Rule 19c-3 securities.[297] As a result of this amendment, market participants will have more complete information about significant OTC market makers and specialists in a security and the prices at which they are willing to trade. The majority of commenters who addressed the amendment to Rule 11Ac1-1(a)(25) endorse the Commission's proposal to end the disparity between Rule 19c-3 securities and non-Rule 19c-3 securities, noting that there is no basis for continuing to draw a regulatory distinction between Rule 19c-3 and non-Rule 19c-3 securities, and that the extension of the Quote Rule will provide meaningful information about significant market makers in listed securities.[298] One commenter asserts that requiring quotations from all significant OTC market makers will succeed in improving the quality of the NMS for all listed securities while at the same time leveling the playing field for all market makers.[299]

Nevertheless, many commenters suggest modifications to the 1% volume threshold. Some commenters suggest that Nasdaq, on behalf of all third market makers, should be viewed as one market participant, and that once its volume exceeds 1% for a listed security, all OTC market makers in that security should be required to maintain continuous two-sided quotations.[300] Other commenters believe that the Commission should adopt a "continuousness of execution" standard rather than a rigid 1% volume threshold.[301] This suggestion would require a dealer to quote if it executes orders on a regular or continuous basis, even if it accounts for less than 1% of the volume, while excluding from quotation requirements a dealer that executes a few large trades that account for more than 1% of the volume. The NYSE suggests an additional threshold, to be used in the alternative with the 1% of volume threshold.[302] This alternative would have the effect of requiring public quotations from market makers who, while not accounting for more than 1% of the aggregate transaction volume, have an active retail business in small-sized trades.

The Commission believes that extending the 1% threshold based on quarterly aggregate trading volume to non-Rule 19c-3 securities is a reasonable method to improve the scope of quotation information to include significant OTC market makers and specialists. This 1% threshold, currently in effect for Rule 19c-3 securities, has proved effective in supplying comprehensive quotation information to the market at large. Moreover, based on the increase in third market trading volume for these securities, the Commission does not believe this standard is unduly burdensome on OTC market makers or specialists.[303] Rather, the Commission believes this threshold strikes a balance between requiring the dissemination of all quotation interest and accommodating those specialists and OTC market makers that are small entities. The Commission believes that OTC market makers and specialists that account for 1% or less of the aggregate volume are not active enough to justify the additional expense of providing continuous quotation display.[304]

Similarly, the Commission believes that applying the 1% threshold to the total over-the-counter volume in a listed security would extend the quotation requirements to inactive market makers. The Commission questions whether the added quotation information would justify the added burden.[305] The Commission also believes that reliance on something other than a numerical standard in this circumstance would lead to confusion in the marketplace. Accordingly, the Commission believes the "greater than 1% aggregate trading volume" threshold for mandatory quotations continues to be appropriate.

ii. Amendment to 11Ac1-1(a)(13) (Definition of an "OTC Market Maker")

Amended Rule 11Ac1-1(a)(13) [306] revises the definition of "OTC market maker" to include any dealer who holds itself out as willing to buy from and sell to its customers, or otherwise, a covered security for its own account on a regular or continuous basis otherwise than on an exchange in amounts of less than block size.[307] Accordingly, dealers that internalize customer order flow in particular stocks, by holding themselves out to customers as willing to buy and sell on an ongoing basis, would fall within the definition even though they may not hold themselves out to all other market participants. In addition, dealers

[297] OTC market makers that trade a significant volume in non-Rule 19c-3 securities have not been subject to the same requirements as third market makers that meet the 1% threshold for Rule 19c-3 securities. For example, an OTC market maker meeting the 1% threshold is required to quote in a Rule 19c-3 security and therefore must register as a CQS market maker with the NASD. *NASD Manual,* Rule 6320. CQS market makers are subject to the NASD's CQS market maker rules, which include firm and continuous two-sided quote obligations and mandatory participation in the ITS through Nasdaq's Computer Assisted Execution System. *NASD Manual,* Rules 6320 and 6330.

[298] *See, e.g.,* Amex Letter; Blume Letter; BSE Letter; CHX Letter; CSE Letter; NASD Letter; PSE Letter; Alex. Brown Letter; Schwab Letter; D.E. Shaw Letter; Dean Witter Letter; Lehman Letter; Madoff Letter; Merrill Letter; PaineWebber Letter; Salomon Letter; Smith Barney Letter; STA Letter.

There were some commenters who did not support the extension of the Quote Rule's requirements to non-Rule 19c-3 securities. *See, e.g.,* NYSE Letter; and Specialists Assoc. Letter, which note that the Commission, rather than expanding the Quote Rule to include non-Rule 19c-3 securities, should re-examine the validity of Rule 19c-3. *See, e.g.,* Letter from Alexander H. Slivka, Executive Vice-President, National Securities Corporation, to Jonathan G. Katz, Secretary, SEC, dated October 25, 1995 ("NSC Letter"); Fahnestock Letter; Letter from Samuel Lieberman, President, Rothschild Lieberman Ltd., to Jonathan G. Katz, Secretary, SEC ("Rothschild Letter"); Letter from Mark T. DeFelice, Vice President, Roosevelt & Cross, Inc., to Jonathan G. Katz, SEC, dated January 24, 1996 ("Roosevelt Letter"), which note that the extension of the quotation requirements to include non-Rule 19c-3, will have an impact on small firms. *See infra* note 307.

[299] Madoff Letter.

[300] *See* PSE Letter; Specialists Assoc. Letter.

A comparable alternative is to require quotations from all OTC market makers who account for more than 1% of the Nasdaq-reported volume in a security. *See* Investors Research Letter.

In the same vein, two commenters suggest that once an OTC market maker or specialist displays a quotation in a listed security, it should be subject to the requirements of the rule. *See* BSE Letter; CSE Letter.

The NYSE and CSE suggest further application of the rule to include brokers and their private trading systems. *See* NYSE Letter; CSE Letter.

[301] *See* CHX Letter; Fahnestock Letter; Jefferies Letter; Salomon Brothers Letter; STA Letter. *See also* Rothschild Letter.

[302] NYSE Letter. *See also* RPM Letter; Specialists Assoc. Letter.

[303] The Commission seeks to avoid imposing burdens on market participants that are not necessary to achieve the Quote Rule's objective of reliable public quotations from all significant markets in a security. The Commission notes that the 1% threshold for quotations in Rule 19c-3 securities has not impaired trading in these securities. Since the Quote Rule was amended, OTC market makers' volume in Rule 19c-3 securities has increased. *See Fragmentation* vs. *Consolidation* at 4-5. The Commission has no reason to believe that imposing mandatory quotations on specialists and OTC market makers that are responsible for more than 1% of the volume in a non-Rule 19c-3 security will affect market making in these securities.

[304] A few commenters expressed concern that the amendment to the Quote Rule would have a detrimental impact on small firms. *See* Fahnestock Letter; NSC Letter; Roosevelt Letter; Rothschild Letter. The Commission believes the requirement that a dealer must transact greater than 1% of the volume in a security before quotations are mandated prevents the rule from becoming unnecessarily burdensome on small firms. For example, a firm would not have to publish continuous two-sided quotations in AT&T unless it transacted more than 1% of the aggregate transaction volume, which the Commission considers more than modest volume.

[305] In a related release issued today, the Commission is proposing an amendment that would require continuous two-sided quotations from OTC market makers and specialists provided that the OTC market maker or specialist is responsible for more than 1% of the aggregate transaction volume for a security included on the Nasdaq Stock Market. *See* Companion Release for a detailed discussion on the proposed amendment to the Quote Rule.

[306] 17 CFR 240.11Ac1-1(a)(13).

