of the immediate family of persons enumerated above in paragraph (2), may be made if such persons do not contribute directly or indirectly to the support of such member of the immediate family; and
   2. Sales may be made to persons specified under paragraphs (3) and (4), if the firm is prepared to demonstrate that the securities were sold to such persons in accordance with their normal investment practice, that the aggregate of the securities so sold is insubstantial and not disproportionate in amount as compared to the sales to members of the public and that the amount sold to any one of such persons is insubstantial in amount.

We understand that by providing Form FR-1 to the aforementioned NASD member we are asserting that no sales were made in contravention of the provisions of the Interpretation.

_____ _____

Signature of Executive Title

**The term immediate family shall include parents, mother-in-law or father-in-law, husband or wife, brother or sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law, children, and any other person who is supported directly or indirectly, to a material extent by the member or other person specified above.*

Form FR-1 3/95

NASD NOTICE TO MEMBERS 95-28

Treasury Provides Government Securities Broker/Dealers With Exemptive Relief In Calculating Haircuts For Options On Certain Mortgage-Backed Securities

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 Department of the Treasury (Treasury) is granting an exemption from the haircut treatment for written mortgage-backed options under Section 402.2a of the Treasury regulations implementing the Government Securities Act of 1986. Treasury consulted with the staff of the Securities and Exchange Commission (SEC) who did not object to the exemption, before granting it.

Discussion of the Exemption

The exemption, available to all registered government securities broker/dealers subject to the capital requirements of Section 402.2, is applicable to written over-the-counter options on mortgage-backed securities, provided the underlying fixed-rate mortgage-backed security is a Treasury Market Risk Instrument (TMRI), as defined in Section 402.2(e). The current Treasury haircut for a position in a 30-year pass-through, fixed-rate mortgage-backed security, that is a TMRI, is 3.3 percent. This haircut percentage recognizes the shorter effective maturity of a 30-year pass-through security, due to the repayment of its principal during the security's life.

Since the risk of holding a position in mortgage-backed securities options derives from the risk inherent in a position in the underlying security, Treasury determined to apply the same haircut factor to both types of instruments. Treasury's exemption allows a registered government securities broker/dealer to calculate its market risk haircut for such options by applying a 3.3 percent haircut factor in lieu of the factor prescribed in SEC Rule 15c3-1a (17 CFR 240.15c3-1a, Appendix A) and then completing the computation of the Other Securities Haircut as outlined in Section 402.2a of the Treasury regulations.

Treasury advises that additional analysis of the mortgage-backed securities market and changes to the SEC or Treasury capital regulations may lead to modification or termination of the exemption. Otherwise, the exemption is now available to registered government securities broker/dealers subject to Treasury's capital requirements.

* * *

Questions concerning this Notice may be directed to Janet Marsh, District Coordinator, Compliance Department, at (202) 728-8228.

NASD NOTICE TO MEMBERS 95-29

Treasury Approves Amendments To Capital Requirements Under The Government Securities Act Of 1986

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 Department of the Treasury (Treasury) recently approved amendments to the financial responsibility requirements established under the Government Securities Act of 1986. The amendments raise the minimum capital requirements for all government securities broker/dealers subject to the provisions of Section 402.2, and require written notification for certain withdrawals of capital. Treasury also approved a conforming change to its recordkeeping requirements. These amendments only affect sole government securities broker/dealers registered pursuant to Section 15C of the Securities Exchange Act of 1934. The amendments became effective March 31, 1995, with the capital increases phased-in over an 18-month period.

Background

In November 1992, the Securities and Exchange Commission (SEC) adopted changes to the minimum net capital requirements for most broker/dealers subject to Rule 15c3-1. These changes, the first in almost 20 years, were made because inflation had reduced the level of protection provided by the minimum requirements. Since the Treasury capital rule uses the SEC net capital rule as a foundation, Treasury decided to change its rule to parallel the SEC's actions. Treasury's changes minimize the differences between the two rules, maintain consistency, and provide greater uniformity regarding capital requirements applicable to government securities broker/dealers.

Minimum Capital Requirements

The amendments increase the minimum capital requirements for all broker/dealers subject to the provisions of Section 402.2. The rule's other capital requirement—that liquid capital must at least equal 120 percent of haircuts—is unaffected by this change.

The amendments create four minimum capital categories:

• Government securities broker/dealers that carry customer or broker/dealer accounts are subject to a minimum level of $250,000.

• Government securities broker/dealers that carry customer accounts but operate under the exemption provided by SEC Rule 15c3-3(k)(2)(i) have a minimum requirement of $100,000.

• Government securities broker/dealers that introduce accounts on a fully disclosed basis and receive, but do not hold customer securities, are subject to a minimum requirement of $50,000.

• Introducing firms that never handle customer funds or securities are subject to a minimum requirement of $25,000.

To ease the compliance burden and provide time for adjustment, Treasury decided to phase in the increases over an 18-month period. A chart of the phase-in schedule, contained in Appendix E to Section 402.2, follows this Notice.

Capital Withdrawal Requirements

Treasury also is amending its capital withdrawal provisions to include notification requirements and certain definitions.

The notification provisions require post-withdrawal notification of certain significant capital withdrawals as well as prior notification for larger withdrawals. Whether notification is required prior to the withdrawal depends upon the aggregate size of total withdrawals relative to the gov-

ernment securities broker/dealer's excess liquid capital over a 30 calendar day period.

• Aggregate withdrawals that exceed 20 percent of a government securities broker/dealer's excess liquid capital in a 30 calendar day period require notification within two business days after the withdrawal.

