

# NASD NOTICE TO MEMBERS 95-73

**NASD Requests  
Comment On Member  
Obligations To File  
Certain Exchange  
Offers That Result In  
Public Distributions;  
Comment Period Expires  
October 15, 1995**

## Suggested Routing

- Senior Management
- Advertising
- Corporate Finance
- Government Securities
- Institutional
- Internal Audit
- Legal & Compliance
- Municipal
- Mutual Fund
- Operations
- Options
- Registration
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- Syndicate
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## Executive Summary

The NASD<sup>®</sup> is proposing to amend the Corporate Financing Rule, Article III, Section 44, of the NASD Rules of Fair Practice (Rule) to require that certain registered and unregistered exchange offers and related information must be filed with the NASD Corporate Financing Department (Department) when members are engaged in "solicitation activities" in connection with such transactions. The NASD has determined that the Rule should provide guidance to members in determining when their exchange-offer activities result in their "participation in a public distribution," and thus become subject to NASD rules and oversight. In view of the record amount of merger and acquisition activity that has occurred in the past two years, the NASD believes that the proposed amendments to the Rule will provide certainty and eliminate confusion regarding the application of the Rule to exchange offers. The proposed amendments describe member participation in certain types of exchange offers that must comply with the substantive provisions of the Rule, including those that relate to underwriting compensation and other distribution terms and arrangements.

The Corporate Financing Committee (Committee) has considered whether certain types of merger and acquisitions transactions should be subject to NASD regulation and believes that the Rule should apply only to exchange offers in which a member firm engages in solicitation activities of security holders on behalf of the issuer when securities are issued. With regard to exchange offers, the Rule is applicable only to members acting as financial advisors to the issuer of securities, but not to those that are advisors to the target company or to any shareholder group. Thus, the Rule will apply to exchange offers registered on SEC Form S-4

where the member is acting as dealer/manager to solicit *consents* to the proposed business reorganization, and to a member that solicits security holders in exchange offers exempt from registration under Section 3(a)(9) of the Securities Act of 1933. The Committee also determined that the Rule should not apply to exchange transactions where the member does not engage in solicitation activities on behalf of the issuer, or to mergers, particularly those that involve stock-for-stock exchanges, or spin-offs of any type.

The NASD realizes the time-sensitive nature of many exchange offers and thus has instructed the staff to expedite their review of any such filings made with the Department. Generally, the staff can be expected to issue a comment letter within 48 hours of receipt of the filing of an exchange offer.

## Analysis Of Provisions Of Proposed Rule Change

Following is an analysis of how the proposed amendments will modify the provisions of the Rule.

## Filing Requirements For Exchange Offers

The NASD has determined to add new Subsections (b)(9)(H) and (b)(9)(I) to the Rule to specify that members that participate in specified exchange transactions must file them with the Department for review. Transactions subject to the Rule would be exchange offers that are either:

- exempt from registration under Section 3(a)(9) of the Securities Act of 1933, when the member's participation involves solicitation activities to facilitate the exchange of securities; or
- registered on Form S-4 with the

Securities and Exchange Commission (SEC), when the member is acting in the capacity as dealer/manager to facilitate the exchange of securities by soliciting investors (collectively, Exchange Offers).

However, notwithstanding these criteria, any exchange offer or merger and acquisition transaction that falls under the provisions of Schedule E to the NASD By-Laws, will continue to be subject to filing with the Department. Specifically, the Rule is being amended to state clearly that filing is required for distributions of securities where Schedule E applies. The SEC and NASD have long held the view that pre-offering review is vital to protect investors when the member and issuer are in a control relationship or have a conflict of interest that is addressed through the application of Schedule E. Furthermore, all of the conditions in *Notice to Members 88-100* would require filing of the merger with the NASD. Specifically, in that Notice, the NASD expressed its special concerns regarding the merger of blank-check companies in the penny stock market with privately held holding companies of members, indirectly creating a publicly held NASD member without having to fully comply with Schedule E to the By-Laws.

All exchange offers exempt from registration under Section 3(a)(9) wherein the member is engaged in solicitation activities must be filed with the Department and are fully subject to the Rule. Solicitation activities by a member include solicitation of or other forms of direct contact with security holders, including these activities:

- being named as a dealer/manager;
- performing tasks that are permitted to be performed by investor relations firms (i.e., ascertaining what action security holders intend to take with respect to the exchange offer);

- contacting security holders to inquire whether they have received the offering materials or answering unsolicited contacts; or
- participating in meetings with security holders or their advisors before or after an exchange offer begins.

If the member's "participation" however, does not involve solicitation activities, but is limited to functions that may include, among other things, delivery of a "fairness opinion," advising the issuer as to the structure and terms of the exchange offer, assisting the issuer in the preparation of the offering documents to be sent to security holders, or other functions that do not include direct solicitation of or other forms of direct contact with security holders, the transaction would be exempt from filing and compliance with the Rule.

The application of the Rule to offerings of securities registered on Form S-4 is expressly limited to only those distributions where the member is engaged by the company to act as dealer/manager and solicit *consents* on behalf of the company to the proposed reorganization and to otherwise facilitate the exchange of securities. In such exchange offers, the member generally acts as a financial advisor to help structure the transaction and will receive a fee, as well as distribution-related compensation for services rendered. The NASD believes that when a member is retained to act as a dealer/manager by a company to solicit consents, the member is then involved in distribution-related activities in connection with registered exchange offers which should be regulated under the Rule. As is set forth below, all other transactions that require securities to be registered on Form S-4 are exempt from the Rule.

### **Exemptions From The Provisions Of The Rule**

The NASD also proposes to adopt

new Sections (C)(8)(I) and (C)(8)(J) to clarify that there are exemptions from the filing requirements and compliance with the other provisions of the Rule for certain merger and acquisition transactions in which the role of the member is to act as financial advisor to the board of directors of the acquirer, or the target company, including providing general financial advice on the structure of the transaction, and under certain circumstances, issuing a fairness opinion. Thus, in transactions where the securities to be issued are registered with the SEC on Form S-4 in connection with a merger or similar form of business combination, the members' activities are exempt from the Rule.

The proposed amendments also provide for an exemption from compliance with the Rule for spin-off transactions. In the case of a typical spin-off, reverse spin-off, or similar transaction of a subsidiary company to existing security holders, the security holders receive shares of the subsidiary as a dividend or distribution. These transactions involve no investment decision by the shareholders and, consequently, the parent's financial advisor is not generally involved in any public solicitation in connection with the spin-off.<sup>1</sup>

### **Transactions Subject To The Rule But Exempt From Filing**

Proposed new Section (b)(7)(F) to the Rule provides for an exemption from the filing requirements for Exchange Offers where the securities to be issued or being acquired are listed on the Nasdaq National Market<sup>®</sup>, the New York Stock Exchange

<sup>1</sup> If, however, a spin-off is followed by a traditional public offering by the spun-off company to raise capital, the company's initial public offering would be subject to the Corporate Financing Rule's filing requirements.

(NYSE), or the American Stock Exchange (AMEX), or for securities distributions of certain seasoned companies. These transactions are exempt from the filing requirements only, and not from compliance with the Rule.

### **Exemption For Securities Listed On Nasdaq National Market, NYSE, Or AMEX**

The NASD believes that it is appropriate to exempt from the filing requirements Exchange Offers where securities to be issued, or are being acquired, are listed on the Nasdaq National Market, the NYSE, or AMEX, thereby permitting the shareholder to readily obtain an alternative marketable investment.<sup>2</sup> The NASD believes that this situation is analogous to a cash tender offer, which is outside the scope of the Rule, where the outstanding shares are purchased for cash. Further, the listing standards for Nasdaq National Market-, NYSE-, and AMEX-listed companies ensure that independent directors of the board will evaluate the offer, and that sufficient information will be distributed to shareholders and made available to the markets so investors can make a decision regarding whether to sell or hold the securities it holds or will receive.

### **Exemption For Seasoned Securities**

The NASD also believes that an exemption from the filing requirements should be available for Exchange Offers by seasoned issuers that would qualify to register securities on Forms S-3, F-3, or F-10 as those forms were in effect prior to October 21, 1992, (for Forms S-3 and F-3) and June 21, 1991, (for Form F-10). This provision would generally require that the company have a three-year history as a public-reporting company, and be in compliance with the current year's periodic reporting requirements of the Securities Exchange Act of 1934 (relating to timely filing of 10-Qs and

10-Ks). In addition, to qualify for this exemption from filing, the minimum required market value of a company's voting stock must be as follows: Form S-3 \$150 million (or \$100 million market value of voting stock and three million shares annual trading volume); and Form F-3 \$300 million (held worldwide). For Form F-10, Canadian issuers must have (CN) \$360 aggregate value of voting stock and a public float of (CN) \$754 million.

### **Regulation Of Financial Advisory "Tail Fee" Arrangements**

The proposed amendments to the Rule include new Section (c)(6)(B)(xiii) that provides that it is an unreasonable term and arrangement when proposed in connection with an Exchange Offer for any agreement or arrangement between a member and a company to contain a "tail fee," if the tail fee has a duration of more than two years from the date the member's services are terminated. However, a member may demonstrate, on the basis of information satisfactory to the NASD, that an arrangement of more than two years is not unfair or unreasonable under the circumstances.

A tail fee is an arrangement or agreement in which the company is obligated to compensate a member in the event the Exchange Offer is not completed and the company subsequently consummates a similar transaction. The NASD evaluated the appropriateness of such an arrangement and agreed to adopt the common industry practice that tail fees should generally be permitted, but limited to a two-year period, calculated from the date the member's services were terminated. The NASD believes that a shorter period of time does not adequately protect a member that may have expended considerable time and effort working on an exchange offer, when a company determines to terminate the services of the member, and nonetheless completes the Exchange Offer. In

Exchange Offers, unlike traditional corporate underwritings, the real benefit derived by the company is the creativity of the strategic advice given by the member for the particular transaction that may include, among other things, assisting the company in defining objectives, performing valuation analyses, formulating restructuring alternatives, and structuring the Exchange Offer. Also, a member providing financial advice in the case of an exchange offer will generally have provided considerable ongoing financial advisory services to the company.

The NASD believes, however, that NASD staff should be able to grant exceptions to the two-year limitation upon demonstration of fairness of the arrangements. The Committee determined, therefore, that the provision should give the staff authority to grant such exceptions upon request, and under circumstances where the member can demonstrate that the creativity of the strategic advice has a potential benefit to the company for more than two years. In the case of offerings exempt from filing but subject to compliance with the Rule where the tail fee arrangement is longer than two years, the member must still comply with this provision of the Rule and, therefore, must request an opinion of the staff as to whether a tail fee with a longer arrangement is permissible under the Rule, even though it is not required to make a formal filing.

### **Interpretation Regarding Reimbursement Of Certain Expenses In Exchange Offers**

Certain types of fees and expense reimbursement arrangements typically negotiated for or received in connection with Exchange Offers are not

<sup>2</sup> In developing the definition of "limited partnership roll-up transaction" in Article III, Section 34, the SEC approved a similar exemption for freely tradable securities.

deemed to be inconsistent with or prohibited by Subsection (C)(6)(B)(iii) of the Rule. With regard to fees, the only compensation that is permitted under this provision of the Rule relates to situations where a member acting as a financial advisor receives a "time and efforts" or similar fee for the services it rendered in connection with an Exchange Offer that is not completed, and the financial advisor does not, therefore, receive the agreed upon success fee. Reimbursement of certain expenses, including, but not limited to, travel costs, document production, and legal fees of the financial advisor, are also typically provided for in the agreements, whether or not the transaction is consummated. The NASD does not believe that these and similar types of reimbursement arrangements in Exchange Offers should be prohibited by the Rule, since their arrangements are not viewed to be directly connected with the issuance of securities.

## Request For Comments

The NASD asks members and other interested parties to comment on the proposed modifications to the Rule. Comments should be addressed to:

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 Charles L. Bennett, Director, or Carl R. Sperapani, Assistant Director, NASD Corporate Financing Department, at (301) 208-2700.

## Text Of Proposed Amendments To The Corporate Financing Rule

### Underwriting Terms and Arrangements

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

Sec. 44

(a) Definitions No change.

(b) Filing Requirements

(1) through (6) No change.

(7) Offerings Exempt From Filing

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

(A) through (E) No change.