[307] The definition, as proposed, read "* * * sell to a customer * * * " but has been modified to read "* * * sell to its customers * * *."

that hold themselves out to particular firms as willing to receive customer order flow, and execute those orders on a regular or continuous basis, also would fall within the definition of an OTC market maker.

This change was in response to the requests of commenters for consistency in the definition of OTC market maker between proposed Rule 11Ac1-1(a)(13) and proposed Rule 11Ac1-4(a)(9). *See, e.g.*, NASD Letter. Additionally, the Commission stated in the Proposing Release that "[a]s in the past, broker-dealers will not be considered to be holding themselves out as regularly or continuously willing to buy or sell a security if they occasionally execute a trade as principal to accommodate a customer's request." Proposing Release at 24. The Commission believes the new language more accurately reflects that premise.

Most commenters addressing this issue assert that it is appropriate to include in the definition of OTC market maker those dealers who internalize customer order flow because they believe that dealers that hold themselves out to their customers as willing to buy and sell securities on a continuous basis should be required to publish quotations.[308] One commenter asserts that the amendment will broaden the definition of who should be required to provide transparency and liquidity to the NMS to include dealers that transact business with other firms' order flow and with their own customers, thus ensuring a minimum level of quotation commitment from those NMS participants vying for public order flow.[309] Some commenters, however, advocate that more than internalization of order flow should be required before a dealer is deemed an OTC market maker. These commenters suggest the Commission adopt some form of a "holding itself out" standard, so that the rule would capture the quotations of professional liquidity providers but not dealers that occasionally accommodate a customer's request.[310] Other commenters, deeming the definition too inclusive, suggest the Commission add an exception for broker-dealers that act solely as agents.[311]

One commenter believes that excluding firms that transact primarily block size orders and therefore account for significant volume is inconsistent with the Commission's goals for increased transparency.[312] However, several commenters note that block size orders are excluded from the existing definition of OTC market maker and argue strongly that it is consistent with the purposes of the rule to continue to exclude them.[313]

The Commission believes that adoption of the amendment is warranted to ensure the availability of quotation information that accurately reflects the interests of all significant market participants. Increased transparency is fundamental to the fairness and efficiency of the securities markets. As noted in the Market 2000 Study, enhanced transparency helps link various market segments.[314] Currently, a dealer can receive order flow from internalization or pre-existing order routing arrangements but avoid publishing quotations, even when it accounts for more than 1% of the volume in a non-Rule 19c-3 security, because it is not currently deemed to be an OTC market maker.[315] Allowing significant market makers that deal actively in securities without publicizing their activity or making available their prices undermines the NMS goal of transparency. The Commission believes that those dealers should be classified under the rule as market makers and be required to publicize their quotations so that investors may know of, and trade on similar terms with, those market makers.

The Commission has considered commenters' suggestions regarding alternative definitions. In fact, in response to the suggestions of some commenters, the Commission has modified the proposed amendment to make clear that more than an isolated transaction is necessary before a dealer is designated an OTC market maker.

The Commission, in regard to orders of block size, has determined to continue to exclude dealers that hold themselves out as only willing to deal in orders equal to or greater than 10,000 shares. Orders of block size are generally negotiated with the dealer and exposed upon execution. Block positioners usually do not maintain prices at which they are willing to buy and sell a particular security; rather, they make known their role of assisting in the purchase and sale of large positions in securities at some price. Consequently, these dealers do not function as typical dealers that maintain a regular or continuous price quote. The Commission has concluded that requiring quotations from these dealers would not provide useful price information and therefore a dealer that acts solely as a block positioner should remain excluded from the definition.

iii. Amendment to 11Ac1-1(a)(6) (Definition of a "Covered Security")

As amended, Rule 11Ac1-1(a)(6)[316] defines "covered security" to include any security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as described in Section 3(a)(51)(A)(ii) of the Exchange Act.[317] This amendment would extend the Quote Rule provisions to OTC market makers and exchange specialists quoting in Nasdaq SmallCap securities.

The Proposing Release noted that the Quote Rule presently does not reflect certain developments in the Nasdaq market, including the large number of securities included on the Nasdaq SmallCap market. Only one commenter addressed this amendment. That commenter, MJT, expressed strong support for the proposal, noting that it is both fair and equitable to apply the Quote Rule to Nasdaq SmallCap securities.[318] The Commission believes it is appropriate to extend coverage of the Quote Rule to these securities in recognition of the development of a liquid trading market and increased investor demand for these securities. NASD rules concerning quotations already require firm quotations for both Nasdaq SmallCap securities and Nasdaq/National Market securities.[319] Thus, the amendment simply extends coverage of the Quote Rule requirements to the same range of securities as

[308] *See* Amex Letter; BSE Letter; CHX Letter; CSE Letter; D.E. Shaw Letter; Madoff Letter; NYSE Letter; PSE Letter; RPM Letter; SIA Letter; STA Letter.

[309] Madoff Letter.

[310] *See* NASD Letter; Jefferies Letter; SIA Letter; PaineWebber Letter; STA Letter. It should be noted that the amended definition includes a requirement that the broker-dealer hold itself out to, at a minimum, its customers on a regular and continuous basis in order to be an OTC market maker.

[311] *See* Fahnestock Letter; Salomon Brothers Letter; Rothschild Letter; Investors Research Letter.

[312] Amex Letter.

[313] *See* Fahnestock Letter; Dillon Letter; Goldman Sachs Letter; Merrill Letter; Salomon Brothers Letter.

[314] See Market 2000 Study at III-7.

[315] Although NASD rules require dealers who are registered as CQS market makers to provide quotations, registration is not mandated. A dealer in reported securities may elect to disseminate quotations by registering as a NASD market maker and "communicating" its best bids and offers to the association by entering two-sided quotations in the Nasdaq System. *See NASD Manual*, Rule 4611.

[316] Rule 11Ac1-1(a)(6), 17 CFR 240.11Ac1-1(a)(6).

[317] 15 U.S.C. 78c(a)(51)(A)(ii).

[318] MJT Letter.

[319] *See NASD Manual*, Rule 4613.

existing NASD firm quote requirements.[320]

c. Response to Other Specific Requests for Comments

In addition to the Quote Rule amendments discussed above, the Proposing Release solicited comment on whether: (1) revisions are necessary to an NASD rule that restricts certain computer generated quotations; [321] and (2) whether the ITS linkage should be expanded to allow NASD CAES members access to the linkage in non-Rule 19c-3 securities.

i. Automatic Generation of Quotations

Requiring active third market makers in non-Rule 19c-3 securities to quote also raises the issue of whether NASD members should continue to be prohibited from using computer systems to generate quotations automatically.[322] Currently, exchange specialists may use automated mechanisms to track the NBBO in a security if they maintain a quotation size of no more than 100 shares.[323] OTC market makers, however, are prohibited by NASD requirements from using automated quotation tracking systems.

The Commission requested comment on whether computer generated quotations should be permitted if active third market makers are required to quote in non-Rule 19c-3 securities, and if so, under what conditions. Commenters in favor of lifting the NASD's automated quotation ban believe that worthwhile computer generated quotes should be permitted.[324] For example, one commenter stresses that a ban on all computer generated quotations impedes technological innovation, protecting the franchise of inefficient market makers at the expense of the investing public. Moreover, the commenter asserts, given the same regulatory environment, there is no reason to believe that firms that make automated markets will quote away from the market any more than firms posting quotes manually.[325]

Certain commenters, including the NASD, believe that the ban should continue in effect. In general, these commenters believe that lifting the ban could create systems capacity and data traffic problems, and result in useless quotations that are automatically maintained away from current market prices.[326]

Even commenters in favor of lifting the ban tend to believe that, while some types of computer generated quotes are appropriate, others, such as quotations automatically maintained away from the best market quotation, should not be permitted. The NASD, which generally favors the ban on automated quotes, believes it may be appropriate to revise its autoquote policy to permit a market maker to automatically update its quote to match either the best bid or best offer, provided liquidity is not withdrawn from the contra-side of the quotation. In this situation, the NASD believes a market maker will be exposed to an execution and will be genuinely contributing to market liquidity.