• Aggregate withdrawals that exceed 30 percent of excess liquid capital in any 30 calendar day period require notification two business days prior to such withdrawal.

A government securities broker/dealer may use the level of excess liquid capital calculated in its most recent Form G-405, "Report on Finances and Operations of Government Securities Brokers and Dealers (FOGS)" filing, provided this amount has not materially changed since that time. *A government securities broker/dealer is not required to provide this notice to Treasury, but instead notice is sent to the SEC and to the broker/dealer's designated examining authority.*

The rule excludes the reporting of net withdrawals that, in the aggregate, are less than $500,000 in any 30 calendar day period or those that represent securities or commodities transactions between affiliates. Forward-settling transactions between affiliates are not eligible for this exclusion. The exclusion for securities and commodities transactions requires that the transactions be conducted in the ordinary course of business and settled no later than two business days after the date of the transaction.

Members should note that Treasury's changes do not include an early warning threshold like the SEC's rule. Treasury's current rule already places a restriction on withdrawals that would cause liquid capital to fall below a level of 150 percent of haircuts.

In addition, the amendments do not give Treasury the authority to prohibit the withdrawal of capital in certain circumstances. Consistent with this approach, Treasury also is excluding this provision of SEC Rule 15c3-1 from the compliance requirements for those government securities broker/dealers registered under Section 15C of the Securities Exchange Act of 1934 that are subject to the SEC net capital rule (i.e., interdealer brokers operating under Section 402.1 (e) and futures commission merchants).

Finally, in amending the withdrawal provisions, Treasury restructured certain related definitions into a Miscellaneous Provisions paragraph (i)(3) and added a description of what constitutes an advance or loan of liquid capital.

Recordkeeping Change

Treasury is adopting a conforming change to the recordkeeping provisions of Part 404, which contains references to the minimum dollar capital amounts required of government securities clearing broker/dealers. The amendments revise these references in accordance with the fully phased-in minimum capital level required of clearing firms.

* * *

Members that are affected by these changes are urged to review Treasury's release in its entirety. It appeared in the March 1, 1995, *Federal Register*. Questions concerning this Notice may be addressed to Janet Marsh, District Coordinator, Compliance Department, at (202) 728-8228.

Government Securities Act Of 1986: Part 402—Financial Responsibility

Minimum Liquid Capital Requirements—18-Month Phase-In Schedule

Class	To 6/30/95	7/1/95 To 12/31/95	1/1/96 To 6/30/96	7/1/96 And After
A. Broker/dealers that carry customer or broker/dealer accounts, and receive or hold funds or securities	$25,000	$100,000	$175,000	$250,000
B. Broker/dealers that carry customer accounts, but operate pursuant to SEC Rule 15c3-3(k)(2)(i)	$25,000	$50,000	$75,000	$100,000
C. Introducing broker/dealers that receive securities, but do not hold securities or funds	$5,000	$20,000	$35,000	$50,000
D. Introducing broker/dealers that do not receive or handle customer funds or securities	$5,000	$11,000	$18,000	$25,000

NASD NOTICE TO MEMBERS 95-30

Memorial 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, May 29, 1995, in observance of Memorial Day. "Regular way" transactions made on the business days noted below will be subject to the following schedule:

Trade Date	Settlement Date	Reg. T Date*
May 19	May 26	May 31
22	30	June 1
23	31	2
24	June 1	5
25	2	6
26	5	7
29	Markets Closed	—
30	6	8

*Pursuant to Sections 220.8(b)(1) and (4) of Regulation T of the Federal Reserve Board, a broker/dealer 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 titled "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 95-31

Nasdaq National Market Additions, Changes, And Deletions As Of March 27, 1995

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 March 27, 1995, the following 34 issues joined the Nasdaq National Market®, bringing the total number of issues to 3,740:

Symbol	Company	Entry Date	SOES Execution Level
CYTOR	Cytogen Corp. (Rts 1/31/97)	2/24/95	200
CYTOW	Cytogen Corp. (Wts 1/31/97)	2/24/95	200
TMSR	ThrustMaster, Inc.	2/24/95	200
TSAI	Transaction Systems Architects, Inc.	2/24/95	500
FAHC	First American Health Concepts, Inc.	2/27/95	200
AVEC	AVECOR Cardiovascular Inc.	3/1/95	500
KIDD	Kiddie Products, Inc.	3/1/95	200
TGVI	TGV Software, Inc.	3/1/95	1000
VIAS	VIASOFT, Inc.	3/1/95	200
INTFW	Interface Systems, Inc. (Wts 6/30/95)	3/3/95	200
PCMS	P-Com, Inc.	3/3/95	500
SWRT	Software Artistry, Inc.	3/3/95	500
BNHNA	Benihana National Corp. (Cl A)	3/6/95	200
DSPC	DSP Communications, Inc.	3/7/95	500
DLTR	Dollar Tree Stores, Inc.	3/7/95	500
PSTV	PST Vans, Inc.	3/7/95	200
RVFD	Riviana Foods Inc.	3/7/95	1000
CRSI	Cardinal Realty Services, Inc.	3/9/95	200
ENET	EqualNet Holding Corp.	3/9/95	500
ATSIW	ATS Medical, Inc. (Wts 3/9/97)	3/10/95	500
ABCN	American Bancorp of Nevada	3/10/95	200
CALC	Commonwealth Aluminum Corp.	3/10/95	1000
FORT	Fort Howard Corp.	3/10/95	500
TIVS	Tivoli Systems Inc.	3/10/95	500
NATI	National Instruments Corp.	3/14/95	1000
ASMLF	ASM Lithography Holding (N.V. Ord. Shrs.)	3/15/95	1000
CCIR	Continental Circuits Corp.	3/15/95	1000
PWIR	Palmer Wireless, Inc.	3/15/95	500
SDLI	SDL, Inc.	3/16/95	200
RMDY	Remedy Corporation	3/17/95	500
UCHM	Uniroyal Chemical Corp.	3/17/95	1000
NOSH	Hain Food Group, Inc. (The)	3/20/95	500
CATX	C*ATS Software Inc.	3/21/95	200
HTCO	Hickory Tech Corporation	3/23/95	500