(F) exchange offers (as defined in subparagraph (9)(H) below) where:

(i) the securities to be issued or the securities being acquired are listed on the Nasdaq National Market, the New York Stock Exchange or the American Stock Exchange; or

(ii) the company issuing securities qualifies to register securities with the Securities and Exchange Commission on Forms S-3, F-3 or F-10, under the requirements for those forms set forth in subparagraph (C) of this paragraph.

(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 (F) No change.

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

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

(I) securities of a subsidiary or other affiliate distributed by a company in a spin-off, reverse spin-off or similar transaction to its existing security holders exclusively as a dividend or other distribution; and

(J) securities registered with the Securities and Exchange Commission on Form S-4 in connection with a merger or similar form of business combination.

(9) Offerings Required to be Filed

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

(A) through (F) No change.

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

(H) exchange offers, exempt from registration under Section 3(a)(9) of the Securities Act of 1933 (if the member's participation involves active solicitation activities) or registered with the Securities and Exchange Commission on Form S-4

(if the member is acting as a dealer-manager) (collectively, “exchange offers”);

(I) any exchange offer or, merger and acquisition transaction which involves offerings of securities subject to Schedule E of the By-Laws, including but not limited to any such offerings and any corporate reorganization involving a member or its parent that results in the direct or indirect public ownership of a member and offerings required to be filed pursuant to subparagraph (H) of this paragraph; and

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

(c) Underwriting Compensation and Arrangements

(1) through (5) No change.

(6) Unreasonable Terms and Arrangements

(A) No member or person associated with a member shall participate in any manner in a public offering of securities after any arrangement pro-

posed in connection with the public offering, or the terms and conditions relating thereto, has been determined to be unfair or unreasonable pursuant to this Section or inconsistent with any By-Law or any Rule of Fair Practice, or other rule or regulation, of the NASD.

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

(i) through (x) No change.

(xi) for a member or person associated with a member to accept, directly or indirectly, any non-cash sales incentive item including, but not limited to, travel bonuses, prizes and awards, from an issuer or an affiliate thereof in excess of \$50 per person per issuer annually. Notwithstanding the foregoing, a member may provide non-cash sales incentive items to its associated persons provided that no issuer, or an affiliate thereof, including specifically an affiliate of the member, directly or indirectly, partici-

pates in or contributes to providing such non-cash sales incentive; [or]

(xii) for a member to participate with an issuer in the public distribution of a non-underwritten issue of securities if the issuer hires persons primarily for the purpose of distributing or assisting in the distribution of the issue, or for the purpose of assisting in any way in connection with the underwriting, except to the extent in compliance with 17 C.F.R. §240.3a4-1 and applicable state law; or

(xiii) when proposed in connection with an Exchange Offer, any agreement or arrangement in which the issuer grants to the member the right to receive a “tail fee” in the event that the Exchange Offer is not completed and the company subsequently consummates a similar transaction if the tail fee arrangement has a duration of more than two (2) years from the date the member’s services are terminated; provided, however, that a member may demonstrate on the basis of information satisfactory to the NASD that an arrangement of more than two (2) years is not unfair or unreasonable under the circumstances.

# NASD NOTICE TO MEMBERS 95-74

## SEC Approves Amendments To Advertising And Sales Literature Filing And Review Requirements

### 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 August 9, 1995, the Securities and Exchange Commission (SEC) approved amendments to Article III, Section 35 of the NASD<sup>®</sup> Rules of Fair Practice and Section 8 of the Government Securities Rules (collectively, the Rules) to broaden the definitions of, and revise the approval and filing requirements for, advertising and sales literature.<sup>1</sup> The amendments also revise the rules relating to recommendations in communications with the public. The amendments became effective on August 9, 1995.

### Background And Description Of Amendments

Article III, Section 35 of the Rules of Fair Practice and Section 8 of the Government Securities Rules govern members' communications with the public regarding general securities and government securities, respectively. The Rules contain definitions, internal approval and recordkeeping requirements, and filing requirements and standards applicable to the content of such communications. To codify existing rule interpretations, rectify inconsistencies, and clarify issues that have been the source of member misunderstanding, the NASD is amending the Rules to revise the definitions of, and the internal approval and timeliness of filing requirements for, advertising and sales literature and the scope of rules relating to "Recommendations."

### Amendments To Definitions

The NASD is amending the definitions of "Advertisement" and "Sales Literature" in Article III, Subsections 35(a)(1) and (2) of the Rules of Fair Practice and Subsections 8(a)(1) and (2) of the Government Securities Rules to include electronic messages. The NASD has consistently applied

its standards for communications with the public to electronic messages sent via computer. Thus, the inclusion of the term "electronic" in the definition of "Advertisement" clarifies the applicability of the Rules to communications available to all computer or electronic network subscribers, including items displayed over network bulletin boards. The new definition of "Advertisement" does not, however, include communications posted by members of the public on electronic bulletin boards sponsored by NASD members; it has never applied to communications by the general public.

The inclusion of the term "electronic" in the definition of "Sales Literature" is intended to clarify the applicability of the Rules to messages sent directly to targeted individuals or groups. The new definition of "Sales Literature" does not, however, include a personalized message sent to a particular individual via electronic mail. Such messages are not treated as sales literature but generally as correspondence under Article III, Section 27(d) of the Rules of Fair Practice.<sup>2</sup>

The NASD is also amending the definition of "Sales Literature" in Article III, Subsection 35(a)(2) of the Rules of Fair Practice and Subsection 8(a)(2) of the Government Securities

<sup>1</sup> See, Securities Exchange Act Rel. No. 36076 (August 9, 1995).

<sup>2</sup> Such personalized electronic correspondence is also distinguished from interactive electronic conversations, either through direct links or so-called "chat rooms."

Interactive conversations will not generally be regarded as correspondence; however, members should be aware that such "conversations" can easily be recorded or reduced to hard copy. Finally, all communications, whether advertising, sales literature, correspondence, or conversations, regardless of the medium, are subject to the anti-fraud provisions of the federal securities laws, SEC rules, and the rules of the NASD.

Rules to include telemarketing scripts. Members often file telemarketing scripts for review with the NASD Advertising Regulation Department that are to be read to prospects and existing customers or delivered electronically through a telemarketing service. These scripts differ from other forms of telephone prospecting and customer contact in that they are always followed up by the caller or callers. The NASD considers these scripts as comparable to a form letter delivered orally and, by including them in the definition, believes it will reduce confusion among members and promote more consistent application of the Rules.

### **Member Review Of Advertising And Sales Literature**

The NASD is also amending Article III, Subsection 35(b)(1) of the Rules of Fair Practice and Subsection 8(b)(1) of the Government Securities Rules to require that each item of advertising and sales literature be approved internally before use only by a registered principal. Before these amendments, the Rules allowed a registered principal to perform the review or delegate this responsibility to a designee. The Rules contained no guidelines for the level of experience, expertise, or qualification that the designee must have to assume this compliance responsibility and, in some cases, individuals less qualified than principals have been designated by registered principals to provide internal approval. The amendments eliminate the potential for inconsistent internal standards applied by different members for the review of communications with the public.

The NASD is also amending Article III, Subsection 35(b)(1) of the Rules of Fair Practice and Subsection 8(b)(1) of the Government Securities Rules to require that advertising and sales literature be approved internally

by members before being filed with the NASD Advertising Regulation Department. Before these amendments, the Rules for review of advertisements and sales literature required that the material be approved internally by the member before first use, but did not require that material be approved internally by the member before being filed with the NASD. Some members have acknowledged that their internal review sometimes occurs after the NASD response is received. This practice places the NASD in the role of providing the initial compliance review, a role that should, in the NASD's view, be maintained within the member firms' compliance departments. The amendments will ensure that members submit material that conforms to the applicable Rules. It is anticipated that the amendments will reduce the amount of refile requested by the NASD Advertising Regulation Department due to extensive deficiencies in the original filings.

### **Filing Requirements**

The NASD is also amending Article III, Subsections 35(c)(1), (2), (3)(A), and (4) to the Rules of Fair Practice and Subsections 8(c)(1)(A) and (B), (c)(2), and (c)(3) of the Government Securities Rules to require that where filings are required to be submitted with certain time frames, the member provide the actual or expected date of first use or publication of the item filed. Before these amendments, the rules required that material be filed within 10 days of first use or 10 days before use, depending on the status of the firm and the subject matter of the communication. Members would file communications for review in various stages of a document's production, ranging from first drafts to finished products, and it was often impossible to determine the date of first use unless the information was provided voluntarily by the member

or requested by the NASD reviewer. Because of the extensive volume of filings the NASD Advertising Regulation Department reviews each month, it is impractical to contact members routinely and request that they provide the date of use for each piece filed and, consequently, the NASD has been unable to determine systematically if member firms were meeting their filing obligations. The amendments will enable the NASD to enforce the existing Rules more effectively and consistently.

In addition, the NASD is deleting Article III, Subsection 35(c)(3)(B) to the Rules of Fair Practice. This provision was always intended to be temporary in that it applied the pre-filing requirements of Subsection 35(c)(3)(A) for one year to those firms that had been filing advertisements for less than one year when the pre-filing provisions became effective. The provision ensured that such firms continued to pre-file advertisements for at least one year from the date their first advertisements were filed. As such, the provision became obsolete one year from its effective date.

### **Standard For Recommendations**

Finally, the NASD is amending Article III, Subsection 35(d)(2)(B) to the Rules of Fair Practice and Subsection 8(d)(2)(B) to the Government Securities Rules to specify that the requirement to disclose the price of a security applies only to communications on behalf of corporate equities and to delete the price disclosure requirement entirely from the Government Securities Rules. Before these amendments, the literal language of the Rules would have required price disclosure with respect to all securities products in all communications deemed to be recommendations. However, the NASD has a longstanding practice of not

requiring price disclosure on communications for securities products other than corporate equities. Nevertheless, both the Rules of Fair Practice and the Government Securities Rules prohibit members from omitting material information in communications with the public. Therefore, if inclusion of the price of the security is necessary to make the material not misleading, then the member is required to include the price.

Questions regarding this Notice may be directed to Thomas Pappas, Assistant Director, Advertising/Investment Companies Regulation Department, at (202) 728-8330, and Robert J. Smith, Attorney, Office of General Counsel, at (202) 728-8176.

### **Text Of Amendments To Article III, Section 35 Of The Rules Of Fair Practice And Section 8 Of The Government Securities Rules**

(Note: New text is underlined; deletions are bracketed.)

#### **ARTICLE III**

##### **Rules of Fair Practice**

Sec. 1 through 34 No change.

##### **Communications With the Public**

Sec. 35.

###### **(a) Definitions**

(1) Advertisement—For purposes of this section and any interpretation thereof, “advertisement” means material published, or designed for use in, a newspaper, magazine or other periodical, radio, television, telephone or tape recording, videotape display, signs or billboards, motion pictures, telephone directories (other than routine listings), electronic or other public media.

(2) Sales literature—For purposes of

this section and any interpretation thereof, “sales literature” means any written or electronic communication distributed or made generally available to customers or the public, which communication does not meet the foregoing definition of “advertisement.” Sales literature includes, but is not limited to, circulars, research reports, market letters, performance reports or summaries, form letters, telemarketing scripts, seminar texts, and reprints or excerpts of any other advertisement, sales literature or published article.

###### **(b) Approval and Recordkeeping**

(1) Each item of advertising and sales literature shall be approved by signature or initial, prior to use or filing with the NASD, by a registered principal [(or his designee)] of the member.

(2) No change.

###### **(c) Filing Requirements and Review Procedures**

(1) Advertisements and sales literature concerning registered investment companies (including mutual funds, variable contracts and unit investment trusts) not included within the requirements of Subsection (c)(2) of this section, and public direct participation programs (as defined in Article III, Section 34 of the Rules of Fair Practice) shall be filed with the Association’s Advertising Regulation Department within 10 days of first use or publication by any member. The member must provide with each filing the actual or anticipated date of first use. Filing in advance of use is recommended. Members are not required to file advertising and sales literature which have previously been filed and which are used without change. Any member filing any investment company advertisement or sales literature pursuant to this Subsection that includes or incorpo-

rates rankings or comparisons of the investment company with other investment companies shall include a copy of the ranking or comparison used in the advertisement or sales literature.