The Commission believes that a total prohibition on the use of computer generated quotes is not appropriate. Such an approach excessively limits the use of sophisticated trading strategies that rely on automation in the quotation process for their success, and it also may act as a competitive disadvantage to market makers and specialists that would otherwise rely on technology to meet their quotation obligations more efficiently. In the latter instance, broad prohibitions on the use of computer generated quotes may cause some market makers and specialists to restrict the number of stocks in which they are willing to make markets.

While the Commission recognizes traditional concerns related to the accessibility of computer generated quotes and the impact of such quotes on systems capacity, it believes that more can and should be done in this area. This is particularly true given the enhanced quotation obligations that will be imposed on some market participants under the revised Quote Rule. The Commission urges the NASD, ITS Participants,[327] and other interested market participants to develop revised standards that would permit the use of computer generated quotes that contribute value to the market. Specifically, the Commission requests that the NASD and ITS Participants resolve this issue before the effective date of the Quote Rule amendments. In the absence of such progress, the Commission recognizes that it will consider invoking its own authority to address this issue.

ii. Expansion of ITS/CAES Access

As discussed in the Proposing Release, the uniform application of the Quote Rule to all exchange-listed securities raises the issue of the disparate treatment of Rule 19c-3 and non-Rule 19c-3 securities under the ITS Plan. The Commission solicited comment on this disparate treatment. The same issue arises with the provision allowing the use of an ECN as an intermediary in communicating quotes to the public quotation system if equivalent access is provided.

Currently, the ITS Plan provides access to the ITS System to any Participant in any Rule 19c-3 security in which the Participant disseminates continuous two-sided quotations, but excludes OTC market makers from ITS access for non-Rule 19c-3 securities. In the past, market makers in non-Rule 19c-3 securities were not subject to mandatory quote requirements. The amendments to the Quote Rule adopted today will subject OTC market makers and exchange specialists to the same quotation requirements for all exchange-listed securities.

The Commission requested comment on whether the Quote Rule amendments justify an expansion of the linkage between ITS and the NASD's CAES interface to provide ITS access to and from any market maker for any exchange-listed security in which that market maker disseminates continuous two-sided quotations. Numerous commenters support expanding the linkage in this manner because they believe an expansion will enhance fair competition and increase opportunities

[320] Section 11A(c)(1) of the Exchange Act grants the Commission the authority to prescribe, among other matters, rules and regulations to assure accurate and reliable quotations "with respect to any security other than an exempted security." The Commission believes that extending the requirements of the Quote Rule to Nasdaq SmallCap securities will further these interests. No new costs should be imposed on market participants because the NASD rules concerning quotations already treat Nasdaq/National Market and SmallCap securities similarly.

[321] *NASD Manual*, Rule 6330. The NASD, however, provides an automated quotation update capability ("auto-refresh") as part of the Small Order Execution System which market makers may elect to use. Specifically, the quote of a market maker using auto-refresh will be automatically updated when the market maker exhausts its exposure limit in the NASD's Small Order Execution System.

[322] *See supra* note 288, concerning the impact of the ECN amendment to the 1% rule.

[323] The 100-share limitation follows the ITS Plan requirement that no ITS Participant may use an automated computer tracking system to generate quotes for more than 100 shares in any security the Participant trades through the ITS system.

[324] *See, e.g.*, BSE Letter; CSE Letter; D.E. Shaw Letter; Investors Research Letters; Lehman Letter; Madoff Letter; Merrill Letter; NSC Letter; NYSE Letter; Smith Barney Letter.

[325] D.E. Shaw Letter.

[326] *See*, e.g., Dean Witter Letter; NASD Letter; PSE Letter; RPM Specialist Letter.

[327] The ITS Plan also places certain restrictions on the use of computer generated quotes. *See supra* note 323. Given the technologies that have developed during the nearly 20 years that these ITS Plan restrictions have been in place, the Commission requests that the ITS Participants review these limitations and whether they continue to be appropriate, in whole or in part, and whether new limitations should replace the existing provisions or whether there should be any ITS Plan limitations on automated quotes.

for best execution.[328] Several commenters also assert that arguments previously made to exclude OTC market maker quotes in non-Rule 19c-3 securities from ITS are no longer valid.[329]

One commenter specifically argues that adoption of the Commission's proposals should end any objection to the NASD's full participation in ITS because the operation of the Quote Rule will reduce opportunities for OTC market makers to trade in ECNs while simultaneously availing themselves of the voluntary aspect of the Quote Rule, and therefore, will expand the imposition of NASD quotation requirements upon OTC market makers. These requirements, according to the commenter, are equal to those of any other market and add greater transparency and liquidity to the markets for exchange-listed securities as well as the NMS.[330]

Those commenters opposed to the expansion generally believe that the existing limitation on ITS access is justified in view of disparities in customer protections afforded by exchanges and exchange members when compared to customer protections mandated by NASD rules.[331]

The Commission recognizes that the expansion of ITS/CAES is a significant issue of concern to many market participants. The Commission therefore encourages a continuing dialogue among the ITS Participants to solve this issue on a timely basis and in a manner beneficial to the market as a whole.

d. Operation of the Rule With Amended Definitions

i. Amendment to 11Ac1-1(a)(25) (Definition of a "Subject Security")

As a result of the amendment adopted today, OTC market makers and exchange specialists who hold themselves out as willing to buy and sell non-Rule 19c-3 securities on a regular or continuous basis, and that account for more than 1% of the quarterly aggregate trading volume, will be subject to the Quote Rule and required to make continuous two-sided quotations available to the public, even if they have not previously elected to register as CQS market makers with the NASD. This amendment will close a significant gap in the quotation information that has been available heretofore to market participants and investors. In a parallel action, the Commission is proposing for comment an additional amendment to the Quote Rule.[332] The Commission believes that the additional proposal, if adopted, would further improve transparency by providing investors with quotation information on Nasdaq securities from significant OTC market makers and specialists.

ii. Amendment to 11Ac1-1(a)(13) (Definition of an "OTC Market Maker")

The definition of OTC market maker now includes any dealer holding itself out as willing to transact business for its own account on a regular or continuous basis, whether it transacts exclusively with its own customers or with the customers of other dealers. Those dealers that hold themselves out to customers as willing to execute orders on a regular or continuous basis, whether by the internalization of customer order flow in particular stocks or through arrangements with particular firms to execute their customer order flow, now fall within the definition of OTC market maker. Therefore, obligations under the Quote Rule will now apply to dealers that internalize customer order flow or hold themselves out to particular firms as willing to execute their customer order flow, and that execute those orders on a regular or continuous basis. As in the past, broker-dealers will not be considered to be holding themselves out as regularly or continuously willing to buy or sell a security if they occasionally execute a trade as principal to accommodate a customer's request.

iii. Amendment to 11Ac1-1(a)(6) (Definition of a "Covered Security")

The amendment extends the coverage of the Quote Rule to all Nasdaq securities where the rule had previously applied only to Nasdaq/National Market securities. As noted previously, NASD rules already require a dealer that makes a market in a Nasdaq SmallCap security to provide quotations.[333] The Commission, therefore, does not believe extending the Quote Rule to include securities covered by an existing NASD rule will result in additional burdens on OTC market makers. Although the definition of covered security has been amended to include Nasdaq SmallCap securities, an exchange specialist or OTC market maker still must make an election, pursuant to paragraphs (b)(5)(i) and (ii), respectively, of the Quote Rule.[334] Accordingly, although the definition has been amended, an OTC market maker or specialist is not mandated by the Quote Rule to provide quotations on Nasdaq SmallCap securities. If, however, an exchange specialist or OTC market maker makes an election to make available quotations, the firmness obligations under paragraph (c) of the Quote Rule become operative.

e. Effective Date

The amendments to Rule 11Ac1-1 adopted by the Commission today will become effective on January 10, 1997.