Nasdaq National Market Symbol And/Or Name Changes

The following changes to the list of Nasdaq National Market securities occurred since February 24, 1995:

New/Old Symbol	New/Old Security	Date Of Change
SMTH/CANO	Smith Environmental Technologies Corp./Canonie Environmental Services Corp.	2/28/95

New/Old Symbol	New/Old Security	Date Of Change
STRT/STRTV	Strattec Security Corp./Strattec Security Corp. (W/I)	2/28/95
FMER/FBOH	FirstMerit Corporation/First Bancorporation of Ohio	3/1/95
HYSW/IMRS	Hyperion Software Corp./IMRS Inc.	3/1/95
HBCI/MNBC	Heritage Bancorp, Inc./Miners National Bancorp, Inc.	3/1/95
HMII/HMII	HMI Industries, Inc./Health-Mor, Inc.	3/2/95
QDRMY/QDRMY	Banca Quadrum S.A./Services Financiero Quadrum S.A.	3/6/95
IPICZ/IPICZ	Interneuron Pharmaceuticals, Inc. (Wts 6/30/95)/ Interneuron Pharm., Inc. (Wts 3/7/95)	3/13/95
AGNU/AGNU	Agri-Nutrition Group, Ltd./PM Agri-Nutrition Group, Ltd.	3/13/95
QDEK/QDEK	Quarterdeck Corporation/Quarterdeck Office Systems, Inc.	3/13/95
STCR/STCR	Starcraft Corp./Starcraft Automotive Corp.	3/16/95
DOSEW/DOSEW	Choice Drug Systems, Inc. (Wts 9/30/95)/ Choice Drug Systems, Inc. (Wts 9/30/94)	3/17/95
VISNW/VISNW	NewVision Technology, Inc. (Wts 10/31/95)/ NewVision Technology, Inc. (Wts 3/31/95)	3/23/95

Nasdaq National Market Deletions

Symbol	Security	Date
CLBGA	Colonial BancGroup, Inc. (Cl A)	2/24/95
NANO	Nanometrics Incorporated	2/24/95
NEBS	New England Business Service, Inc.	2/24/95
MGMA	Magma Power Company	2/27/95
SMLS	SCIMED Life Systems, Inc.	2/27/95
CYTDZ	CytoRad Inc. (Uts 1/31/97)	2/28/95
BBTF	BB & T Financial Corporation	3/1/95
FROK	FirstRock Bancorp, Inc.	3/1/95
NSCB	NBSC Corporation	3/1/95
PSNC	Public Service Company of North Carolina, Inc.	3/1/95
SDYNW	Staodyn, Inc. (Wts 2/28/95)	3/1/95
AFMXF	Affymax N.V.	3/2/95
APTV	Advanced Promotion Technologies, Inc.	3/3/95
BLCC	Balchem Corporation	3/3/95
PHMC	Plaza Home Mortgage Corporation	3/6/95
PYRD	Pyramid Technology Corporation	3/7/95
FCBN	Furon Company	3/8/95
NSCO	Network Systems Corporation	3/8/95
SONO	Sonoco Products Company	3/8/95
SONOP	Sonoco Products Co. (Cum. Conv. Pfd Cl A)	3/8/95
CVIS	Cardiovascular Imaging Systems, Inc.	3/10/95
OESI	OESI Power Corp.	3/10/95
SMIN	Southern Mineral Corp.	3/10/95
HKYIF	Canstar Sports Inc.	3/14/95
BIRT	Birtcher Medical Systems, Inc.	3/15/95
GCCC	General Computer Corp.	3/15/95
CFER	ConferTech International, Inc.	3/16/95
NUSA	NAMIC U.S.A. Corp.	3/17/95
WBCO	Webco Industries, Inc.	3/17/95
RDCR	Radiation Care, Inc.	3/22/95

Symbol	Security	Date
JSMNE	Jasmine Ltd.	3/23/95
SRCGE	Search Capital Group, Inc.	3/23/95
COOL	Cooper Development Company	3/24/95
KNKB	Kankakee Bancorp, Inc.	3/24/95
TDMK	TideMark Bancorp, Inc.	3/24/95
COGRA	Colonial Group, Inc. (Cl A)	3/27/95

Questions regarding this Notice should be directed to Mark A. Esposito, Nasdaq Market Services Director, Issuer Services, at (202) 728-6966. 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 95-32

Fixed Income Pricing System Additions, Changes, And Deletions As Of March 29, 1995

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 March 29, 1995, the following bonds were added to the Fixed Income Pricing System (FIPS℠). These bonds are not subject to mandatory quotation:

Symbol	Name	Coupon	Maturity
RHLD.GA	RHI Holdings	11.875	3/1/99
CWL.GA	Chartwell	10.250	3/1/04
MVE.GA	MVE, Inc.	12.500	2/15/02
FAMR.GB	Family Restaurants	10.875	2/1/04
SWEC.GC	Sweetheart Cup.	10.500	9/1/03
REVL.GF	Revlon Worldwide	0.000	3/15/98
SAFH.GA	Santa Fe Hotel	11.000	12/15/00
STBR.GA	Stater Bros.	11.000	3/1/01
TEXN.GA	Tex-N.M. Power	8.700	9/1/06
TEXN.GB	Tex-N.M. Power	9.625	7/1/19
USMC.GA	USA Mobile Commun. II	14.000	11/1/04
MXS.GH	Maxus	8.430	9/29/03
MXS.GI	Maxus	8.440	9/29/03
MXS.GJ	Maxus	7.560	9/29/98
MXS.GK	Maxus	7.570	9/29/98
MXS.GL	Maxus	8.460	9/29/03
MXS.GM	Maxus	8.420	9/30/03
MXS.GN	Maxus	9.000	12/17/99
MXS.GO	Maxus	10.830	9/1/04
MOSL.GA	Mosler	11.000	4/15/03
UAI.GF	United Air	10.110	1/5/06
VALA.GA	Valassis Inserts	9.375	3/15/99
TRAM.GA	Transamerican Refining	18.500	2/15/02
TRAM.GB	Transamerican Refining	16.500	2/15/02
GUES.GB	Guess?	9.500	8/15/03
WRTE.GA	WRT Energy	13.875	3/1/02
MRO.GK	MRO	7.200	2/15/04
DEC.GA	Digital Equipment	7.125	10/15/02
DEC.GB	Digital Equipment	7.000	11/15/97
ORX.GA	Oryx Energy	9.750	9/15/98
ORX.GB	Oryx Energy	10.375	1/1/18
ORX.GC	Oryx Energy	10.000	4/1/01
ORX.GD	Oryx Energy	9.300	5/1/96
ORX.GE	Oryx Energy	10.000	6/15/99
ORX.GF	Oryx Energy	9.500	11/1/99
AFNP.GA	Affiliated Newspapers Inv.	13.250	7/1/06
RYR.GA	Rymer Foods	11.000	12/15/00
GEOG.GA	Gerrity Oil & Gas Corp.	11.750	7/15/04
STSP.GA	Stratosphere Corp.	14.000	5/15/02
ASDW.GD	ASD Warren Co.	0.000	1/1/04
PRWL.GA	Pricellular Wireless	0.000	1/1/01
HWCC.GA	Hollywood Casino Corp.	14.000	4/1/98
HEGP.GA	Helicon Gp. LP/Cap/Corp.	11.000	11/1/03
SCIT.GA	SCI Television Inc.	7.500	6/30/98
CFCB.GA	CF Cable, Inc.	11.625	2/15/05
MCAB.GB	Marcus Cable Oper/Cap II	13.500	8/1/04
AAMS.GA	Aames Finl.	10.500	2/1/02
GDFI.GA	Capital Gaming International	11.500	2/1/01
GSTS.GA	Gulf Sts Utils. Co.	9.720	7/1/98

Symbol	Name	Coupon	Maturity
USTR.GA	US Trails Inc.	12.000	7/15/98
TTX.GA	Tultex Corp.	10.625	3/15/05
CUPK.GA	Consumers Packaging, Inc.	12.500	7/15/02
PADE.GA	Pace Inds. Inc.	10.625	12/1/02
JOIN.GC	Jones Inter Cable	9.625	3/15/02
HMX.GA	Hartmarx Corp	10.875	1/15/02
TFYP.GA	Thrifty Payless Inc.	11.750	4/15/03
ASHC.GA	Amerisource Distr. Corp.	11.250	7/15/05

As of March 29, 1995, the following changes to the list of FIPS symbols occurred:

New Symbol	Old Symbol	Name
FORT.GA	FOHO.GA	Fort Howard Corporation
FORT.GB	FOHO.GB	Fort Howard Corporation
FORT.GC	FOHO.GC	Fort Howard Corporation
FORT.GD*	FOHO.GD	Fort Howard Corporation
FORT.GE	FOHO.GE	Fort Howard Corporation
FORT.GF*	FOHO.GF	Fort Howard Corporation
FORT.GG	FOHO.GG	Fort Howard Corporation
U.GA	USAR.GA	USAir Inc.
U.GB	USAR.GB	USAir Inc.

***A mandatory FIPS bond**

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 DISCIPLINARY ACTIONS

Disciplinary Actions Reported For April

The NASD has taken disciplinary actions against the following firms and individuals for violations of the NASD Rules of Fair Practice; securities laws, rules, and regulations; and the rules of the Municipal Securities Rulemaking Board. Unless otherwise indicated, suspensions will begin with the opening of business on Monday, April 17, 1995. The information relating to matters contained in this Notice is current as of the fifth of this month. Information received subsequent to the fifth is not reflected in this edition.