(2) Advertisements concerning collateralized mortgage obligations registered under the Securities Act of 1933, and advertisements and sales literature concerning registered investment companies (including mutual funds, variable contracts and unit investment trusts) that include or incorporate rankings or comparisons of the investment company with other investment companies where the ranking or comparison category is not generally published or is the creation, either directly or indirectly, of the investment company, its underwriter or an affiliate, shall be filed with the Association’s Advertising Regulation Department for review at least 10 days prior to use (or such shorter period as the Department may allow in particular circumstances) for approval and, if changed [or expressly disapproved] by the Association, shall be withheld from publication or circulation until any changes specified by the Association have been made, or [in the event of disapproval], if expressly disapproved, until the advertisement has been refiled for, and has received, Association approval. The member must provide with each filing the actual or anticipated date of first use. Any member filing any investment company advertisement or sales literature pursuant to this Subsection shall include a copy of the data, ranking or comparison on which the ranking or comparison is based.

(3)(A) Each member of the Association which has not previously filed advertisements with the Association (or with a registered securities exchange having standards comparable to those contained in this section) shall file its initial advertisement with



the Association's Advertising Department at least ten days prior to use and shall continue to file its advertisements at least ten days prior to use for a period of one year. The member must provide with each filing the actual or anticipated date of first use.

(B) [Each member which, on the effective date of this section, had been filing advertisements with the Association (or with a registered securities exchange having standards comparable to those contained in this section) for a period of less than one year shall continue to file its advertisements, at least ten days prior to use, until the completion of one year from the date the first advertisement was filed with the Association or such exchange.]

[(C)] Except for advertisements related to municipal securities, direct participation programs or investment company securities, members subject to the requirements of subparagraphs (c)(3)(A) or (c)(3)(B) of this section may, in lieu of filing with the Association, file advertisements on the same basis, and for the same time periods specified in those subparagraphs, with any registered securities exchange having standards comparable to those contained in this section.

(4) Notwithstanding the foregoing provisions, any District Business Conduct Committee of the Association, upon review of a member's advertising and/or sales literature, and after determining that the member has departed and there is a reasonable likelihood that the member will again depart from the standards of this section, may require that such member file all advertising and/or sales literature, or the portion of such member's material which is related to any specific types or classes of securities or services, with the Association's Advertising Department and/or the District

Committee, at least ten days prior to use. The member must provide with each filing the actual or anticipated date of first use.

The Committee shall notify the member in writing of the types of material to be filed and the length of time such requirement is to be in effect. The requirement shall not exceed one year, however, and shall not take effect until 30 days after the member receives the written notice, during which time the member may request a hearing before the District Business Conduct Committee, and any such hearings shall be held in reasonable conformity with the hearing and appeal procedures of the Code of Procedure.

(5) through (7) No change.

**(d) Standards Applicable to Communications With the Public**

(1) No change.

**(2) Specific Standards**

In addition to the foregoing general standards, the following specific standards apply:

(A) No change.

(B) Recommendations: In making a recommendation, whether or not labeled as such, a member must have a reasonable basis for the recommendation and must disclose [the price at the time the recommendation is made, as well as] any of the following situations which are applicable:

(i) that the member usually makes a market in the securities being recommended, or in the underlying security if the recommended security is an option, and/or that the member or associated persons will sell to or buy from customers on a principal basis;

(ii) that the member and/or its offi-

cers or partners own options, rights or warrants to purchase any of the securities of the issuer whose securities are recommended, unless the extent of such ownership is nominal;

(iii) that the member was manager or co-manager of a public offering of any securities of the recommended issuer within the last 3 years.

The member shall also provide, or offer to furnish upon request, available investment information supporting the recommendation. Recommendations on behalf of corporate equities must provide the price at the time the recommendation is made.

A member may use material referring to past recommendations if it sets forth all recommendations as to the same type, kind, grade or classification of securities made by a member within the last year. Longer periods of years may be covered if they are consecutive and include the most recent year. Such material must also name each security recommended and give the date and nature of each recommendation (e.g., whether to buy or sell), the price at the time of the recommendation, the price at which or the price range within which the recommendation was to be acted upon, and indicate the general market conditions during the period covered.

Also permitted is material which does not make any specific recommendation but which offers to furnish a list of all recommendations made by a member within the past year or over longer periods of consecutive years, including the most recent year, if this list contains all the information specified in the previous paragraph. Neither the list of recommendations, nor material offering such list, shall imply comparable future performance. Reference to the results of a previous specific recommendation, including such a reference in a follow-up research

report or market letter, is prohibited if the intent or the effect is to show the success of a past recommendation, unless all of the foregoing requirements with respect to past recommendations are met.

(C) through (N) No change.

## GOVERNMENT SECURITIES RULES

Sec. 1 through Sec. 7 No change.

### Communications With the Public

#### Sec. 8

##### (a) Definitions

(1) Advertisement—For purposes of this section and any interpretation thereof, “advertisement” means material published, or designed for use in, a newspaper, magazine or other periodical, radio, television, telephone or tape recording, videotape display, signs or billboards, motion pictures, telephone directories (other than routine listings), electronic or other public media.

(2) Sales Literature—For purposes of this section and any interpretation thereof, “sales literature” means any written or electronic communication distributed or made generally available to customers or the public that does not meet the foregoing definition of “advertisement.” Sales literature includes, but is not limited to, circulars, research reports, market letters, performance reports or summaries, form letters, standard forms of option worksheets, telemarketing scripts, seminar texts, and reprints or excerpts of any other advertisement, sales literature, or published article.

##### (b) Approval and Recordkeeping

(1) Each item of advertising and sales literature shall be approved by signature or initial, prior to use or filing

with the NASD, by a registered principal [(or designee)] of the member.

(2) No change.

##### (c) Filing Requirements and Review Procedures

(1) Members shall file advertisements for review with the Association’s Advertising Regulation Department as follows:

(A) Advertisements containing government securities (as defined in Section 3(a)(42) of the Securities Exchange Act of 1934) other than collateralized mortgage obligations shall be filed by members with the Association’s Advertising Department within 10 days of first use or publication; and

(B) advertisements concerning collateralized mortgage obligations shall be filed with the Association’s Advertising Regulation Department for review at least 10 days prior to use (or such shorter period as the Department may allow in particular circumstances) for approval and, if changed [or expressly disapproved] by the Association, shall be withheld from publication or circulation until any changes specified by the Association have been made or, [in the event of disapproval] if expressly disapproved, until the advertisement has been refiled for, and has received, Association approval. The member must provide with each filing concerning government securities and collateralized mortgage obligations the actual or anticipated date of first use.

(2) Each member of the Association that has not previously filed advertisements with the Association shall file its initial advertisement concerning government securities with the Association’s Advertising Department at least 10 days prior to use and shall continue to file its advertise-

ments concerning government securities at least 10 days prior to use for a period of one year. The member must provide with each filing the actual or anticipated date of first use.

(3) Notwithstanding the foregoing provisions, any District Business Conduct Committee of the Association, upon review of a member’s government securities advertising and/or sales literature, and after determining that the member will again depart from the standards of this section, may require that such member file all government securities advertising and/or sales literature, or the portion of such member’s material that is related to any specific types or classes of securities or services, with the Association’s Advertising Department and/or the District Committee, at least 10 days prior to use. The member must provide with each filing the actual or anticipated date of first use.

The Committee shall notify the member in writing of the types of material to be filed and the length of time such requirement is to be in effect. The requirement shall not exceed one year, however, and shall not take effect until 30 days after the member receives the written notice, during which time the member may request a hearing before the District Business Conduct Committee, and any such hearings shall be held in reasonable conformity with the hearing and appeal procedures of the Code of Procedure.

(4) through (5) No change.

##### (d) Standards Applicable to Communications With the Public

(1) No change.

##### (2) Specific Standards

In addition to the foregoing general standards, the following specific

standards apply:

(A) No change.

(B) Recommendations: In making a

recommendation, whether or not labeled as such, a member must have a reasonable basis for the recommendation made and must disclose [the price at the time the recommendation

is made, as well as] any of the following situations which are applicable:

(i) through (iii) No change.

# NASD NOTICE TO MEMBERS 95-75

## SEC Approves Amendment Regarding Trading In Anticipation Of The Issuance Of A Research Report

### 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 August 9, 1995, the Securities and Exchange Commission (SEC) approved a new Interpretation to Article III, Section 1 of the Rules of Fair Practice that prohibits a member firm from purposefully adjusting an inventory position in a particular security in anticipation of the firm's issuance of a research report in that same security. The amendment took effect on August 9, 1995.<sup>1</sup>

### Background

Historically, the NASD<sup>®</sup> has monitored the trading activity of members that precedes a particular firm's issuance of research reports on a specific security. Firms with research departments frequently prepare research reports that recommend that customers take certain actions for a particular security. In some instances, firms may establish proprietary positions in a security in anticipation of meeting expected customer demand after a research report is issued.

In *Notice to Members 94-40*, the NASD solicited member comment on developing an interpretation that would clearly state that a member's purposefully establishing an inventory position in anticipation of a research report would violate just and equitable principles of trade. The NASD also sought comment on a policy that would recommend, but not require, that member firms develop and implement information barriers (Chinese Walls) to isolate research and trading activities within individual departments of the firm.

After considering comments, the NASD Board determined to adopt an Interpretation to the Rules of Fair Practice, and it was recently approved by the SEC.

### Description

Under the new Trading Ahead of Research Reports Interpretation to Article III, Section 1 of the Rules of Fair Practice, NASD members are prohibited from engaging in trading activity that purposefully affects the firm's inventory position in a security in anticipation of the issuance of a research report in that security. The Interpretation specifically recommends, but does not require, that member firms develop procedures that create information barriers (Chinese Walls) to isolate information on research reports to prevent the trading department from adjusting its inventory position by using advance knowledge of an upcoming research report. If a firm does not choose to establish information barriers to prevent the improper flow of information to the trading desk or some other area, the firm will have a greater burden of showing that any inventory adjustments before the research report was issued were not caused by its knowledge of the report.

The new Interpretation applies to trading in securities listed on The Nasdaq Stock Market<sup>SM</sup>, and to third-market trading in exchange-listed securities. Thus, NASD members must adhere to the new policy when trading Nasdaq National Market<sup>®</sup> and The Nasdaq SmallCap Market<sup>SM</sup> securities, as well as exchange-listed securities traded in the third market. The Interpretation also applies to derivative products, including options, that underlie these securities. The Interpretation does not specifically address securities that are quoted on the OTC Bulletin Board (OTCBB<sup>®</sup>). However, when trading OTCBB securities that are the subject of a research report, members should remain cognizant of the gen-

<sup>1</sup> See, Securities Exchange Act Rel. No. 36077 (August 9, 1995).

eral policy that trading based on knowledge of their impending research report could be deemed a violation of just and equitable principles of trade.

The new Interpretation also prohibits a firm from doing indirectly what it may not do directly. Thus, the Interpretation states that a member may not purposefully establish, increase, decrease, or liquidate a position in a derivative security based on a Nasdaq® or exchange-listed security in anticipation of the firm's issuance of a research report on the security underlying the derivative position. For instance, trading in an option on a Nasdaq or exchange-listed security may be economically equivalent to trading the underlying equity.

The Interpretation defines purposeful trading activity as any trading that is undertaken to establish or adjust a firm's inventory position in a security based on advance knowledge of a research report the firm is about to issue. Adjustment to an inventory position in anticipation of a research report means that a firm has purposefully increased, decreased, liquidated a position, or established a long or a short position. Thus, the Interpretation covers any purposeful adjustment to inventory because the firm is about to issue a research report whether the report is bullish or bearish.

In addition, the Interpretation encourages but does not require firms to establish information barriers (i.e., also known as Chinese Wall procedures or Chinese Walls) to control the flow of information between their research and trading departments. Information barriers are risk management controls to enhance the likelihood that knowledge of upcoming events will be isolated within a single group and not disclosed to other groups that might trade on or otherwise benefit from the information. Because many firms today already

use information barriers between the research and trading departments of their firms, the Interpretation encourages the use of information barriers as the preferred method of complying with the Interpretation. If a member determines not to implement information barriers, it would carry a significantly greater burden of proving that security accumulations or liquidations before the issuance of a research report had not been purposeful if an NASD investigation into the firm's buying or selling activity were initiated.

Finally, it should be noted that the new policy does not apply to research done solely for internal firm use. Such research, however, cannot be used in any way for external distribution.