C. Price Improvement for Customer Market Orders

1. Proposed Rule

In the Proposing Release, the Commission sought comment on a market-wide Price Improvement Rule for customer market orders. The proposed rule was designed to apply across exchange and OTC markets to promote the execution quality of orders by providing increased opportunities for customer orders to interact at better prices without the intervention of a dealer. The proposal included a non-exclusive safe harbor as one means by which a specialist or OTC market maker could be assured that an order received a sufficient opportunity for price improvement for purposes of the rule.

The proposed rule was intended to encourage market participants to take advantage of current technologies and provide customer market orders with improved access to price improvement opportunities, regardless of where such orders are routed for execution. Although the proposed rule would have required specialists and OTC market makers to provide price improvement opportunities for customer orders, the Commission did not prescribe any particular method of achieving price improvement in recognition of the fact that competition can produce innovative price improvement mechanisms. The Commission proposed a non-exclusive safe harbor, however, to provide certainty regarding one alternative by which a specialist or OTC market maker would be deemed to have satisfied its price improvement obligation.

Under the safe harbor, a specialist or OTC market maker would have been deemed in compliance with the

[328] *See, e.g.* D.E. Shaw Letter; Investors Research Letter; Lehman Letter; NASD Letter; NSC Letter; Madoff Letter; Rothschild Letter; Schwab Letter; STA Letter.

[329] *See, e.g.*, Madoff Letter.

[330] *Id.* Madoff states that the NASD now requires every OTC market maker to conform with NMS principles, respect all other NMS quotations in listed securities, and not trade through better quotes in the NMS. Madoff further notes that, in contrast, exchanges do not impose similar restrictions with respect to trading through off-exchange quotations.

[331] *See* Amex Letter; BSE Letter; CHX Letter; CSE Letter; PSE Letter; Specialists Assoc. Letter.

[332] *See* Companion Release.

[333] *See* NASD Rule 4613.

[334] 17 CFR 240.11Ac1-1(b)(5)(i)

proposed price improvement rule if it exposed, in its quote, a customer market order at an improved price and provided the customer with a guaranteed execution at the "stop" price.[335] This procedure was designed to promote the interaction of exposed orders at prices better than the NBBO with orders or trading interest in other markets. The safe harbor also was intended to lead to increased competition by encouraging specialists and OTC market makers to compete more actively for order flow on the basis of their published quotations. The Commission made clear, however, that the order exposure procedures set out in the proposed safe harbor neither would be mandatory, nor the exclusive means by which to satisfy the obligation to provide an opportunity for price improvement.

Many of the 145 commenters discussed the proposed Price Improvement Rule. The commenters raise numerous questions and concerns regarding the proposed rule. For example, some commenters claim that an absolute rule would reduce the broker-dealer's fiduciary obligation of best execution to an algorithm, eliminating the exercise of professional judgment in identifying price improvement opportunities.[336] Instead, the commenters argue that customers and market professionals should be able to use discretion in deciding when and how price improvement should be sought.[337]

In addition, several commenters are concerned that the proposed safe harbor would become the industry standard. These commenters believe that, although non-exclusive, the proposed safe harbor would dictate the minimum acceptable standard to follow, thereby stifling innovation and competition.[338] Many commenters also are troubled by various technical aspects regarding the application of the safe harbor. For example, some commenters believe the 30-second exposure period would be insufficient to allow other market participants to respond to the exposed order, even with today's technology.[339] Other commenters are concerned with the mechanics of the "stopping" procedures.[340] At least one commenter argues that the requirement to stop stock blurs the distinction between price guarantees and price improvement opportunities.[341]

The potential costs associated with the proposed rule also concern many commenters. They claim that necessary systems upgrades would be expensive.[342] In addition, several commenters claim that the number of quotes generated as a result of the safe harbor would pose a serious threat to system capacity.[343] Many commenters warn that the increased traffic would reduce trading efficiency, decrease transparency and increase overall risk.[344] Some commenters also state that market price integrity would be reduced due to the proliferation of flickering, ephemeral quotations.[345]

A common suggestion from the commenters is that the Commission not adopt the proposed rule prior to evaluating the effects of the other initiatives contained in the proposal.[346] Some commenters believe that the amendments to the Quote Rule and the proposed Limit Order Display Rule should act to narrow spreads by eliciting the true market for a given security, thereby decreasing the utility and necessity of seeking better prices for customer orders. According to these commenters, if such results are achieved through the other initiatives, the potential costs and significant market operations changes associated with the proposed Price Improvement Rule would far outweigh any potential benefit.

Although the Commission continues to believe that the opportunity for price improvement can contribute to providing customer orders with enhanced executions, the Commission has determined to defer action on the proposed Price Improvement Rule for the present time. The Commission believes that the other initiatives adopted today will greatly improve the price discovery process and the opportunity for customer orders to receive enhanced execution prices. These initiatives should act to narrow spreads by making available to all market participants the true buying and selling interest in a given security. The Commission believes, therefore, that the most appropriate course of action is to monitor the operation of the initiatives adopted today, and assess their impact on spreads, the quality of markets, and the quality of executions. This assessment will enable the Commission to better determine the need for further Commission action regarding specific price improvement obligations.

2. Best Execution Obligations

The proposed Price Improvement Rule was designed to complement the long-standing duties of broker-dealers to seek to obtain best execution of their customer orders; the Commission did not intend for the proposed rule to modify this existing best execution obligation.[347] Therefore, the Commission's decision to defer consideration of the proposed rule in no way should be taken as an indication that the duty of best execution has been altered.

A broker-dealer's duty of best execution derives from common law agency principles and fiduciary obligations, and is incorporated both in SRO rules and, through judicial and Commission decisions, in the antifraud provisions of the federal securities laws.[348] This duty of best execution requires a broker-dealer to seek the most favorable terms reasonably available under the circumstances for a customer's transaction.[349] The scope of this duty of best execution must evolve as changes occur in the market that give rise to improved executions for customer orders, including

[335] The proposed safe harbor provided for an order to be "stopped" at the national best bid (for a sell order) or offer (for a buy order) for the lesser of either the full size of the order, or the size associated with the national best bid (for a sell order) or offer (for a buy order).

[336] *See, e.g.*, Goldman Sachs Letter; Jefferies Letter; Madoff Letter; Merrill Letter; NYSE Letter; PaineWebber Letter; PSE Letter.

[337] *See, e.g.*, CSE Letter; Goldman Sachs Letter; Madoff Letter; Merrill Letter; NSC Letter; NYSE Letter; PSE Letter.

[338] *See, e.g.*, AZX Letter; Blume Letter; HHG Letter; Lehman Letter; Merrill Letter; Morgan Stanley Letter; NASD Letter; Salomon Letter; Schwab Letter; Smith Barney Letter; PaineWebber Letter; Ruane Letter.