Firms Suspended, Individuals Sanctioned

South Richmond Securities, Inc. (New York, New York), Herman Ralph Garcia, Jr. (Registered Principal, Staten Island, New York) and **Barbara Hosman (Registered Principal, Deer Park, New York)** submitted an Offer of Settlement pursuant to which they were fined $75,000, jointly and severally, and ordered to pay $109,994 in restitution to public customers. In addition, the firm was suspended from effecting principal retail transactions for 10 business days and suspended from participating in any underwritings for three months. Hosman was barred from association with any NASD member as a general securities principal, and Garcia was fined $20,000 and barred from association with any NASD member in any capacity. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Garcia, dominated and controled the market for a common stock to the extent that there was no independent, competitive market in the stock. The findings also stated that the firm, acting through Garcia, engaged in a course of conduct that operated as a fraud upon purchasers of a common stock in that the prices at which the firm sold the stock to public customers from inventory were unfair, and the prices charged to the customers contained fraudulent and/or excessive markups ranging from 5 to 30 percent over the prevailing market price, thus violating the NASD Mark-Up Policy. The NASD also determined that the firm, acting through Hosman, failed to establish, maintain, and enforce written procedures that would have enabled them to supervise properly the activities of the firm's associated persons, including Garcia. In addition, the NASD found that Garcia failed to provide testimony in an on-the-record interview with the NASD.

U.S. Securities Clearing Corporation (San Diego, California) and **Anthony James Miranti (Registered Principal, San Diego, California)** were fined $55,000, jointly and severally, and required to pay $396,846 in restitution to public customers. The firm also was suspended from effecting any principal transactions for 90 days, and Miranti was suspended from association with any NASD member in any capacity for 90 days.

The Securities and Exchange Commission (SEC) affirmed the sanctions following appeal of a September 1993 National Business Conduct Committee (NBCC) decision. The sanctions were based on findings that the firm, acting through Miranti, executed 301 principal retail sales to public customers at unfair and unreasonable prices taking into consideration all relevant circumstances. The firm was not a market maker in the relevant securities at the time the trades were effected, and the markups on these retail sales ranged from 5.1 to 150 percent over the prevailing market price for the securities. In addition, the firm, acting through Miranti, failed to report its price and volume activity for its prin-

cipal transactions in non-Nasdaq securities.

Miranti has appealed this action to a U.S. Court of Appeals, and the sanctions as to him are not in effect pending consideration of the appeal.

Firms And Individuals Fined

Enex Securities Corporation (Kingwood, Texas) and **Luther Clyde Campbell (Registered Principal, Spring, Texas)** submitted an Offer of Settlement pursuant to which they were fined $12,500, jointly and severally. Without admitting or denying the allegations, the respondents consented to the described sanction and to the entry of findings that the firm, acting through Campbell, effected transactions in nonexempt securities while failing to maintain its minimum required net capital. The findings also stated that the firm, acting through Campbell, failed to comply with SEC Rule 15c3-3 by taking possession of customer funds while purporting to operate under exemptive provisions of the Rule.

Strategic Resource Management, Inc. (Englewood, Colorado) and **William A. Moler (Registered Principal, Aurora, Colorado)** were fined $10,000, jointly and severally. The NBCC imposed the sanction following review of a Denver District Business Conduct Committee (DBCC) decision. The sanction was based on findings that the firm, acting through Moler, effected securities transactions with retail customers at prices that were unfair in that the respondents failed to calculate the retail price on the basis of the firm's contemporaneous cost for the securities, resulting in excessive markups.

This action has been appealed to the SEC, and the sanctions are not in effect pending consideration of the appeal.

Individuals Barred Or Suspended

Norman D. Autry (Registered Representative, Tijeras, New Mexico) was fined $25,000 and suspended from association with any NASD member in any capacity for two years. The NBCC affirmed the sanctions following appeal of a Denver DBCC decision. The sanctions were based on findings that Autry participated in and received compensation for private securities transactions and outside business activities without providing prior written notice to his member firm.

Richard Stanley Chancis (Associated Person, New York, New York) was fined $70,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Chancis acted as an associated person of a member firm and engaged in a securities business when he was subject to a statutory disqualification and not properly registered as required by Schedule C of the NASD By-Laws. In addition, Chancis failed to appear at the NASD for an on-the-record interview.

Bron Allen Gailey (Registered Representative, Boise, Idaho) submitted an Offer of Settlement pursuant to which he was fined $10,000 and barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Gailey consented to the described sanctions and to the entry of findings that he submitted six Requests for Change of Dealer or Agent forms to his member firm and signed the investors' names, all without their prior knowledge, authorization, or consent.

Robert Lester Gardner (Registered Representative, Castaic, California) was fined $50,000, suspended from association with any NASD member in any capacity for 30 days, and ordered to requalify by examination as a general securities representative. The NBCC imposed the sanctions following appeal of a San Francisco DBCC decision. The sanctions were based on findings that Gardner effected the purchase of stock in the account of a public customer without the customer's knowledge or consent.

Gardner has appealed this action to the SEC, and the sanctions are not in effect pending consideration of the appeal.

David L. Gray, Jr. (Registered Representative, Tampa, Florida) was fined $40,000, barred from association with any NASD member in any capacity, and required to pay $11,424.25 in restitution to a public customer. The sanctions were based on findings that Gray misrepresented to a public customer that he was aware of certain non-public information that indicated the price of a stock would increase, and thus caused the customer to purchase the stock. In addition, Gray failed to respond to an NASD request for information.

Richard L. Hess (Registered Representative, Scotia, New York) was fined $25,000 and suspended from association with any NASD member in any capacity for two years. The sanctions were based on findings that Hess engaged in private securities transactions outside the regular course or scope of his employment with his member firm without giving prior written notice to the firm describing in detail the proposed transactions, his proposed role therein, and whether he received selling compensation in connection with the transactions.

Clinton Hugh Holland, Jr. (Registered Principal, Salem, Oregon) was fined $5,000, suspended from association with any NASD member in any capacity for five busi-

ness days, and required to requalify by examination as a registered principal. The NBCC affirmed the sanctions following appeal of a Seattle DBCC decision. The sanctions were based on findings that Holland recommended to a public customer the purchase of speculative or high-risk securities without having reasonable grounds for believing that such recommendations were suitable for the customer considering the size and nature of the transactions, the concentration of speculative securities in the account, and the customer's financial situation, circumstances, needs, and objectives.