Questions regarding this Notice may be directed to Eugene A. Lopez, Office of the General Counsel, The Nasdaq Stock Market, Inc., at (202) 728-6998, or Halley Milligan, NASD Market Surveillance Department, at (301) 590-6464.

### **Text Of Amendments To Article III, Section 1 Of The Rules Of Fair Practice**

(Note: New text is underlined.)

#### **Trading Ahead of Research Reports Interpretation To Article III, Section 1 of the NASD Rules of Fair Practice**

The Board of Governors, under its statutory obligation to protect investors and enhance market quality, is issuing an Interpretation to the Rules of Fair Practice regarding a member firm's trading activities that occur in anticipation of a firm's issuance of a research report regarding a security. The Board of Governors is concerned with activities of member firms that purposeful-

ly establish or adjust the firm's inventory position in Nasdaq-listed securities, an exchange-listed security traded in the OTC market, or a derivative security based primarily on a specific Nasdaq or exchange-listed security in anticipation of the issuance of a research report in that same security. For example, a firm's research department may prepare a research report recommending the purchase of a particular Nasdaq-listed security. Prior to the publication and dissemination of the report, however, the trading department of the member firm might purposefully accumulate a position in that security to meet anticipated customer demand for that security. After the firm had established its position, the firm would issue the report, and thereafter fill customer orders from the member firm's inventory positions.

The NASD believes that such activity is conduct which is inconsistent with just and equitable principles of trade, and not in the best interests of investors. Thus, this Interpretation prohibits a member from purposefully establishing, creating or changing the firm's inventory position in a Nasdaq-listed security, an exchange-listed security traded in the third market, or a derivative security related to the underlying equity security, in anticipation of the issuance of a research report regarding such security by the member firm.

Article III, Section 1 of the Rules of Fair Practice states that:

A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.

In accordance with Article VII, Section 1(a)(2) of the NASD By-Laws, the NASD Board of Governors has approved the following Interpretation of Article III, Section 1:

Trading activity purposefully establishing, increasing, decreasing, or liquidating a position in a Nasdaq security, an exchange-listed security traded in the over-the-counter market, or a derivative security based primarily upon a specific Nasdaq or exchange-listed security, in anticipation of the issuance of a research report in that security is inconsistent with just and equitable principles of trade and is a violation of Article III, Section 1 of the Rules of Fair Practice.

For the purposes of this Interpretation, a "purposeful" change in the

firm's inventory position means any trading activities undertaken with the intent of altering a firm's position in a security in anticipation of accommodating investor interest once the research report has been published. Hence, the Interpretation does not apply to changes in an inventory position related to unsolicited order flow from a firm's retail or broker/dealer client base or to research done solely for in-house trading and not in any way used for external publication.

Under this Interpretation, the Board recommends, but does not require, that member firms develop and implement policies and procedures to

establish effective internal control systems and procedures that would isolate specific information within research and other relevant departments of the firm so as to prevent the trading department from utilizing the advance knowledge of the issuance of a research report. Firms that choose not to develop "Chinese Wall" procedures bear the burden of demonstrating that the basis for changes in inventory positions in advance of research reports was not purposeful.

# NASD NOTICE TO MEMBERS 95-76

## SEC Permits NASD To Discipline Members And Associated Persons Who Fail To Honor Arbitration Or Mediation Settlement Agreements

### 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 August 10, 1995, the Securities and Exchange Commission (SEC) approved amendments to the NASD's rules to make a failure to honor a written and executed settlement agreement of a dispute arbitrated by any self-regulatory organization or mediated by the NASD<sup>®</sup> a violation of the Rules of Fair Practice. The amendments also permit the NASD to suspend or cancel the membership or registration of a member or associated person for failing to honor a written and executed settlement agreement of a dispute arbitrated or mediated by the NASD. The amendments will become effective on October 2, 1995. The text of the amendments follows this Notice.

### Background

On August 10, 1995, the SEC approved amendments to the *Resolution of the Board of Governors—Failure to Act Under Provisions of Code of Arbitration Procedure* (Resolution) to make a failure to honor a written and executed settlement agreement obtained in connection with a dispute arbitrated by any self-regulatory organization (SRO) or mediated by the NASD a violation of Article III, Section 1 of the Rules of Fair Practice. The SEC also approved amendments to Article VI, Section 3 of the By-Laws to permit the NASD to suspend or cancel the membership or registration of a member or associated person for failing to honor a written and executed settlement agreement of a dispute arbitrated or mediated by the NASD. The amendments will become effective on October 2, 1995.

### Enforcing Settlement Agreements

In administering its Arbitration Program, the NASD has noted that

many disputes or claims for damages submitted to arbitration before the NASD, another SRO forum, or the American Arbitration Association (AAA), are settled before a hearing on the merits. The NASD also recently implemented a Mediation Program, to be administered with the Arbitration Program, designed to increase the number of claims that are settled before a hearing.

The NASD has also noted that occasionally members and associated persons fail to honor settlement agreements reached in connection with arbitration proceedings. The NASD is concerned that a failure by a member or associated person to honor a settlement agreement imposes substantial added costs on the prevailing party or parties in the form of delayed recoveries, actions to enforce the agreements, and additional fees connected with canceling or rescheduling hearings on short notice. The NASD Arbitration Department also incurs additional costs in rescheduling hearings, and, on occasion, has had to appoint new arbitrators to hear a matter. In addition, the NASD believes that the credibility of the arbitration process suffers if members and their associated persons are able to delay the resolution of a dispute by failing to honor a settlement agreement. Finally, the NASD believes that reducing or eliminating such failures on the part of members and associated persons is an appropriate preventative measure that should not await the development of serious problems.

The Resolution states that "it may be deemed ... a violation of Article III, Section 1 of the Rules of Fair Practice for a member or person associated with a member to ... fail to honor an [arbitration] award ... ." The Resolution was adopted in 1973 and has been used to discipline members and associated persons who fail to pay an arbitration award unless

they have moved to vacate the award.<sup>1</sup> The Resolution applies to awards rendered in NASD arbitrations, as well as arbitrations sponsored by other SROs and the AAA.

The NASD believes that the failure by a member or associated person to honor a settlement agreement entered into in connection with an arbitration proceeding or a mediation should have the same consequences as the failure to pay an arbitration award. Therefore, the NASD is amending the Resolution to make the failure by a member or associated person to honor a written and executed settlement agreement actionable as a violation of Article III, Section 1 of the Rules of Fair Practice.<sup>2</sup> The amendment is limited to settlement agreements that have been reduced to writing and have been executed. The amendment, therefore, will not encompass unexecuted settlements.

### **Revocation And Disciplinary Proceedings**

In 1993, the NASD amended Article VI, Section 3 of the By-Laws to provide that a membership or registration could be suspended or canceled on 15-days' notice for failing to honor an arbitration award rendered in an NASD arbitration. The use of such revocation proceedings was limited to awards in NASD-sponsored proceedings because NASD oversight of the arbitration process provides greater assurance about the awards that would be enforced in such proceedings.<sup>3</sup>

The NASD believes that the failure by a member or an associated person of a member to honor settlement agreements entered into in connection with an arbitration proceeding or mediation sponsored by the NASD should be subject to the same revocation proceedings as are arbitration awards. Accordingly, the NASD is

also amending Article VI, Section 3 of the By-Laws to provide that membership or registration can be suspended or canceled on 15-days' notice for failing to honor a settlement agreement obtained in connection with an NASD arbitration or mediation. The action of the NASD under Article VI, Section 3 of the By-Laws with respect to failure to honor settlement agreements will be conducted as a revocation proceeding pursuant to the provisions of Article VI of the Code of Procedure. Article VI permits the member or associated person to request a hearing, and the final decision is reviewable by the SEC.

While the NASD recognizes that the amendments would apply only to member firms and associated persons, not another non-member or unregistered party who fails to honor a settlement agreement, members should note that the NASD has no jurisdiction over non-members and persons not associated with members and cannot, therefore, sanction such persons for failing to honor agreements.

Members and associated persons with members have a fundamental obligation to "observe high standards of commercial honor" under Article III, Section 1 of the Rules of Fair Practice and to promote investor protection by ensuring that the arbitration process is fair and efficient. Honoring settlement agreements is a component of meeting those obligations.

In addition, there are procedural protections for members and associated persons designed to prevent unwarranted suspensions or revocations. A member or associated person receiving a notice of revocation proceedings or a disciplinary complaint may request a hearing to demonstrate that a valid reason exists for not honoring a settlement agreement. Thus, for example, if a settlement agreement contained a condition precedent to the member's performance under the

agreement, that would likely constitute a complete defense to the revocation proceeding until the condition precedent occurred and the obligation of the member to perform under the agreement arose. The NASD would have the discretion not to initiate a proceeding if clear evidence of a valid reason for not honoring a settlement agreement existed.

If a settlement agreement resulted from arbitrations conducted at other SROs or the AAA, the amended Rules do not provide for the use of the NASD's suspension or revocation proceedings. Where a party to an arbitration conducted in another forum complains to the NASD that a member or associated person failed to honor a settlement agreement, the complaint would be investigated in the same manner as any other customer complaint. Such an investigation would include obtaining copies of the records of the arbitration proceeding from the other forum and determining if there are any facts that would demonstrate that disciplinary action is warranted. If it is determined that the member or associated person may have failed to honor a settlement agreement, a formal com-

<sup>1</sup> Under the Federal Arbitration Act and many state statutes, such a motion to vacate must be filed within 90 days after the award is rendered.

<sup>2</sup> Because the NASD is the only forum currently offering mediation, the amended Resolution specifies that only settlement agreements entered into in connection with an NASD mediation are subject to the requirements. In the event other SROs adopt mediation programs, the NASD may consider expanding the scope of the Resolution.

<sup>3</sup> The use of Article VI of the Code of Procedure for such proceedings was initiated in connection with the NASD's adoption of an amendment to Article VI, Section 3 of the By-Laws relating to failure to pay arbitration awards. *See*, SR-NASD-91-73, approved by the SEC in Securities Exchange Act Rel. No. 31763 (January 28, 1993).



plaint would be issued and the member or associated person would be entitled to a hearing before a panel of a District Business Conduct Committee and would be afforded a right to appeal any adverse decision to the National Business Conduct Committee, the SEC, and the courts.

Questions regarding this Notice may be directed to Deborah Masucci, Vice President and Director, Arbitration Department, at (212) 858-8330, or Elliott R. Curzon, Assistant General Counsel, Office of General Counsel, at (202) 728-8451.

### **Text Of Amendment To The Code Of Arbitration Procedure And By-Laws**

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

### **CODE OF ARBITRATION PROCEDURE**

#### ***Resolution of the Board of Governors—***

#### **Failure to Act Under Provisions of Code of Arbitration Procedure**

It may be deemed conduct inconsistent with just and equitable principles of trade and a violation of Article III, Section 1 of the Rules of Fair

Practice for a member or a person associated with a member to: (1) fail to submit a dispute for arbitration under the NASD Code of Arbitration Procedure as required by that Code[, to]; (2) fail to appear or to produce any document in his possession or control as directed pursuant to provisions of the NASD Code of Arbitration Procedure[, or]; (3) fail to honor an award [of arbitrators properly rendered pursuant to the Uniform Code of Arbitration], or comply with a written and executed settlement agreement, obtained in connection with an arbitration submitted for disposition pursuant to the procedures specified by the National Association of Securities Dealers, Inc., the New York, American, Boston, Cincinnati, [Midwest] Chicago, Pacific, or Philadelphia Stock Exchanges, the Chicago Board Options Exchange, the Municipal Securities Rulemaking Board, or pursuant to the rules applicable to the arbitration of securities disputes before the American Arbitration Association where timely motion has not been made to vacate or modify such award pursuant to applicable law[.]; or (4) fail to comply with a written and executed settlement agreement, obtained in connection with a mediation submitted for disposition pursuant to the procedures specified by the National Association of Securities Dealers, Inc.

## **BY-LAWS**

### **ARTICLE VI**

#### **Dues, Assessments and Other Charges**

Sec. 1 and 2 No change.