Some commenters believe their current operations would satisfy the rule and, therefore, they would not need to utilize the safe harbor procedures. *See, e.g.*, Amex Letter; BSE Letter; CHX Letter; NYSE Letter; PSE Letter.

[339] *See, e.g.*, Amex Letter; Blume Letter; BSE Letter; CHX Letter; CSE Letter; NYSE Letter; PSE Letter; Schwab Letter;. *But see, e.g.*, Letter from Raymond E. Wooldridge, Chief Executive Officer, Southwest Securities, to Mr. Jonathan G. Katz, Secretary, SEC, dated January 9, 1996 ("Southwest Letter"); STANY Letter.

[340] *See, e.g.*, Madoff Letter; MJT Letter; Smith Barney Letter.

[341] *See* Sutro Letter.

[342] *See, e.g.*, Blume Letter; Dean Witter Letter; Fahnestock Letter; Goldman Sachs Letter; LJR Letter; NASD Letter; PaineWebber Letter; Ruane Letter; Salomon Letter; Schwab II Letter; SIA Letter.

[343] *See, e.g.*, Bear Stearns Letter; FIF Letter; Merrill Letter; PSE Letter; STANY Letter.

[344] *See, e.g.*, Amex Letter; Bear Stearns Letter; Blume Letter; FIF Letter; LJR Letter; Madoff Letter; Merrill Letter; Morgan Stanley Letter; NASD Letter; PSE Letter; Salomon Letter; STA Letter; STANY Letter; Specialist Assoc. Letter.

[345] *See, e.g.*, Dean Witter Letter; ICI Letter; Merrill Letter; Morgan Stanley Letter; NASD Letter; NYSE Letter; PSE Letter; Salomon Letter; Schwab II Letter; Specialist Assoc. Letter; STANY Letter.

[346] *See, e.g.*, Bear Stearns Letter; Dean Witter Letter; DOJ Letter; Goldman Sachs Letter; Lehman Letter; Madoff Letter; Morgan Stanley Letter; NASD Letter; NSC Letter; Schwab II Letter; SIA Letter; Sutro Letter.

[347] Proposing Release at 49.

[348] *See* Market 2000 Study, Study V at V-1, 2 and sources cited therein.

[349] *See* Market 2000 Concept Release, *supra* note 10; Market 2000 Study, Study V.

opportunities to trade at more advantageous prices. As these changes occur, broker-dealers' procedures for seeking to obtain best execution for customer orders also must be modified to consider price opportunities that become "reasonably available." [350]

In the past the Commission has recognized the practical necessity of automating the handling of small orders, and has indicated that automated routing or execution of customer orders is not necessarily inconsistent with best execution.[351] At the same time, the Commission has emphasized that best execution obligations require that broker-dealers routing orders for automatic execution must periodically assess the quality of competing markets to assure that order flow is directed to markets providing the most beneficial terms for their customers' orders.[352] While in the past quote-based executions in OTC securities were generally recognized as satisfying best execution obligations, the development of efficient new facilities has altered what broker dealers must consider in seeking best execution of customer orders.[353] The Commission thus noted the importance of the opportunity for price improvement as a factor in best execution, speaking in the context of aggregate order handling decisions for both listed and OTC stocks.[354] Therefore, the Commission believes that routing order flow for automated execution, or internally executing order flow on an automated basis, at the best bid or offer quotation, would not necessarily satisfy a broker-dealer's duty of best execution for small orders in listed and OTC securities.[355]

Both the rule and the amendments adopted today should further improve a broker-dealer's ability to obtain improved executions for customer orders. These changes will enhance the public quote by including in the public quotation system many superior prices not currently reflected there. The ECN amendment is intended to publicize superior market maker ECN prices in the public quote, which should make these prices more easily accessible. Similarly, the Display Rule will include more customer prices in the public quote through requiring the display of customer limit orders.

Nonetheless, various markets and market makers may continue to provide opportunities for executions at prices superior to the enhanced national best bid and offer for their customer orders.[356] For example, some markets or market makers may continue to offer price improvement opportunities, based on internal order flow or execution algorithms. The Commission believes that broker-dealers deciding where to route or execute small customer orders in listed or OTC securities must carefully evaluate the extent to which this order flow would be afforded better terms if executed in a market or with a market maker offering price improvement opportunities. In conducting the requisite evaluation of its internal order handling procedures, a broker-dealer must regularly and rigorously examine execution quality likely to be obtained from the different markets or market makers trading a security.[357] If different markets may be more suitable for different types of orders or particular securities, the broker-dealer will also need to consider such factors.

Where material differences exist between the price improvement opportunities offered by markets or market makers, these differences must be taken into account by the broker-dealer. Similarly, in evaluating its procedures for handling limit orders, the broker-dealer must take into account any material differences in execution quality (*e.g.*, the likelihood of execution) among the various markets or market centers to which limit orders may be routed. The traditional non-price factors affecting the cost or efficiency of executions also should continue to be considered; [358] however, broker-dealers must not allow an order routing inducement, such as payment for order flow or the opportunity to trade with that order as principal, to interfere with its duty of best execution.[359] Of course, as the Commission has previously noted, in light of a broker-dealer's obligation to assess the quality of the markets to which it routes packaged order flow absent specific instructions from customers, the Commission does not believe that a broker-dealer violates its best execution obligation merely because it receives payment for order flow or trades as principal with customer orders.[360]

Prices superior to the public quote may at times be available in ECNs, even after adoption of the ECN amendment, based, for example, on orders of institutional participants and others not covered by the ECN amendment. Superior prices also may be available in other systems not classified as ECNs. As the Commission noted in the Proposing Release in September, 1995, and reiterates today, where reliable, superior prices are readily accessible in such systems, broker-dealers should consider these prices in making decisions regarding the routing of customer orders.[361] The Commission recognizes that many of these systems are less accessible and involve higher costs for broker-dealers than the public markets. In addition, in many cases it is not currently feasible to efficiently obtain price information from these systems or link to these systems on an automated basis. The Commission is not suggesting that broker-dealers must engage in manual handling of small orders if necessary to access these systems.[362] Nonetheless, the Commission believes that because technology is rapidly making these systems more accessible, broker-dealers must regularly evaluate whether prices or other benefits offered by these systems are reasonably available for purposes of seeking best execution of these customer orders. For example, if an ECN provides an automated link that makes it cost effective for a broker-dealer to access these systems for its retail orders on an automated basis, the broker-dealer must take the prices and other relevant costs in that system into account in handling these customer orders.

Pursuant to the Display Rule, most customer limit orders at superior prices will be required to be displayed and

350 Proposing Release at 7–10.

351 *Id.* at 8.

352 Payment for Order Flow Release, *supra* note 23, at n. 30 and accompanying text; *See* Securities Exchange Act Release No. 37046 (March 29, 1996), 61 FR 15322 (April 5, 1996) ("CSE Approval Order"); Securities Exchange Act Release No. 37045 (March 29, 1996), 61 FR 15318 (April 5, 1996) ("BSE Approval Order").

353 Proposing Release at 10.

354 *Id.*; *see also* Payment for Order Flow Release, *supra* note 23 at text accompanying notes 31–33. *See* CSE Approval Order, *supra* note 352; BSE Approval Order, *supra* note 352.

355 Proposing Release at 9–10; *see also* note 360 and accompanying text (factors relevant to best execution).

356 *Id.*

357 CSE Approval Order, 61 FR at 15329. "Price improvement" in this context is defined as the difference between execution price and the best quotes prevailing in the market at the time the order arrived at the market or market maker. Any evaluation of price improvement opportunities would have to consider not only the extent to which orders are executed at prices better than the prevailing quotes, but also the extent to which orders are executed at inferior prices.