This action has been appealed to the SEC, and the sanctions are not in effect pending consideration of the appeal.

William H. Kautter (Registered Principal, Kansas City, Missouri), Janet K. Gatz-Bennett (Registered Principal, Stilwell, Kansas), and **Brian G. Augustyn (Registered Principal, Kansas City, Missouri)** submitted an Offer of Settlement pursuant to which Kautter was fined $12,500 and suspended from association with any NASD member in any principal capacity for six months. Gatz-Bennett was fined $12,500 and suspended from association with any NASD member in any capacity for one year and Augustyn was fined $5,000 and suspended from association with any NASD member in any capacity for two weeks. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that, in connection with the promotion and sale of shares of a mortgage fund, Kautter, Gatz-Bennett, and Augustyn misrepresented, or failed to state to participating broker/dealers, certain material facts concerning the status of an extension of an initial public offering of the fund. The findings also stated that Kautter, Gatz-Bennett, and Augustyn distributed to the broker/dealers materials that contained material misrepresentations about the past performance of the fund. In addition, the NASD determined that Kautter and Gatz-Bennett failed and neglected to supervise properly the activities of Augustyn.

Augustyn's suspension began March 20, 1995, and concluded April 2, 1995.

Thomas C. Kocherhans (Registered Representative, Orem, Utah) was fined $50,500, suspended from association with any NASD member in any capacity for one year, and ordered to requalify by examination as a general securities representative. The NBCC imposed the sanctions following appeal of a Market Surveillance Committee decision. The sanctions were based on findings that Kocherhans knowingly and willfully engaged in a manipulative, deceptive, and fraudulent scheme to increase the reported closing price of a common stock. Specifically, Kocherhans effected a series of purchases in a manner that caused the purchases to be executed at or near the close of the market with the intent to cause the market for the stock to close at a price higher than the previously reported trade, thereby reducing or avoiding margin calls on an account held in his wife's name, and to deter higher maintenance requirements on the stock. In addition, Kocherhans failed to inform his member firm in writing that he maintained brokerage accounts at two other member firms.

Kocherhans has appealed this action to the SEC, and the sanctions are not in effect pending consideration of the appeal.

John Austin Leech, Sr. (Registered Representative, Houston, Texas) was fined $25,000, suspended from association with any NASD member in any capacity for 60 days, and required to requalify by examination if he becomes associated with any NASD member. The sanctions were based on the findings that Leech engaged in excessive trading in the account of a public customer, resulting in a loss of $43,000 without having reasonable grounds for believing such transactions were suitable for the customer. In addition, Leech exercised discretion in executing transactions in the same customer's account without having written authority from the customer.

Cristina I. Marti (Registered Representative, Miami, Florida) submitted an Offer of Settlement pursuant to which she was fined $10,000 and barred from association with any NASD member in any capacity with the right to reapply to become an associate with a member after two years. Without admitting or denying the allegations, Marti consented to the described sanctions and to the entry of findings that she submitted modifications to customer payroll deduction agreements without the authorization of the customers.

Bryan W. McEldowney (Registered Representative, Cromwell, Connecticut) was fined $10,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that McEldowney caused a $3,092.14 check to be issued for the account of a public customer, forged the customer's endorsement, and converted the funds to his own use without the prior knowledge, authorization, or consent of the customer.

Katherine Sholes Parker (Registered Principal, Heaters, West Virginia) submitted an Offer of Settlement pursuant to which she was fined $5,000 and suspended from association with any NASD member as a limited financial princi-

pal or in a similar principal capacity for one year, provided, however, the suspension shall not prohibit Parker, on behalf of any member of the NASD who is required to have associated with it a financial principal, and acting under the supervision of such financial principal, or who is exempted by the NASD from maintaining a financial principal, from preparing financial statements and FOCUS reports and filing FOCUS reports with the SEC and the NASD. Without admitting or denying the allegations, Parker consented to the described sanctions and to the entry of findings that a member firm, acting through Parker, failed to file its annual certified audit within the time required, and failed to maintain its minimum required net capital. The findings also stated that Parker, acting on behalf of the firm, failed to record properly bank deposits on the firm's books and records.

William F. Rizzo (Registered Representative, Bellrose, New York) submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined $50,000 and barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Rizzo consented to the described sanctions and to the entry of findings that he withheld and misappropriated to his own use and benefit customer funds totaling $38,548 intended for investment in insurance products and variable annuities.

Bruce L. Sage (Registered Representative, Rogers, Arkansas) submitted an Offer of Settlement pursuant to which he was fined $100,000 and barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Sage consented to the described sanctions and to the entry of findings that he signed a public customer's name to 13 separate documents, including letters of authorization, without having obtained prior written approval from the customer. The findings also stated that Sage received from the same customer $29,516.30 and converted those funds to his own use and benefit.

William Howard Sandberg (Registered Representative, Minneapolis, Minnesota) submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined $5,000 and suspended from association with any NASD member in any capacity for 14 business days. Without admitting or denying the allegations, Sandberg consented to the described sanctions and to the entry of findings that he executed securities transactions for the accounts of public customers without their prior knowledge or consent.

Ronald Kevin Shimkus (Registered Representative, Houston, Texas) was fined $10,000 and suspended from association with any NASD member in any capacity until an arbitration award is satisfied. The sanctions were based on findings that Shimkus failed to pay a $22,144.13 NASD arbitration award.