#### **Suspension or Cancellation of Membership or Registration**

Sec. 3. The Corporation after fifteen (15) days notice in writing, may suspend or cancel the membership of any member or the registration of any person in arrears in the payment of any fees, dues, assessments or other charges, or for failure to furnish any information or reports requested pursuant to Section 2 of this Article, or for failure to comply with an award of arbitrators properly rendered pursuant to Section 41 of the Code of Arbitration Procedure, where a timely motion to vacate or modify such award has not been made pursuant to applicable law or where such a motion has been denied[.], or for failure to comply with a written and executed settlement agreement obtained in connection with an arbitration or mediation submitted for disposition pursuant to the procedures specified by the Corporation.

# NASD NOTICE TO MEMBERS 95-77

## Columbus 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 schedule of trade dates-settlement dates below reflects the observance by the financial community of Columbus Day, Monday, October 9, 1995. On this day, The Nasdaq Stock Market<sup>SM</sup> and the securities exchanges will be open for trading. However, it will not be a settlement date because many of the nation's banking institutions will be closed.

Trade Date	Settlement Date	Reg. T Date*
Oct. 2	Oct. 5	Oct. 9
3	6	10
4	10	11
5	11	12
6	12	13
9	12	16
10	13	17

\*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 five 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."

**Note:** October 9, 1995, is considered a business day for receiving customers' payments under Regulation T of the Federal Reserve Board. Transactions made on Monday, October 9, will be combined with transactions made on the previous business day, October 6, for settlement on October 12. Securities will not be quoted ex-dividend, and settlements, marks to the market, reclamations, and buy-ins and sell-outs, as provided in the Uniform Practice Code, will not be made and/or exercised on October 9.

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 95-78

Nasdaq National Market  
Additions, Changes,  
And Deletions As Of  
August 21, 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 August 21, 1995, the following 59 issues joined the Nasdaq National Market®, bringing the total number of issues to 3,863:

Symbol	Company	Entry Date	SOES Execution Level
CBXC	Cybox Computer Products Corporation	7/28/95	500
FLCN	Falcon Drilling Company, Inc.	7/28/95	200
FGAS	Forcenergy Gas Exploration, Inc.	7/28/95	200
KERA	KeraVision, Inc.	7/28/95	1000
PRCN	Percon Incorporated	7/28/95	500
TLCM	TelCom Semiconductor, Inc.	7/28/95	500
PHHM	Palm Harbor Homes, Inc.	7/31/95	200
INBI	Industrial Bancorp, Inc.	8/1/95	500
JACC	Jayhawk Acceptance Corporation	8/1/95	1000
KNIC	L.L. Knickerbocker Co., Inc. (The)	8/1/95	200
KNICW	L.L. Knickerbocker Co., Inc. (The) (Wts 12/7/97)	8/1/95	200
ONTC	ON Technology Corporation	8/1/95	500
ONSI	Orion Network Systems, Inc.	8/1/95	500
TEMPA	Sequana Therapeutics, Inc.	8/1/95	1000
SFLX	Smartflex Systems, Inc.	8/1/95	1000
VETS	The Pet Practice, Inc.	8/1/95	1000
UCMP	UniComp, Inc.	8/1/95	200
OSTC	Ostech, Inc.	8/2/95	500
PRSW	Pure Software Inc.	8/2/95	500
UACA	Union Acceptance Corporation	8/2/95	200
LVNTF	Livent, Inc.	8/3/95	200
OWEN	Owen Healthcare, Inc.	8/3/95	1000
TSBS	Trenton Savings Bank FSB	8/3/95	500
AMIE	Ambassadors International, Inc.	8/4/95	1000
MECK	Mecklermedia Corporation	8/4/95	200
MOOV	Moovies, Inc.	8/4/95	1000
RWTI	Redwood Trust, Inc.	8/4/95	1000
RWTIW	Redwood Trust, Inc. (Wts 12/31/97)	8/4/95	1000
STER	Sterling Healthcare Group, Inc.	8/4/95	200
SUMT	Summit Medical Systems, Inc.	8/4/95	500
NORPY	Nord Pacific Limited (ADR)	8/7/95	200
INDEW	IndeNet, Inc. (Wts Cl B 8/31/98)	8/8/95	200
USAD	USA Detergents, Inc.	8/8/95	500
NANO	Nanometrics Incorporated	8/9/95	200
NSCP	Netscape Communications Corporation	8/9/95	200
TRDX	Tridex Corporation	8/9/95	1000
USBR	U.S. Bridge of N.Y., Inc.	8/9/95	200
USBRW	U.S. Bridge of N.Y., Inc. (Wts 8/8/00)	8/9/95	200
WFSI	WFS Financial Inc.	8/9/95	200
CRPB	Cerprobe Corporation	8/10/95	500
CCAI	Community Care of America, Inc.	8/10/95	1000
ATLS	Atlas Air, Inc.	8/11/95	200
DTOP	Desktop Data, Inc.	8/11/95	200
HPRI	HPR, Inc.	8/11/95	200
NERXW	NeoRx Corporation (Wts 4/25/98)	8/11/95	200
SSHI	Sunstone Hotel Investors, Inc.	8/11/95	1000

Symbol	Company	Entry Date	SOES Execution Level
GUCO	Grand Union Company (The)	8/14/95	500
KKRO	Koo Koo Roo, Inc.	8/14/95	200
CBUK	Cutter & Buck Inc.	8/15/95	1000
NHPI	NHP Incorporated	8/15/95	1000
NORM	Normandy America, Inc. (CI A)	8/15/95	200
ROMC	Romac International, Inc.	8/15/95	1000
VNTV	Vantive Corporation (The)	8/15/95	200
IART	Integra LifeSciences Corp.	8/16/95	200
HOOK	Redhook Ale Brewery, Inc.	8/17/95	1000
MKIE	Mackie Designs, Inc.	8/18/95	200
MSADY	Mid-States PLC (ADR)	8/18/95	200
TRCW	TransCor Waste Services, Inc.	8/21/95	200
USTDV	US Trust Corp. (New WI)	8/21/95	1000

### Nasdaq National Market Symbol And/Or Name Changes

The following changes to the list of Nasdaq National Market securities occurred since July 27, 1995:

New/Old Symbol	New/Old Security	Date Of Change
USDC/USDCV	USDATA Corp/USDATA Corp (WI)	7/28/95
IWBK/IWBK	InterWest Bancorp, Inc./InterWest Savings Bank	7/31/95
CORE/PRAI	CORE, Inc./Peer Review Analysis, Inc.	7/31/95
LION/LION	Fidelity National Corporation/Fidelity Southern Corporation	8/1/95
GLCCF/LFIIF	Gaming Lottery Corporation/Laser Friendly, Inc.	8/2/95
SQNA/TEMPA	Sequana Therapeutics, Inc./Sequana Therapeutics, Inc.	8/2/95
MADGF/MADGF	Madge Networks N.V./Madge N.V.	8/3/95
CPDN/APPS	APPS Dental, Inc./APPS Dental, Inc.	8/4/95
NPCI/NPCIA	NPC International, Inc./NPC International, Inc. (CI A)	8/9/95
LBTYA/LBTAV	Tele-Commun Inc.A (Liberty Media Grp)/ Tele-Commun Inc.A (Liberty Media Grp) (WI)	8/11/95
LBTYB/LBTBV	Tele-Commun Inc.B (Liberty Media Grp)/ Tele-Commun Inc.B (Liberty Media Grp) (WI)	8/11/95
TCOMA/TCOMA	Tele-Commun Inc. (Ser A TCI Group)/Tele-Commun Inc. (CI A)	8/11/95
TCOMB/TCOMB	Tele-Commun Inc. (Ser B TCI Group)/Tele-Commun Inc. (CI B)	8/11/95

### Nasdaq National Market Deletions

Symbol	Security	Date
ALMO	Alamo Group Inc.	7/28/95
SHFLW	Shuffle Master, Inc. (Wts 1/20/98)	7/28/95
ONEC	OneComm Corp.	7/31/95
AMSE	American Mobile Systems, Inc.	8/1/95
CRON	Cooper Cameron Corporation	8/1/95
EPURW	Enviropur Waste Refining and Tech., Inc. (CI B Wts)	8/1/95
IMET	Intermetrics, Inc.	8/1/95
NACC	National Auto Credit Inc.	8/1/95
CFCN	Commercial Federal Corp.	8/2/95
LEPGY	Lep Group plc (ADR)	8/2/95

<b>Symbol</b>	<b>Security</b>	<b>Date</b>
ABRS	Amber's Stores, Inc.	8/3/95
BIND	Bindley Western Industries, Inc.	8/3/95
IFSC	Interferon Sciences, Inc.	8/3/95
OSHRF	Oshap Technologies Ltd. (Rts)	8/4/95
UFBI	UF Bancorp, Inc.	8/7/95
NPCIB	NPC International, Inc. (Cl B)	8/9/95
VFIC	VeriFone, Inc.	8/10/95
GTII	Genetic Therapy, Inc.	8/15/95
TLIOQ	Telios Pharmaceuticals, Inc.	8/16/95
NORM	Normandy America, Inc.	8/16/95
BOLLE	Bollinger Industries, Inc.	8/17/95
FTTR	Fretter, Inc.	8/18/95
FNOW	Future Now, Inc. (The)	8/18/95
BRNO	Bruno's, Inc.	8/21/95
GBAN	Gateway Bancorp, Inc.	8/21/95

Questions regarding this Notice should be directed to Mark A. Esposito, Nasdaq Market Services Director, Issuer Services, at (202) 496-2536. 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 95-79

Fixed Income Pricing  
System Additions,  
Changes, And Deletions  
As Of August 25, 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 August 25, 1995, the following bonds were added to the Fixed Income Pricing System (FIPS<sup>SM</sup>). These bonds are not subject to mandatory quotation:

Symbol	Name	Coupon	Maturity
NAE.GA	NorAm Energy	7.500	8/1/00
HRVD.GB	Harvard Indus	11.125	8/1/05
YGBR.GB	Young Broadcasting	10.125	2/15/05
HEIA.GA	Heileman Acquis	9.625	1/31/04
DICT.GA	Dictaphone Corp	11.750	8/1/05
USG.GI	USG	8.500	8/1/05
STO.GK	Stone Container Corp	12.125	9/15/95
THC.GA	Tenet Healthcare	9.625	9/1/02
THC.GB	Tenet Healthcare	10.125	3/1/05
DEC.GC	Digital Equipment	8.625	11/1/12
DEC.GD	Digital Equipment	7.750	4/1/23
POP.GA	Pope & Talbot	8.375	6/1/13
CCP.GA	CCP Insurance	10.500	12/15/04
CAG.GA	ConAgra	9.750	11/1/97
CNC.GA	Conseco	8.125	8/29/95
BRUO.GA	Bruno's	10.500	8/29/95

As of August 25, 1995, the following changes to the list of FIPS symbols occurred:

New Symbol	Old Symbol	Name
CTYA.GE	CTY.GE	Century Comm

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.

# DISCIPLINARY ACTIONS

## Disciplinary Actions Reported For September

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, September 18, 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 Expelled, Individuals Sanctioned**

**Cartwright and Walker Securities, Inc. (Los Angeles, California)** and **Everett Scoville Walker, Jr. (Registered Principal, West Hollywood, California)** were fined \$100,000, jointly and severally. The firm was expelled from NASD membership and Walker was barred from association with any NASD member in any capacity. The sanctions were based on findings that the firm and Walker failed to respond to NASD requests for information about customer complaints.

### **Firms Fined, Individuals Sanctioned**

**Camelot Investment Corp. (Hauppauge, New York)** and **John J. Fasano (Registered Principal, Hauppauge, New York)** submitted a Letter of Acceptance, Waiver and Consent pursuant to which they were fined \$50,000, jointly and severally, and required to pay \$41,089 in restitution to public customers. Fasano was also barred from association with any NASD member in any capacity and required to pay a \$12,000 arbitration award. Without admitting or denying the allegations, the respondents consented to the

described sanctions and to the entry of findings that the firm, acting through Fasano, conducted a securities business while failing to maintain its required minimum net capital and failed to hire a financial and operations principal (FINOP) when the acting FINOP left abruptly, and continued to conduct a securities business. The findings stated that the firm, acting through Fasano, failed to file its FOCUS Part I and IIA reports and filed late FOCUS Part I reports. The NASD also found that the firm, acting through Fasano, failed to comply with its restriction agreement in that it did not maintain its required net capital and permitted unauthorized trades of securities in seven customer accounts. In addition, the NASD determined that Fasano failed to pay a \$12,000 arbitration award.