358 *See* Market 2000 Study, Study V at V–2, 3.

359 Payment for Order Flow Release, *supra* note 23.

360 *Id.*

361 Proposing Release at 10.

362 The Commission has recognized that it may be impractical, both in terms of time and expense, for a broker that handles a large volume of orders to determine individually where to route each order it received. Proposing Release at 8.

included in the public quote.[363] The display of a limit order by a market maker directly affects its responsibilities in handling other customer orders. The Commission has long said that broker-dealers must consider quotation information contained in the public quotation system in seeking best execution of customer orders.[364] In executing customer market orders, a market maker must give no less consideration to the price of its own displayed customer limit order than any other public quotation price. Therefore, under the new Display Rule, a market maker that has displayed a customer limit order would be expected to provide an offsetting customer market order an execution at that limit price at least up to the size of the limit order.

In addition, the Commission notes that currently, some market makers that hold a customer limit order on one side of the market, priced better than the market maker's own quote, and a customer market order on the other side of the market, will execute both orders as principal rather than crossing the two orders. As a result, the market order customer receives the best bid and offer rather than receiving the benefit of a better limit order price. In light of the increased opportunities for price improvement now available and the rules the Commission is adopting today, the Commission believes that going forward this practice is no longer appropriate given the broker-dealer's obligation, as part of its duty of best execution, to its market order customer.[365]

In conclusion, although the Commission has determined for the present to defer final action on the proposed Price Improvement Rule, the Commission's adoption of the Display Rule and the Quote Rule amendments should substantially improve public quotations. Moreover, the Commission firmly believes that broker-dealers, when deciding where to route or execute customer orders, must carefully consider and evaluate opportunities for obtaining improved executions.

IV. Authority

As discussed above, the 1975 Act Amendments to the Exchange Act set forth Congress' goals for a national market system. Several commenters argue that the proposed rules violate Congress's direction that the Commission facilitate the establishment of, rather than design, a national market system.[366] Many of these comments were directed at the proposed Price Improvement Rule and in particular the proposed price improvement safe harbor. The Commission today is deferring action on that rule proposal. To the extent that the comments relate to the rule and amendments adopted today, however, they reflect a fundamental misunderstanding regarding the purpose of the rules and the Commission's role in facilitating a national market system.

The Commission's adoption of these rules is fully consistent with the role that Congress envisioned in 1975 for the Commission. Congress's direction to the Commission to "facilitate" the establishment of a national market system for securities that implemented Congressionally enumerated objectives was not intended as a limitation on the Commission's authority but rather was "designed to provide maximum flexibility to the Commission and the securities industry in giving specific content to the general concept of the national market system." [367] Congress granted the Commission broad rulemaking authority over the national market system and market participants and this grant of specific rulemaking authority was not conditioned on the expectation that the Commission refrain from using it.

Although Congress expressed a preference that where possible the national market system evolve through the interplay of competitive forces, it recognized that "competition may not be sufficient" and that in such cases, the Commission should act "promptly and effectively to insure that the essential mechanisms of an integrated secondary trading system [be] put into place * * *." [368] Congress specifically identified in 1975 some of the concerns addressed today and the Commission has examined these issues on several occasions over the intervening years in response to evolving market conditions and technologies. In view of the caution and deliberation with which the Commission has proceeded over the past 21 years, its actions today cannot fairly be viewed as arresting natural competitive forces, but rather should be regarded as an attempt to foster efficiency and redress shortcomings in the national market system that have developed since then, or that the securities industry on its own has been unable to resolve over this time.

The subject matter of these rule and rule amendments is an area of the national market system in which Congress itself recognized that the Commission's expertise and authority were paramount. Indeed, Section 11A was specifically enacted to eliminate "arguments about the SEC's authority" in this area. For that reason, the Commission was given "pervasive rulemaking power" with respect to the business of collecting, processing, or publishing information relating to quotations for and transactions in securities.[369] The rules adopted today implement Congress' goals as to dissemination of trading information: "to insure the availability of prompt and accurate trading information, to assure that these communications networks are not controlled or dominated by any particular market center, to guarantee fair access to such systems by all brokers, dealers and investors, and to prevent any competitive restriction on their operation not justified by the purposes of the Exchange Act." [370]

It bears noting that the standards adopted by the Commission today are intended to allow markets to adapt and evolve in meeting the objectives of the national market system; the rules establish performance standards but do not dictate market structure. With regard to the Quote Rule, the rules do not determine how non-Rule 19c–3 market makers may make markets or how electronic communications networks may operate. Non-Rule 19c–3 market makers are free to operate as they please so long as they report their quotations to the extent they execute a certain level of volume in a security. Likewise, market makers and specialists may place priced orders in ECNs of many different designs as long as they change their quotes to reflect the orders in the ECN or the ECNs publicly report the quotes and provide access to such

[363] The Commission notes that the NASD's interpretation prohibiting market makers from trading ahead of customer limit orders applies both to displayed and nondisplayed customer limit orders held by the market maker. *See* NASD Conduct Rule IM 2110–2 (Trading Ahead of Customer Limit Orders).

[364] *See* Quote Rule Adopting Release, *supra* note 208.

[365] *Cf.*, NASD Notice to Members 96–10 (February, 1996) at 43; NASD Notice to Members 95–67 (August, 1995) at 417.

[366] *See, e.g.*, ABA Letter; Fahnestock Letter; HHG Letter; LJR Letter; NSC Letter; PaineWebber Letter; RPM Letter; Ruane Letter; SIA Letter.

[367] Conference Report, *supra* note 213, at 92. *See* Senate Report, *supra* note 31, at 8–9 ("the sounder approach appeared * * * to be to establish a statutory scheme clearly granting the Commission broad authority to oversee the implementation, operation, and regulation of the national market system and at the same time to charging it with the clear responsibility to assure that the system develops and operates in accordance with Congressional determined goals and objectives."). The Conference Committee report on the 1975 Act Amendments indicates that the conferees adopted with minor revisions the Senate's provisions concerning the national market system. Conference Report, *supra* note 213, at 92.

[368] Conference Report, *supra* note 213 at 92.

[369] Conference Report, *supra* note 213, at 93.

[370] Senate Report, *supra* note 31.

priced orders. With regard to the Limit Order Display Rule, the rule does not seek to create a central limit order book or central limit order file. Broker-dealers are free to satisfy the rule in several different ways, so long as the result is that customer limit orders priced at or better than the NBBO are publicly displayed.

Some commenters also argue that the proposed rules are contrary to Congress' direction to assure fair competition between auction and dealer markets as structures for the trading of securities[371] and inappropriately introduce auction market principles into dealer markets. Although requiring display of superior-priced customer limit orders could be viewed as an auction market principle, such a requirement does not supplant the basic features of a dealer market or undermine competition between the exchange and OTC markets. Congress clearly intended that dealer markets would benefit from use of some auction market principles[372] and the 1975 Amendments specifically announce as a goal of the national market system that customer orders be able to interact without the intervention of a dealer to the extent that such a goal is consistent with other national market system objectives.[373] At a minimum, where feasible, customer limit orders should have a meaningful opportunity to interact with customer market orders.[374]

One of the main benefits contemplated by Congress was that the national market system would enable investors in dealer markets to execute against another limit order or market order at a better price than currently being quoted by a dealer for his own account.[375] Display of superior-priced limit orders would permit investors to compete in some cases with market makers and specialists, thereby increasing the competitiveness of dealer markets in these securities and enhancing the quality of customer limit order execution. Display of customer limit orders, however, would not compromise the essential features of dealer markets. In the absence of any superior-priced customer limit orders, dealers would continue to compete for market orders at their published quotations and would be able to execute against customer limit orders that would otherwise prevent the market maker from trading with a market order. Further, the widespread use by OTC dealers of ECNs to trade at prices better than the dealers' published quotes is of such recent vintage that it can hardly be viewed as a necessary part of a dealer market structure.[376]

[371] *See, e.g.*, Goldman Sachs Letter; Jefferies Letter; Merrill Lynch Letter; RPM Letter; Schwab I Letter; Schwartz & Wood Letter; SIA Letter; Specialist Assoc. Letter; *see also* Exchange Act Section 11A(a)(1)(C)(ii), 15 U.S.C. 78k-1(a)(1)(C)(ii).