Gregory Allen Soares (Registered Representative, Santa Rosa, California) was suspended from association with any NASD member in any capacity for 15 business days. The sanction was based on findings that Soares recommended and effected the purchase of securities in the account of a public customer without having a reasonable basis for believing that such recommendation was suitable for the customer based upon her other security holdings, financial situation, and needs.

Jacquelyn Straub (Registered Representative, Emporia, Kansas) submitted a Letter of Acceptance, Waiver and Consent pursuant to which she was fined $5,000 and suspended from association with any NASD member in any capacity for two years. Without admitting or denying the allegation, Straub consented to the described sanctions and to the entry of finding that she participated in private securities transactions without prior written notice to her member firm.

Lincoln T. Tedeschi (Registered Representative, Willington, Connecticut) was fined $15,000 and suspended from association with any NASD member in any capacity for six months. The NBCC affirmed the sanctions following appeal of a Boston DBCC decision. The sanctions were based on findings that Tedeschi engaged in private securities transactions without providing prior written notification to his member firm.

Gregory D. Weinstein (Registered Representative, Englewood, Colorado) submitted an Offer of Settlement pursuant to which he was fined $10,000 and barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Weinstein consented to the described sanctions and to the entry of findings that he maintained a securities account at a member firm other than his member firm and failed to notify either firm of his association with the other firm. In addition, the NASD found that Weinstein provided false and misleading information to NASD staff when responding to staff inquiries, Weinstein denied having a securities account at a member firm other than at his member firm. The findings also stated that Weinstein disseminated unapproved and misleading sales literature.

Kenneth Mitchell Wiggins, Jr. (Registered Principal, Kent, Washington) submitted an Offer of Settlement pursuant to which he was

fined $55,000, barred from association with any NASD member in any capacity, and required to pay $12,000 in restitution to public customers. Without admitting or denying the allegations, Wiggins consented to the described sanctions and to the entry of findings that he received from a public customer two checks totaling $2,000 intended for investment purposes and failed to remit the funds for their intended purpose, but instead, caused these monies to be deposited into the operating account of his member firm where the funds were used for the benefit of the firm. The findings also stated that Wiggins solicited and raised $290,000 from six investors to purchase security interests that were not recorded on the books and records of his member firm, thereby precluding the review of these securities transactions by the NASD or other regulatory examining authorities. In addition, the NASD determined that Wiggins made misrepresentations and omissions to a customer regarding an investment.

Louis A. Zannella (Registered Representative, East Providence, Rhode Island) submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined $10,000 and barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Zannella consented to the described sanctions and to the entry of findings that he received from 27 insurance customers cash totaling $6,743 intended for auto insurance premium payments, and, without the customers' knowledge or consent, misappropriated the funds for his own use and benefit.

Individuals Fined

Howard Mattes Crosby (Registered Principal, Spokane, Washington) was fined $12,000. The NBCC affirmed the sanction following appeal of a Seattle DBCC decision. The sanction was based on findings that Crosby effected private securities transactions with individuals or issuers without providing prior written notice to his member firm. In addition, Crosby served as a principal of his member firm without being registered as a principal.

Firm Expelled For Failure To Pay Fines, Costs, And/Or Provide Proof Of Restitution In Connection With Violations

Post Oak Capital Incorporated, Houston, Texas

Firms Suspended

The following firms were suspended from membership in the NASD for failure to comply with formal written requests to submit financial information to the NASD. The actions were based on the provisions of Article IV, Section 5 of the NASD Rules of Fair Practice and Article VII, Section 2 of the NASD By-Laws. The date the suspension commenced is listed after each entry. If the firm has complied with the requests for information, the listing also includes the date the suspension concluded.

American Financial Services, Germany (March 15, 1995)

CMS Financial Group, Inc., Virginia Beach, Virginia (March 15,1995)

First Affiliated Securities, San Diego, California (March 15, 1995)

First Lauderdale Securities, Inc., Fort Lauderdale, Florida (March 15, 1995)

Investors Services, Richmond, Virginia (March 15, 1995)

Marc Thomaes Securities, Inc., Oradell, New Jersey (March 15, 1995)

Printon, Kane Group, Inc., Short Hills, New Jersey (March 15, 1995)

Public Fidelity Corporation, Costa Mesa, California (March 15, 1995)

Robert Todd Financial Corp., New York, New York (March 15, 1995)

U.S. Securities Corporation, Chevy Chase, Maryland (March 15, 1995)

Suspensions Lifted

The NASD has lifted suspensions from membership on the dates shown for the following firms, because they have complied with formal written requests to submit financial information.

Eurocapital Partners, Inc., Laguna Hills, California (February 17, 1995)

Lone Cypress Capital Corporation, Phoenix, Arizona (March 1, 1995)

Individuals Whose Registrations Were Revoked For Failure To Pay Fines, Costs, And/Or Provide Proof Of Restitution In Connection With Violations

J. Paul Boyle, Bala Cynwyd, Pennsylvania

William G. Brehmer, Dallas, Texas

Philip J. Davis, Littleton, Colorado

Mark A. Fischer, Tampa, Florida

David A. Grachek, Omaha, Nebraska

Kevin F. LaPlante, Maple Grove, Minnesota

Ralph D. Meredith, Port Huron, Michigan

George E. Sledge, Jr., Houston, Texas

NASD Suspends Falcon Trading Group, Ltd.