**Cousins Securities Corporation (Oakbrook, Illinois), William Roy Cousins (Registered Principal, Bolinbrook, Illinois), and Vonciel McClain Gaines (Registered Representative, Olympia Fields, Illinois)** submitted a Letter of Acceptance, Waiver and Consent pursuant to which the firm and Cousins were fined \$15,000, jointly and severally. Gaines was fined \$28,000 and suspended from association with any NASD member in any capacity for 30 days. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Cousins, effected securities transactions when it failed to maintain its minimum required net capital and failed to compute its net capital accurately. The findings also stated that the firm, acting through Cousins, allowed Gaines to be engaged in the securities business of the firm by effecting securities sales and receiving commissions when he was not effectively qualified or registered with the NASD in the appropriate capacity, and that Gaines engaged in

such activities when he was not effectively qualified or registered with the NASD.

**M.S.U. Inc. (East Lansing, Michigan)** and **David L. Alexa (Registered Principal, Okemos, Michigan)** submitted an Offer of Settlement pursuant to which the firm was fined \$17,500. Alexa was fined \$7,500, barred from association with any NASD member as a financial and operations principal, and suspended from association with any NASD member in any principal capacity for one year. In addition, Alexa was required to requalify by examination in the appropriate principal capacity and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Alexa, effected transactions in securities while failing to maintain its minimum required net capital and maintained inaccurate net capital computations. The findings also stated that the firm, acting through Alexa, filed inaccurate FOCUS reports and failed to file FOCUS reports and an annual audit report with the NASD. Furthermore, the NASD found that the firm, acting through Alexa, failed to file FOCUS reports and an annual audit report with the NASD in a timely manner. In addition, the NASD determined that the firm, acting through Alexa, participated in the sales of common stock when such shares were not properly registered or exempt from registration.

**Network 1 (Red Bank, New Jersey), Richard A. O'Reilly, (Registered Principal, Shrewsbury, New Jersey), Kevin T. Cabell (Registered Principal, Griffin, Georgia), and Guy G. Mockbee (Registered Representative, Rochester, New York).** The firm,

O'Reilly, and Mockbee submitted Offers of Settlement pursuant to which the firm and O'Reilly were fined \$16,500, jointly and severally. Also, O'Reilly must requalify by examination as a principal. Mockbee was fined \$16,500, suspended from association with any NASD member in any capacity for 20 days, prohibited from becoming associated and/or employed with an NASD member in a principal capacity for one year, and required to requalify by examination as a registered representative. Cabell, in a separate decision, was fined \$16,500, suspended from association with any NASD member in any capacity for 20 days, and suspended from association with any NASD member as a registered principal for one year. In addition, Cabell must requalify by examination as a principal. Without admitting or denying the allegations, the firm, O'Reilly, and Mockbee consented to the described sanctions and to the entry of findings that the firm, acting through O'Reilly, allowed Cabell and Mockbee to engage actively in the management of a branch office of the firm without being registered with the NASD as principals. The findings stated that the firm, O'Reilly, Cabell, and Mockbee, allowed associated persons of the firm to engage in the investment banking and securities business, before being effectively registered with the NASD. The NASD also found that the firm, acting through O'Reilly, failed to supervise its registered representatives and/or associated persons and to enforce the firm's written supervisory procedures.

#### **Firms And Individuals Fined**

**D.M. Black & Company, Inc. (Spokane, Washington)** and **David Morley Black (Registered Principal, Spokane, Washington)** were fined \$15,000, jointly and severally, and required to pay \$33,458 in restitution, jointly and severally, to customers.

The sanctions were based on findings that the firm, acting through Black, executed municipal securities transactions at prices that were unfair and unreasonable. In addition, the firm, acting through Black, engaged in securities transactions in the same customer's account at unfair prices with markups, markdowns, and commissions charged to the customers ranging from 2.1 to 7.7 percent over the firm's contemporaneous cost in violation of the Board of Governors Interpretation concerning the NASD Mark-Up Policy. Furthermore, Black engaged in a pattern of activity and/or a course of conduct and sales efforts involving the solicitation and execution of securities in customer's accounts that violated the Board of Governors' policy regarding fair dealings with customers. Black also recommended to a customer the purchase and sale of mutual funds in the customer's account without having reasonable grounds for believing that such recommendations were suitable for the account in view of the cost and nature of the recommended securities, the objectives of the funds, and the customer's financial objectives, situation, circumstances, and needs.

#### **Firms Fined**

**Lehman Brothers, Inc. (New York, New York)** submitted an Offer of Settlement pursuant to which the firm was fined \$10,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to supervise a registered individual so as to prevent unauthorized transactions in customers' accounts.

**Metropolitan Life Insurance Company (New York, New York)** and **MetLife Securities, Inc. (New York, New York)** submitted a Letter of Acceptance, Waiver and Consent pursuant to which they were fined \$75,000, jointly and severally. In



addition, the firms must perform the following undertakings:

- submit a copy of their supervisory procedure indicating the name or title of the individuals responsible for the accuracy and prompt submission of all Uniform Termination Notice for Securities Industry Registration (Form U-5) transmissions;
- have an audit by an independent consultant of the accuracy of their current registration records and a review including, but not limited to, all policies and procedures, including supervisory assignments relevant to the reporting of terminations and complaint information on Form U-5;
- prepare a report to senior management indicating any deficiencies with any recommended corrective action and state that the requirements in Article IV, Section 3 of the NASD By-Laws and the reporting requirements of the Form U-5 as well as all applicable rules and regulations were taken into account in conducting this audit and review;
- submit a copy of the audit report to the NASD with details of the corrective action taken as a result of the recommendations in the report; and
- provide the NASD with a summary report outlining the details of every late or incomplete Form U-5 filing, if any, made within the previous six months with an explanation of the cause of the delay or incomplete report and corrective action taken.

Without admitting or denying the allegations, the firms consented to the described sanctions and to the entry of findings that they made 351 Form U-5 filings that were incomplete or were filed more than 30 days after termination.

**Morgan Stanley & Co. Incorporated (New York, New**

**York)** submitted a Letter of Acceptance, Waiver and Consent pursuant to which the firm was fined \$19,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to honor quotations it caused to be disseminated through the Nasdaq® system.

**Seidel & Fasano (New York, New York)** submitted a Letter of Acceptance, Waiver and Consent pursuant to which the firm was fined \$3,500. The firm was further fined \$12,700, jointly and severally, with other individuals. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that, in three direct participation program offerings, the firm received commissions in excess of the amount stated in the respective direct participation program private placement memoranda. In addition, the findings stated that the firm permitted individuals to function in the capacity of general securities representatives without being registered with the NASD.

**Shearson Lehman Brothers, Inc., (New York, New York)** submitted an Offer of Settlement pursuant to which the firm was fined \$10,000, which includes disgorgement of \$6,610 in commissions. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to supervise adequately the activities of a registered individual.

### **Individuals Barred Or Suspended**

**Charles Bennett (Registered Representative, Brooklyn, New York)** submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined \$100,000, barred from association with any NASD member in any capacity, and ordered to pay \$38,579.39 in restitu-

tion to his member firm. Without admitting or denying the allegations, Bennett consented to the described sanctions and to the entry of findings that he received from a public customer checks totaling \$46,586.30 to be placed in an investment for the customer, and, instead, he misappropriated and converted the funds to his personal use.

**Ira Berkowitz (Registered Representative, Bayside, New York)** submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined \$5,000, suspended from association with any NASD member in any capacity for 15 business days, and ordered to requalify by examination before again acting in any capacity. Without admitting or denying the allegations, Berkowitz consented to the described sanctions and to the entry of findings that, without the knowledge or consent of his member firm or a public customer, he signed the customer's name to a Securities Investment Acknowledgement form.

**Mark Deadrick Booth (Registered Representative, Birmingham, Alabama)** submitted an Offer of Settlement pursuant to which he was suspended from association with any NASD member in any capacity for six months and required to requalify by examination following the suspension. Without admitting or denying the allegations, Booth consented to the described sanctions and to the entry of findings that he made sales and purchase recommendations to a public customer without having reasonable grounds for believing that the transactions were suitable for the customer based on facts disclosed by the customer as to her other security holdings, financial situation, and needs.

**Andrew E. Bressman (Registered Principal, Alpine, New Jersey)** submitted a Letter of Acceptance,

Waiver and Consent pursuant to which he was fined \$35,000 and suspended from association with any NASD member in any capacity for five business days. Without admitting or denying the allegations, Bressman consented to the described sanctions and to the entry of findings that he placed orders for customers at unfair and unreasonable prices that resulted in excessive commissions.

**James M. F. Chen (Registered Representative, Hoffman Estates, Illinois)** and **Manuel A. DeMoya (Associated Person, Arlington Heights, Illinois)** submitted Offers of Settlement pursuant to which Chen was fined \$5,000, suspended from association with any NASD member in any capacity for 60 days, and required to requalify by examination. DeMoya was fined \$100,000, barred from association with any NASD member in any capacity, and required to pay \$16,113 in restitution. Without admitting or denying the allegations, Chen and DeMoya consented to the described sanctions and to the entry of findings that DeMoya obtained from a public customer \$45,500 for the purchase of securities. The NASD determined that DeMoya used \$24,500 for the purchase of securities, and retained \$21,000 for his own use and benefit until a later date, when he returned \$5,000 to the customer. In addition, the NASD found that DeMoya failed to qualify or register in the appropriate capacity before engaging in the securities business of a member firm. The findings also stated that DeMoya obtained a \$113.20 check that represented a refund of insurance premiums to a public customer. According to the findings, instead of delivering the check to the customer, and without the customer's knowledge or consent, DeMoya signed the check and deposited it in a bank account in which he had a beneficial interest. Furthermore, the NASD found that Chen failed to ensure that DeMoya

was properly qualified and registered in an appropriate capacity before engaging in the securities business of a member firm, and personally paid DeMoya securities commissions totaling \$1,008 while he was not properly registered.

**Steven Alfred Custer (Registered Representative, Oconomowoc, Wisconsin)** and **Danny Lee Wayne (Registered Representative, Oconomowoc, Wisconsin)**. Wayne was fined \$20,000, suspended from association with any NASD member in any capacity for 60 days, and required to requalify by examination. Custer submitted an Offer of Settlement pursuant to which he was fined \$15,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Custer and Wayne engaged in private securities transactions with public customers while failing to give or obtain from their member firm prior written authorization to engage in such activities. The findings also stated that Custer and Wayne recommended the above securities to such customers without having reasonable grounds for believing that such recommendations were suitable for the customers based on information available to them concerning the nature of the entity issuing the securities, and/or based on the customers' investment objectives, financial situations, and needs.

**James E. Davis (Registered Representative, Rochester, New York)** submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined \$24,200, barred from association with any NASD member in any capacity, and required to pay restitution. Without admitting or denying the allegations, Davis consented to the described sanctions and to the entry of findings that he obtained from public customers \$4,831.11 that was to be applied to insurance poli-

cies on behalf of the customers. The NASD found that Davis failed to apply the funds as requested and used them for some purpose other than for the benefit of the customer.

**Duane K. Duclaux (Registered Representative, Metairie, Louisiana)** submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined \$10,000, barred from association with any NASD member in any capacity with a right to reapply for association with a member firm after three years, and required to pay restitution to his member firm. Without admitting or denying the allegations, Duclaux consented to the described sanctions and to the entry of findings that he executed stock purchase transactions on behalf of two institutional customers that were placed in his member firm's inventory account, without the knowledge or consent of his member firm. These transactions created a short position in the firm's inventory account thereby resulting in the firm incurring a \$143,512 loss.

**Eugene J. Filippino (Registered Representative, Del Ray Beach, Florida)** submitted an Offer of Settlement pursuant to which he was fined \$5,000 and suspended from association with any NASD member as a general securities representative for three weeks. Without admitting or denying the allegations, Filippino consented to the described sanctions and to the entry of findings that he executed or caused to be executed transactions in a public customer's account without the customer's prior knowledge, authorization, or consent.