[372] Senate Report, *supra* note 31, at 16.

[373] Exchange Act Section 11A(a)(1)(C)(v).

[374] Exchange Act Section 11A(a)(1)(C)(v).

[375] Senate Report *supra* note 31, at 16.

V. Summary of Final Regulatory Flexibility Act Analysis

This following discussion summarizes the Commission's analysis of the rules adopted today under the Regulatory Flexibility Act. A complete final copy of the Final Regulatory Flexibility Act is available in the Public File.

The rules adopted today by the Commission are intended to allow markets to adapt and evolve in meeting the objectives of the national market system. In this regard, the rules establish performance standards but do not dictate market structure. The Quote Rule does not dictate how market makers or specialists that trade non-Rule 19c-3 securities may conduct their market making activities or how ECNs may service their subscribers. Market makers will be able to continue their regular market making activities so long as they report their quotations if they trade more than 1% of the transaction volume in a security. Likewise, market makers and specialists may place priced orders in ECNs of many different designs as long as they change their quotes to reflect better priced orders they have entered in ECNs or, alternatively, such ECNs provide for the public reporting of these prices and provide access to such priced orders. Moreover, broker-dealers are free to satisfy the Display Rule in several different ways, so long as the result is that customer limit orders priced at or better than the NBBO are publicly displayed in accordance with the rule.

A. Display Rule

The Commission considered several significant alternatives to Rule 11Ac1-4 consistent with the Rule's objectives and designed to minimize the impact of the rule on small entities. The Commission solicited comment on, among other things: (i) Whether the display requirement should be based on a *de minimis* threshold; (ii) the classes of securities to which the Rule should apply; (iii) whether to permit limit orders to be delivered to an exchange- or association-sponsored system that displays limit orders in accordance with the rule; and (iv) whether to permit limit orders to be delivered to an ECN or a PTS. The Commission believes that the rule as adopted imposes a smaller burden upon small brokers and dealers than do other alternatives considered.

[376] While the rule and rule amendments adopted today function as an integrated response to the problems the Commission has identified in the implementation of a NMS, each separately advances the Congressional goals of market efficiency, fair competition, transparency, and best execution, and accordingly the Commission intends that they be treated as severable for purposes of review.

The Commission believes that the ability of brokers and dealers to send a limit order to another party or system that will display that order provides all brokers and dealers, including small brokers and dealers, with the greatest possible flexibility to satisfy the NMS objectives embodied in the rule in the most economical manner. In this regard, the Commission decided to expand one of the exceptions to the display requirement that will permit market makers to comply with the rule by delivering customer limit orders to an ECN that complies with the ECN amendment to the Quote Rule. Furthermore, the Commission added a new exemptive provision that enables the Commission to exempt any responsible broker or dealer, ECN, exchange, or association from the requirements of the Display Rule.

The Commission considered allowing display of a representative size of a limit order rather than the full size, but concluded that display of the full size will provide the most accurate picture of the depth of the market at a particular price. The Commission does not believe that it is practicable to exempt small entities from the Display Rule because to do so would be inconsistent with the Commission's statutory mandate to protect investors. In that regard, the Commission believes that the pricing and size conventions documented in the 21(a) Report referenced above make it imperative that the requirements of the Display Rule apply to all market participants with equal force. The Commission notes that any exception for small brokers and dealers could create an incentive for Nasdaq market makers to create special market making subsidiaries qualifying as small broker-dealers which would be free to engage in the anti-competitive practices identified in the 21(a) Report.

B. Quote Rule

Allowing market makers that deal actively in securities without publicizing their activity or making available their prices undermines the NMS goal of transparency. The Commission believes that those dealers should be recognized as market makers and their quotations publicized so that investors may know of, and trade on similar terms with, those market makers. Therefore, the definition of OTC

market maker now includes any dealer holding itself out as willing to transact business for its own account on a regular or continuous basis, whether it transacts exclusively with its own customers or with the customers of other dealers. Thus, those dealers that internalize customer order flow in particular stocks or through arrangements with other firms to execute that order flow, now fall within the definition of OTC market maker and are subject to the obligations under the Quote Rule. As in the past, broker-dealers will not be considered to be holding themselves out as regularly or continuously willing to buy or sell a security if they occasionally execute a trade as principal to accommodate a customer's request. In response to the suggestions of some commenters, the Commission has modified the amendment to make clear that more than one isolated transaction is necessary before a dealer is designated an OTC market maker.

In addition, the Commission believes that extending the 1% threshold based on quarterly aggregate trading volume to non-Rule 19c–3 securities is a reasonable method to improve the scope of quotation information to include significant OTC market makers and specialists. This 1% threshold, currently in effect for Rule 19c–3 securities, has proved effective in supplying comprehensive quotation information to the market at large. Moreover, based on the increase in third market trading volume for these securities, the Commission does not believe this standard is unduly burdensome on OTC market makers. Rather, the Commission believes this threshold strikes a balance between requiring the dissemination of all quotation interest and accommodating those specialists and OTC market makers that may be small entities. The Commission believes that OTC market makers and specialists that account for 1% or less of the aggregate volume are not active enough to justify the additional expense of providing continuous quotation display. Accordingly, the Commission believes the "greater than 1% aggregate trading volume" threshold for mandatory quotations continues to be appropriate. To limit a possible inconsistency in the treatment of exchange-listed and Nasdaq securities, the Commission today is proposing that the 1% test be extended from all exchange-listed securities to all Nasdaq-listed securities.

The Commission considered several significant alternatives to the proposed amendments to the Quote Rule consistent with the Rule's objectives and designed to minimize the impact of the amendments on small entities. The Commission solicited comment on numerous alternatives to the amendments proposed to ensure that investors receive consolidated quotations that truly reflect the best prices available for a security. The Commission solicited comment on, among other issues: (i) Whether the Commission should require SROs to amend their rules to permit computer-generated quotations; (ii) whether there existed alternatives to the ECN proposal that minimized certain consequences of the rule while assuring public dissemination of the best priced orders in such systems; (iii) whether there should be exceptions to the ECN proposal and under what circumstances; and (iv) whether the objectives of the Quote Rule and the ECN amendment could be achieved by allowing ECNs to furnish prices to the applicable SRO, while providing access to the prices in their ECN. The Commission believes that the amendments as adopted impose a smaller burden upon small brokers and dealers than does any other alternative considered.

In recognition of the concerns raised by some commenters, the ECN display alternative is designed to preserve the benefits associated with the anonymity that certain ECNs currently offer to subscribing market makers and specialists. This alternative also ensures that the best market maker and specialist prices in the ECN are publicly disseminated and that non-subscribing brokers and dealers may trade with the orders represented by those prices. Under the display alternative, the price of a specialist's or market maker's order entered into an ECN would be publicly disseminated while the specialist or market maker remains anonymous. This alternative not only preserves anonymity, but also eliminates the risk that a market maker or specialist may be exposed to multiple executions at the ECN price. With the addition of the alternative, the ECN amendment permits the display of the best price either in the specialist's or market maker's quote or through an ECN that provides for the dissemination of the best market maker and specialist prices entered into the ECN.