The NASD announced that it has ordered Falcon Trading Group, Ltd. (Falcon Trading); its trader, principal, and part-owner, Glen T. Vittor; and an associated trader, Philip Gurian, to pay a total of $410,000 in fines and $189,125 in restitution. The NASD also suspended Falcon Trading for 30 business days in all capacities, barred Vittor from acting as a principal in all capacities, suspended Vittor for one year from association with any NASD member in all capacities, required Vittor to requalify as a registered representative, and barred Gurian in all capacities.

The NASD found that Falcon Trading failed to honor two trades each for 13,000 shares of Spectrum Information Technologies, Inc. (Spectrum) after the price declined by about 53 percent on a volume of 34.4 million shares. Specifically, the NASD found that Falcon Trading, through Vittor, separately bid PaineWebber, Inc., and Lehman Brothers, Inc., for 13,000 shares of Spectrum at 12 7/8 on May 20, 1993, at 10:11 and 10:13 a.m., respectively. PaineWebber and Lehman agreed to the trades and reported the same to the NASD Automated Confirmation Transaction Service (ACT℠). Shortly thereafter, the market price of Spectrum declined precipitously and closed at 6, down 53 percent. Falcon Trading, through Vittor, deliberately failed to respond to, or confirm, such trades through ACT. The NASD found that, over several hours, Vittor intentionally misled both selling firms, over several hours, to obstruct their respective follow-up efforts to resolve the trades. Vittor subsequently declined both trades through ACT the following morning. The NASD found that Vittor engaged in bad-faith conduct to mitigate trading losses, without equitable excuse or justification, thus violating Article III, Section 1 of the NASD Rules of Fair Practice.

In its March 1, 1995, decision, the NASD stated that, "in such cases, we believe it is necessary to impose a substantial fine over and above the restitution amount, to remove any incentive to 'ride the market' and discourage individuals who otherwise might believe that the only penalty for refusing to honor trades is a requirement to compensate others for any damages incurred."

The NASD also found that Falcon Trading, through Vittor, permitted Gurian, an individual with a revoked registration and disciplinary history involving conduct detrimental to public customers, to act in improper capacities on behalf of Falcon Trading, including those of a trader. This activity contravened the Board of Governors' Interpretation of Article V, Section 1 and Article III, Section 1 of the NASD Rules of Fair Practice.

The NASD further found that Gurian knowingly failed to appear for three written requests for formal on-the-record testimony, thus violating Article IV, Section 5 and Article III, Section 1 of the NASD Rules of Fair Practice.

The NASD's decision was issued following an appeal of a Market Surveillance Committee disciplinary action to the NASD NBCC. This case was investigated by the NASD Market Surveillance Department.

The bar in all principal capacities imposed on Vittor and the bar in all capacities imposed on Gurian were effective immediately upon the issuance of the NBCC's decision on March 1, 1995.

While this disciplinary action represents a final enforcement action by the NASD, the respondents have the opportunity to file an appeal with the SEC.

The monetary sanctions set forth above include a $300,000 fine and a $189,125 restitution order against Falcon Trading and Vittor arising out of their failure to honor their trading commitments with PaineWebber and Lehman and their permitting Gurian's impermissible activities at Falcon Trading. Additionally, Gurian was fined $50,000 for such impermissible activities and $60,000 for his failure to respond to the NASD's requests for testimony.

FOR YOUR INFORMATION

SEC Delays Requirements For Disclosure Of Payment-For-Order-Flow Practices From April 3 To October 2, 1995

On March 10, 1995, the SEC determined to delay, until October 2, 1995, the effective date of Rule 11Ac1-3 and certain amendments to Rule 10b-10 concerning disclosure of payment-for-order-flow practices. These changes originally were scheduled to go into effect on April 3, 1995.

In addition, the SEC is postponing an amendment to Rule 10b-10 requiring a broker/dealer that is excluded from membership in SIPC to make a disclosure of its non-SIPC status on customer confirmations. This amendment now is scheduled to take effect on October 2, 1995.

Although the SEC is delaying the effective date of these changes, the SEC staff has advised that it will not object if members begin complying with the new requirements before October 2.

SEC Approves Extension Of Two Of The Interim SOES Rules

On March 27, 1995, the SEC approved the NASD's proposal to extend, through October 2, 1995, the effectiveness of two of the Interim SOES℠ Rules—the SOES Minimum Exposure Limit Rule and the SOES Automated Quotation Update Feature. The SOES Minimum Exposure Limit Rule provides for a reduction in the minimum exposure limit for unpreferenced SOES orders from five times the maximum order size to two times the maximum order size, and for the elimination of exposure limits for preferenced orders. The SOES Automated Quotation Update Feature permits market makers to automatically update their quotes when the market maker's exposure limit has been exhausted.

Effective March 28, 1995, however, the SOES Maximum-Order Size Rule lapsed and the maximum-size order eligible for execution through SOES returned to 1,000 shares. Accordingly, effective March 28, 1995, the minimum exposure limit for SOES is 2,000 shares (2 x 1,000). The maximum-size order eligible for execution through SOES in The Nasdaq SmallCap Market℠ securities remains 500 shares.

Questions concerning this should be directed to Glen Shipway, Nasdaq Market Operations, at (212) 858-4448 or Tom Gira, Office of General Counsel, at (202) 728-8957.

Foreign Exam Center Changes

Please note the following changes to the schedule of foreign examination centers:

• Paris, France—June 24, October 14

• Heidelberg, Germany—June 10, August 12, October 14

• Tokyo, Japan—June 24