**Aaron D. Fischman (Registered Representative, Woodmere, New York)**, **Michael C. Woloshin (Registered Representative, New York, New York)**, and **Avrum R. Tokayer (Registered Principal, Cedarhurst, New York)**. Fischman and Woloshin submitted an Offer of

Settlement pursuant to which they were each fined \$50,000 and barred from association with any NASD member in any capacity. Tokayer, in a separate decision, was fined \$364,937.50 and barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Fischman and Woloshin consented to the described sanctions and to the entry of findings that Fischman, Woloshin, and Tokayer manipulated the price of a common stock and failed to appear for testimony as requested by the NASD in connection with an ongoing investigation. The NASD found that Fischman and Tokayer effected transactions in customer accounts without obtaining written agreements from customers and failed to provide risk disclosure statements to customers before effecting the customers' trades. The findings also stated that Fischman and Tokayer failed to provide public customers with the inside bid and ask quotations before effecting transactions for the customers and, when confirming the trade for the customers, failed to disclose its compensation. In addition, the NASD entered findings that Fischman failed to disclose to customers the compensation received by associated persons in connection with transactions before effecting the customers' trades, and that Tokayer also failed to establish or enforce an effective supervisory system that would have enabled his member firm to prevent the foregoing misconduct.

**John P. Galli (Registered Representative, Brooklyn, New York)** was fined \$10,000 and barred from association with any NASD member in any capacity. The National Business Conduct Committee (NBCC) affirmed the sanctions following appeal of a Philadelphia District Business Conduct Committee (DBCC) decision. The sanctions were based on findings that Galli arranged to have an impersonator

take the Series 7 examination for him. Galli has appealed this action to the SEC and the sanctions, other than the bar, are not in effect pending consideration of the appeal.

**Otis Harville (Registered Representative, Rochester, Michigan)** was fined \$120,000, barred from association with any NASD member in any capacity, and ordered to pay \$107,230.58 in restitution to a member firm. The sanctions were based on findings that Harville obtained from public customers \$107,230.58 to purchase shares in mutual funds and life insurance policies. Harville failed to follow the customers' instructions and used the funds for some purpose other than for the benefit of the customers. In addition, Harville failed to respond to NASD requests for information.

**Todd Levaughn Hickman (Registered Representative, Bronx, New York)** submitted an Offer of Settlement pursuant to which he was fined \$20,000 and barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Hickman consented to the described sanctions and to the entry of findings that he made misrepresentations and omissions of material fact in an effort to induce public customers to invest in a government securities fund. The NASD also found that Hickman falsified firm records by forging or causing the public customer's signature to be forged on investment product disclosure forms that each customer was required to sign before purchasing shares of the aforementioned fund. In addition, the NASD determined that Hickman made untrue statements to the NASD at an on-the-record interview concerning customer signatures.

**Lester Joseph Hoefflich (Registered Representative, Cheektowaga, New York)** submitted an Offer of

Settlement pursuant to which he was fined \$23,000, barred from association with any NASD member in any capacity, and required to pay \$1,236.13 in restitution. Without admitting or denying the allegations, Hoefflich consented to the described sanctions and to the entry of findings that he requested and received cash disbursements totaling \$1,236.13 from insurance policies for public customers, and, without the customers' knowledge or consent, he used the funds for some purpose other than for the benefit of the customers. In addition, the NASD found that Hoefflich failed to respond to NASD requests for information.

**Harry K. Howard (Registered Representative, Hamilton, Ohio)** submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined \$5,000 and barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Howard consented to the described sanctions and to the entry of findings that he obtained from his member firm checks totaling \$205.89 for commissions made payable to a registered principal with the firm. The NASD found that Howard failed to remit the checks to the principal and, instead, used the proceeds for some purpose other than the benefit of the principal.

**John J. Jarvis (Registered Representative, Pittsburgh, Pennsylvania)** was fined \$5,000 and suspended from association with any NASD member in any capacity for 10 business days. The sanctions were based on findings that Jarvis failed to submit to the NASD an amended Uniform Application for Securities Industry Registration (Form U-4) disclosing a Securities and Exchange Commission (SEC) order and suspension.

**Larry Ira Klein (Registered Representative, Oakland,**

**California**) was fined \$150,000 and suspended from association with any NASD member in any capacity for six months. In addition, Klein was ordered to requalify by examination before becoming associated with any NASD member following his suspension. The NBCC affirmed the sanctions following appeal of a San Francisco DBCC decision. The sanctions were based on findings that Klein, in connection with the sale of stock, made material misstatements of fact and omitted material facts to the customers. Furthermore, Klein made unsuitable recommendations to customers regarding the purchase of stock without having reasonable grounds for believing that the investment was suitable for the customers in light of the customers' other security holdings, financial situation, and needs.

Klein has appealed this action to the SEC, and the sanctions are not in effect pending consideration of the appeal.

**Lawrence R. Klein (Registered Representative, Woodland Hills, California)** was barred from association with any NASD member in any capacity with the right to apply for association with an NASD member after five years. The NBCC imposed the sanctions following appeal of a Los Angeles DBCC decision. The sanctions were based on findings that Klein caused \$17,000 to be wired from the joint account of public customers and used the funds, among other things, to repay monies he owed to a third party. In addition, Klein forged the customers' signatures on an authorization to transfer federal funds directing his member firm's clearing firm to effect the unauthorized transfer of funds.

Klein has appealed this action to the SEC, and the sanctions, other than the bar, are not in effect.

**Stephen S. Knepp (Registered Representative, Pottstown, Pennsylvania)** was fined \$25,000, barred from association with any NASD member in any capacity, and required to disgorge to customers the commission earned totaling \$39,465. The NBCC affirmed the sanctions following appeal of a Philadelphia DBCC decision. The sanctions were based on findings that Knepp engaged in private securities transactions while failing to give prior written notice of such transactions to his member firm and engaged in the sale of securities while a registration statement was not in effect as to such securities. In addition, Knepp failed to exercise due diligence to ascertain the financial status of the issuer of securities offered and sold by a firm or to verify the purported existence of insurance on the receivables in which it purported to invest as a factor. Furthermore, Knepp failed to register a firm with the SEC as a broker or dealer.

**Leonard C. Ladia (Registered Representative, Pasadena, California)** 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, Ladia consented to the described sanctions and to the entry of findings that he forged a customer's signature on a change of beneficiary form and backdated a reinstatement request form to reinstate the customer's life insurance policy that had been canceled. According to the findings, Ladia stood to receive about \$448 in commissions by doing so.

**Daniel Ray Licon (Registered Representative, Brisbane, California)** was fined \$40,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that

Licon failed to pay a \$7,367.28 Pacific Stock Exchange arbitration award and a \$137,750 NASD arbitration award. Licon also failed to respond to NASD requests for information.

**Junor Lissidous Morgan (Registered Representative, Queens, New York)** was fined \$100,000, barred from association with any NASD member in any capacity, and ordered to pay \$29,570 in restitution to his member firm. The sanctions were based on findings that Morgan received from public customers \$21,445 for deposit into mutual fund accounts and to be applied toward the premiums on insurance policies and, instead, converted the funds for his personal use. Morgan also caused loan checks totaling \$28,550 to be issued from customers' insurance policies, caused the checks to be sent to an address other than that of the customers, and converted to funds for his own personal use. In addition, Morgan failed to respond to NASD request for information.

**Richard Eugene Moyer (Registered Representative, Summit, New Jersey)** submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined \$7,500 and suspended from association with any NASD member in any capacity for 12 months. Without admitting or denying the allegations, Moyer consented to the described sanctions and to the entry of findings that, while subject to a statutory disqualification, he failed to receive the requisite regulatory approvals before, or during, his association with his member firm.

**Ronald Edward Nitz (Registered Representative, Crest Hill, Illinois)** submitted an Offer of Settlement pursuant to which he was fined \$20,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that

Nitz failed to respond to NASD requests for information concerning customer complaints.

**Michael R. Paro (Registered Representative, Wilmette, Illinois)** submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined \$120,000, barred from association with any NASD member in any capacity, and required to pay \$22,139.50 in restitution to a member firm. Without admitting or denying the allegations, Paro consented to the described sanctions and to the entry of findings that he received through loans from insurance policies owned by public customers \$24,847.45 in checks and signed, or caused to be signed, the customers' names to the checks issued by his member firm without the knowledge or consent of the customers. The findings also stated that Paro used \$2,707.95 to fund a new life insurance policy for one of the customers and used the remaining \$22,139.50 for some purpose other than for the benefit of the customers. In addition, the NASD found that Paro failed to respond to NASD requests for information.

**Barry V. Parr (Registered Representative, Laguna Niguel, California)** submitted an Offer of Settlement pursuant to which he was fined \$31,432.81 and barred from association with any NASD member in any capacity with the right to reapply after 10 years. Without admitting or denying the allegations, Parr consented to the described sanctions and to the entry of findings that he participated in private securities transactions in that he sold to 10 public customers an annuity and/or shares in an investment company through another broker/dealer, but failed to provide prompt written notification to his member firm before participating in such private securities transactions.

**Jarred N. Parris (Registered Representative, Freeport, New**

**York)** submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined \$5,000 and barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Parris consented to the described sanctions and to the entry of findings that he signed the name of a registered representative to a check made payable to an individual without authority, and cashed the check.

**Joyce A. Ritterbusch (Registered Representative, Crystal Lake, Illinois)** submitted a Letter of Acceptance, Waiver and Consent pursuant to which she was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Ritterbusch consented to the described sanctions and to the entry of findings that, contrary to instructions given to her, she took notes that contained material relevant to the Series 7 exam into the exam room.

**Patrick Albert Rouach (Registered Representative, Luxembourg)** was fined \$5,000 and suspended from association with any NASD member in any capacity for five business days. The sanctions were based on findings that Rouach sold and purchased shares of common stocks in the account of a public customer, without the customer's prior knowledge, consent, or authorization.

**Sean E. Sammler (Registered Representative, Rochester, New York)** submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined \$6,325, barred from association with any NASD member in any capacity, and required to pay restitution. Without admitting or denying the allegations, Sammler consented to the described sanctions and to the entry of findings that he obtained from his member firm a \$1,263.14

check representing the cash surrender value on an insurance policy owned by an insurance customer. The NASD found that Sammler had previously submitted a request to his member firm to assign all benefits and interests in the policy to him, without the knowledge or consent of the customer, and subsequently used the funds for some purpose other than for the benefit of the customer.

**Richard Dee Scott (Registered Representative, Seattle, Washington)** submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined \$10,000 and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the allegations, Scott consented to the described sanctions and to the entry of findings that he permitted a statutorily disqualified and unregistered person to be associated with a member firm.

**Jin Hwy Shin (Registered Representative, Sunnyvale, California)** was fined \$5,000, suspended from association with any NASD member in any capacity for 30 days, and required to requalify by examination as an investments companies and variable contracts products limited representative. The NBCC affirmed the sanctions following review of a San Francisco DBCC decision. The sanctions were based on findings that Shin received from public customers \$2,926.09 for the purchase of insurance and converted the proceeds for his own use and benefit.

**Martin B. Sloate (Registered Representative, Greenwich, Connecticut)** submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined \$15,000, ordered to disgorge income of \$12,000, and suspended from association with any NASD member

in any capacity for one year. In addition, Sloate is required to requalify by examination.

Without admitting or denying the allegations, Sloate consented to the described sanctions and to the entry of findings that he failed to keep current his applications with the NASD when he failed to disclose an SEC permanent injunction on his Form U-4. The findings also stated that Sloate was associated with an NASD member while being statutorily disqualified without applying to, or receiving relief from, the NASD for the ineligibility.

**Michael Edward Tippy (Registered Representative, Murphysboro, Illinois)** submitted an Offer of Settlement 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, Tippy consented to the described sanctions and to the entry of findings that he obtained from a public customer \$25,000 intended for investment purposes. According to the findings, Tippy failed to follow the customer's instructions and deposited the funds in an account in which he had a beneficial interest until a later date, when he repaid the customer.

The NASD also found that, in connection with the above activities, Tippy issued false confirmations to a public customer to show that he had made the securities purchases when, in fact, the securities were not purchased for the customer's account or through a broker/ dealer who was an NASD member. In addition, the NASD determined that Tippy failed to respond to NASD requests for information.

**Kevin D. Wirth (Registered Representative, Katonah, New York)** submitted a Letter of Acceptance, Waiver and Consent 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, Wirth consented to the described sanctions and to the entry of findings that he conducted securities transactions outside the scope of his employment and without providing prior written notification to his member firm.

**Michael W. Zimonja (Registered Principal, Salt Lake City, Utah)** and **Mark R. Sansom (Associated Person, Salt Lake City, Utah)** submitted an Offer of Settlement pursuant to which Zimonja was fined \$1,000 and suspended from association with any NASD member in any capacity for two years. Sansom was fined \$5,000 and suspended from association with any NASD member in any capacity for 30 days.

Without admitting or denying the allegations, Zimonja and Sansom consented to the described sanctions and to the entry of findings that Sansom acted as a registered representative without being properly qualified and registered, and Zimonja allowed Sansom to perform functions at their member firm that required him to be registered as a registered representative of the firm.

### **Individual Fined**

**Howard S. Gartenhaus (Registered Principal, Rockville, Maryland)** submitted an Offer of Settlement pursuant to which he was fined \$10,000. Without admitting or denying the allegations, Gartenhaus consented to the described sanction and to the entry of findings that, in contravention of the Free-Riding and Withholding Interpretation of the Board of Governors, Gartenhaus purchased shares of securities that traded at a premium in the secondary market when he was prohibited from purchasing such securities.

### **Firm Expelled For Failure To Pay Fines And Costs In Connection With Violations**

**Accord Capital Growth, Inc.,**  
Dallas, Texas (August 17, 1995)

### **Firm Suspended**

The following firm was suspended from membership in the NASD for failure to comply with formal written requests to submit financial information to the NASD. The action was 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 the entry. If the firm has complied with the requests for information, the listing also includes the date the suspension concluded.

**Genesis Holding Group, Ltd.,**  
Chicago, Illinois, (August 1, 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.

**1st Cleveland Securities Corporation,** Beachwood, Ohio  
(July 25, 1995)

**Trinity Group Securities, Inc.,**  
Mendham, New Jersey (July 27, 1995)

### **Individuals Whose Registrations Were Revoked For Failure To Pay Fines, Costs And/Or Provide Proof Of Restitution In Connection With Violations**

**Michael Apostol,** New York,  
New York

**Betty J. Avery**, Atlanta, Georgia

**Stuart J. D. Mills**, Englewood,  
Colorado

**Lawrence A. Rosenberg**, Brooklyn,  
New York

**Bethel P. Williamson, Jr.**, Lithonia,  
Georgia

**Individual Whose  
Registration Was Suspended  
For Failure To Pay And/Or  
Provide Proof Of Restitution**

**David Morley Black** (Spokane,  
Washington)

# FOR YOUR INFORMATION

## **SEC Approves Amendment For Not Adjusting Order Prices Where Dividend Is Less Than One Cent**

On August 22, 1995, the SEC approved an amendment to Article III, Section 46 of the Rules of Fair Practice to provide that where a dividend or other distribution is less than

one cent (\$.01), the price of the order will not be adjusted. The NASD believes that the effect of such a small dividend is *de minimus* and, therefore, the likelihood that unadjusted orders will result in poor executions (the problem Section 46 is designed to prevent) is remote. The amendment is effective immediately.



# SPECIAL NASD NOTICE TO MEMBERS 95-80

## NASD Further Explains Members Obligations And Responsibilities Regarding Mutual Funds Sales Practices

### 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 obligation of NASD<sup>®</sup> members under the Rules of Fair Practice with respect to mutual fund sales practices is a continuing concern of the NASD. The proliferation of new mutual funds and varied fee structures has significantly increased the options available for investors. As a result, the mutual fund selection process has become more complex.

To make appropriate recommendations, members and their associated persons, collectively referred to herein as “members,” must know the key points regarding the mutual funds they recommend or sell. Members must ensure:

- complete and balanced disclosure is made to investors regarding the distinctions among classes of a multi-class fund or feeders of a master-feeder fund;
- if an expense ratio is represented as an advantage of a particular fund, it is explained in the context of and compared with other mutual fund expense ratios;
- if a mutual fund portfolio may include financial derivatives, the potential risks involved are fully disclosed and explained;
- when performance information is presented, the concepts of total return, yield, and distribution rates are explained to and understood by the investor;
- any recommendation made is suitable and based on the investor’s investment objectives;
- any recommendation that a customer switch mutual funds is made with the investor’s best interest in mind, rather than based on incentives received by the associated person;
- materials designed for internal or

“dealer only” use are not distributed in any manner to the public, orally or in writing; and

- electronic communications are treated the same as any other advertising and/or sales literature, and are supervised and used only under the same parameters.

Members who fail to carry out these obligations and responsibilities, or who do not communicate information concerning mutual funds accurately and completely, may be subject to NASD disciplinary action.

### Background

In *Notice to Members 94-16* (March 1994), the NASD reminded members of their obligations under the Rules of Fair Practice with respect to mutual fund sales practices. Members were instructed to ensure that their communications with the public (oral and written) were accurate and complete regarding disclosure of material information, SIPC coverage, breakpoints, and switching. Comprehensive internal supervisory and compliance controls are needed to ensure that mutual fund sales practices comply with all relevant NASD Rules and are consistent with just and equitable principals of trade. Previous *Notices to Members 93-87* (December 1993) and *91-74* (November 1991) also addressed sales practice issues relating to the growth of mutual fund sales as a result of the reinvestment of maturing certificates of deposit or other bank depository instruments.

Due to the development of innovative and more complex mutual fund products, and to expanding channels of distribution, additional concerns have arisen since the publication of *Notice to Members 94-16*. The NASD has observed, commensurate with the increasing complexity of the

structure of mutual funds, an increase in the varieties of sales charges and service charges associated with fund sales. The NASD is concerned that investors may not understand the distinctions among and ramifications of these various products, their fee structures and charges. It is imperative that the associated person recommend the most suitable mutual fund, based on the goals, investment objectives, and financial status of the investor, without being influenced by incentive arrangements.

## Disclosure

Material facts must be disclosed to investors in recommending the purchase of a mutual fund. The member must attempt to obtain information sufficient to determine the suitability of the recommendation for the investor and to evaluate whether factors concerning that mutual fund recommendation are material to the investor. As addressed in *Notice to Members 94-16*, material facts may include, but are not limited to, the fund's investment objective; the fund's portfolio, historical income, or capital appreciation; the fund's expense ratio and sales charges; risks of investing in the fund relative to other investments; and the fund's hedging or risk management strategies. Disclosure of these and other facts concerning a recommended investment is required because this information is material to the investor's investment decision.

As indicated earlier, sales charges and service charges associated with fund sales have become increasingly complex. In multi-class funds, each class of the fund participates in the same underlying portfolio but may have different expenses, levels of service, and other options. Consequently, each class generates a different share price and performance record, and appears as a separate fund in

newspaper fund listings.

Master-feeder funds are two-tiered structures in which one or more registered open-end funds (feeder) invest in a single investment company (master). Similar to the various classes of a multi-class fund, the feeder funds may have various distribution configurations tailored to specific markets.

Prospectuses disclose many of the details of these products. However, members are reminded that they must provide sufficient information for investors to understand and evaluate the structure of multi-class and master-feeder funds. As the number of share classes continues to increase, it is imperative that investors are told the differences among a front-end load, a spread load (deferred sales charge and 12b-1 fee), and a level load, and that they are instructed about why one type of fee may be higher or lower than another. Another important disclosure relates to explaining how factors such as the amount invested, the rate of return, the amount of time the investor remains in the fund, and the fund's conversion features affect an investor's overall costs.

To the extent that members declare expense ratios as material to an investor purchasing fund shares, these expense ratios need to be explained and compared with those of other mutual funds. Expense ratios are derived by dividing a fund's annual operating expenses by average net assets. Operating expenses may include management fees, investment advisory fees, director fees, 12b-1 fees, and expenses for preparing and mailing prospectuses and financial reports.

Concerning tax issues, members should remind investors, where appropriate, that distributions of interest, dividends, and capital gains

are subject to federal income tax even though the customer chooses to have the funds reinvested. A high portfolio turnover also generates higher transaction costs and may affect taxes.

In offering funds that invest in financial derivatives, members must make clear to investors the risks involved. For example, funds that use repurchase agreements, purchase mortgage-related securities, purchase securities on a "when issued" basis, or purchase or sell securities on a "forward commitment" basis all involve special risks. Such risks are material to an investor's decision as to whether the mutual fund is a suitable investment. Members should familiarize themselves with a fund's investment objective, portfolio techniques, and policies as noted in the prospectus, and should convey such information to investors.

## Performance Information

When recommending mutual funds, members should make certain that investors understand the concept of total return. When explaining total return, members should ensure that investors understand that total return measures overall performance of a mutual fund, whereas current yield is based only on interest or dividend income received by the fund. Relatedly, where appropriate, members should explain to investors the difference between return *of* principal and return *on* principal.

Members are reminded that the Securities and Exchange Commission (SEC) requires that a yield quotation in an advertisement be restricted to a quotation of current yield based on the SEC formula, as calculated in the Statement of Additional Information, and the quotation must be accompanied by quotations of total return. Thus, when presenting information

to customers regarding distribution rates, members must fully explain the difference between distribution rate and current yield.

### **Suitability**

A starting point in a member's recommendation of a mutual fund is to clearly define the investor's objectives and financial situation. The need for current income, liquidity, diversification, and acceptable levels of risk are important considerations common to most investors. In recommending mutual funds, the member should match the investor's objective with the stated objective and investment strategy of a particular fund. An added concern relative to funds having multiple fee structures is not only matching the type of fund to the investor's objective, but also recommending the appropriate fee structure. Article III, Section 2 of the Rules of Fair Practice states that, in recommending to the investor the purchase, sale, or exchange of any security, the member must have reasonable grounds for believing that the recommendation is suitable for such investor, based on the facts disclosed by the investor. A member should be able to demonstrate the rationale for its recommendation and suitability determination, based on the information in Article III, Sections 2 and 21 of the Rules of Fair Practice.

### **Switching**

In *Notice to Members 94-16*, members were reminded of their obligation to ensure that any recommendation to switch mutual funds is evaluated with regard to the net investment advantage to the investor. Switching among certain fund types may be difficult to justify if the financial gain or investment objective to be achieved by the switch is undermined by the

transaction fees associated with the switch. For example, if a member recommends that an investor redeem a mutual fund purchased with a front-end sales load, and then purchase another fund with a contingent deferred sales charge, it would be inappropriate to assert that no sales charge will be paid relative to the new fund purchase because the investor may redeem the shares before the contingent period ends. Additionally, many funds with contingent deferred sales charges also assess asset-based sales charges. Thus, the member must disclose that an investor who holds the fund long term may pay more than the economic equivalent of a front-end sales charge. Further, recommendations to engage in market timing transactions should be made for transactions in a single family of funds or where there are virtually no transaction costs associated with the trade.

Members must not recommend that a customer switch from one mutual fund to another based on the compensation that the member or its associated persons will receive for effecting the switch. Members are obligated to ensure that their supervisory and compliance procedures are adequate to monitor switching of customers among funds, and should be prepared to document their reasons for switching a customer from one fund to another.

### **Dealer-Use-Only Material**

Members must make certain that material intended for distribution only to dealers and registered representatives is not delivered to the public unless the material is in compliance with all Rules applicable to communication with the public.

Fund sponsors, dealers and wholesalers often use this material to educate sales personnel about the

benefits of a fund and to provide marketing ideas. This material is not required to be filed with the NASD as "sales literature" because it is considered an internal communication and thus it is exempt from NASD filing requirements. Consequently, the material is not reviewed by the NASD for compliance with applicable rules. If such material is ever passed on to investors, the material would be considered sales literature and must be filed with the NASD. The NASD will review the material under the same standards as other material used with the public.

Members preparing and distributing dealer-use-only material are urged to label all such material clearly and prominently, indicating that it is not approved for distribution to the public, and must not be copied or used with the public. Members should limit the extent of distribution of such material and be aware of who it has been given to, including how many copies are sent to each location.

The NASD is also concerned about oral presentations based on information contained in dealer-use-only material. This practice could present a potential regulatory problem if the material has not been filed with and reviewed by the NASD, as there can be no assurance that the information provided to investors is in accordance with applicable rules.

### **Electronic Communications**

Members are reminded that they have the same obligations under the NASD Rules of Fair Practice, specifically Article III, Section 35, relative to communications with the public sent electronically via computer as they do with regard to any other type of communication covered by these rules. Communications available to network subscribers, including items displayed over network bulletin