The Commission also notes that the ECN display alternative reduces the compliance burden on broker-dealers, including small entities, by permitting specialists and market makers to comply with the ECN amendment if the ECN into which the market maker's order is entered ensures that the best market maker prices entered therein are communicated to an exchange, association or securities information processor and the ECN provides a means for brokers and dealers to trade with the orders market makers and specialists put in the ECN.

The Commission recognizes that the ECN display alternative may reduce the content of information that is publicly available because under this alternative, the identity of the market maker or specialist that entered the better priced order in the ECN will be withheld. The Commission believes this result is justified because the inside prices and full sizes of orders entered by market makers and specialists will be in the public quotation system to inform the entire market of these prices and ECNs will provide equivalent access to those prices. Moreover, the Commission believes the benefits of facilitating the use of ECNs, by permitting the continued anonymity of market makers and specialists, more than offset the reduced information available on the identity of a particular market maker or specialist.

The Commission believes the data it has reviewed supports the need for prompt adoption of the ECN amendment to the Quote Rule. As discussed more fully in the Appendix to the 21(a) Report, an analysis of data for April through June 1994 shows that approximately 85% of bids and offers displayed by market makers on Instinet and 90% of bids and offers displayed on SelectNet (an ECN sponsored by the NASD) were at better prices than those disseminated to the public via Nasdaq. In addition, approximately 77% of trades executed on Instinet and 60% of trades executed on SelectNet were at prices superior to the Nasdaq inside spread. Given this strong evidence that investors would benefit from public dissemination of these hidden prices that are broadly disseminated to subscribers in these systems, the Commission believes that it is appropriate to adopt the amendments to the Quote Rule.

The Commission does not believe that it is practicable to exempt small entities from the Quote Rule amendments because to do so would be inconsistent with the Commission's statutory mandate to protect investors. In this regard, the Commission notes the clear evidence of a two-tiered market, in which market makers routinely trade at one price with customers and at better prices with ECN participants. The Commission believes that it is imperative to further the long-standing objectives of the 1975 Amendments to ensure reliable and accurate quotes by making these prices available to the public. The Commission believes that any exception for small brokers and

dealers could create an incentive for Nasdaq market makers to create special market making subsidiaries qualifying as small broker-dealers which would be free to engage in the anti-competitive practices identified in the 21(a) Report.

A final copy of the Final Regulatory Flexibility Act analysis is available in the Public File.

VI. Paperwork Reduction Act

As set forth in the Proposing Release,[377] the proposed amendments to Rule 11Ac1-1 and proposed Rule 11Ac1-4 contain collections of information within the meaning of the Paperwork Reduction Act ("PRA"). Accordingly, proposed amendments to Rule 11Ac1-1 and proposed Rule 11Ac1-4 were submitted to the Office of Management and Budget ("OMB") for review pursuant to Section 3507 of the PRA (44 U.S.C. 3507), and were approved by OMB which assigned the following control numbers: Amendments to Rule 11Ac1-1, control number 3235-0461; Rule 11Ac1-4, control number 3235-0462. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid OMB control number. This is the final notice regarding the collection of information under Rule 11Ac1-4, the Display Rule. A new notice regarding the collections of information under Rule 11Ac1-1, the Quote Rule, may be found in the Companion Release (published elsewhere in the Federal Register today) which proposes an additional amendment to the Quote Rule. The PRA section in the preamble of the Companion Release provides new estimates of the burden in responding to the collections of information under the Quote Rule as a whole.

The reporting requirement in Rule 11Ac1-4 is found in 17 CFR 240.11Ac1-4. The collection of information is mandatory and responses are not confidential. The respondents are OTC market makers, as defined under the rule. (Although exchange specialists are also required to follow the rule, as noted in the Proposing Release the Commission does not anticipate any significant additional burden on exchange specialists in light of current exchange order handling practices.) The Rule requires market makers to change their published quotation to reflect the price and/or size of a customer limit order that would improve their published bid or offer or otherwise ensure that such limit order is displayed. The burden on market makers will depend on the extent and variety of their market-making activities and their choice of the various compliance options offered by the regulations. The ability of market makers to utilize facilities of national securities exchanges, registered national securities associations, and ECNs to comply with the reporting requirement should ease the compliance burden. The proposed rule would have permitted market makers to execute a limit order or send a limit order to another market maker or exchange or association facility that would ensure display of such orders in lieu of the market makers' own display. Rule 11Ac1-4 as adopted maintains these alternatives and also permits respondents to send a limit order to an ECN meeting certain criteria. The information reported will be displayed to all persons who have access to a quotation montage as that term is defined in 17 CFR 240.11Ac1-2(a)(16).

The Commission carefully considered comments received from the NASD and SIA concerning the Commission's burden estimates.[378] The NASD stated that the Commission underestimated the number of limit orders to be displayed per trading day, given the NASD's view that Rule 11Ac1-4 will lead to increased limit order exposure. After considering the NASD's comment, and based upon further review of the market data, the Commission is revising its burden estimate for Rule 11Ac1-4 as follows. There are approximately 570 respondents. Each respondent on average will respond to the collection of information 42,000 times per year, based on a 252 trading day year. The total time burden for each respondent per year is estimated to be 35 hours, based on an estimate of 3 seconds per response (*i.e.*, the time it takes to update a quote to reflect a limit order, or to transmit the order for display elsewhere).[379] The total annual aggregate burden for all respondents is estimated to be 19,950 hours.

VII. Effects on Competition

Section 23(a)(2) of the Exchange Act[380] requires the Commission to consider the anti-competitive effects of any rules it adopts thereunder, and to balance them against the benefits that further the purposes of the Act. As discussed above, several commenters raised concerns regarding the competitive implications of the order handling proposals.[381] The foregoing discussion contains extensive analysis of the competitive effects of both the rule and rule amendments; this section summarizes the Commission's conclusions. The Commission has considered the proposals in light of the comments and the standard embodied in Section 23(a)(2) and has concluded any burdens on competition imposed by the Display Rule and the amendments to the Quote Rule are necessary and appropriate in furtherance of the purposes of the Exchange Act, in particular, the purposes of Section 11A.

The Commission notes that the primary burden imposed by the Display Rule will be to require exchange specialists and OTC market makers to ensure that customer limit orders improving their quotes are displayed. The Commission believes that if systems upgrades are necessary, those systems upgrades reflect one-time charges. The Commission also notes that ensuring public dissemination of limit orders enhances market transparency, increases pricing efficiency, and quote-based competition, and permits investors' orders to interact with all available market interest. Moreover, the limit order display rule will provide an opportunity for investors to compete directly in the market. This additional competition should limit certain anticompetitive practices identified in the 21(a) Report and discussed supra. For the reasons discussed above, the Commission does not believe the Display Rule will have a significantly different effect on wholesale and retail market makers.[382] The Commission notes that the Antitrust Division of the U.S. Department of Justice similarly concluded that the Display Rule will promote competition and will thereby benefit the investing public.

Similarly, the Commission notes that the primary burden imposed by the ECN Amendment to the Quote Rule will be to require exchange specialists and OTC market makers to add personnel or upgrade systems to ensure that their quotes reflect priced orders entered into those ECNs that do not disseminate

[377] Proposing Release at 70.

[378] The SIA noted that they join in the concerns expressed by the NASD that the Commission's estimates under the PRA are too low, and need to be revised and extended to include the proposed safe harbor under Rule 11Ac1-5. SIA Letter at 4. As noted above, the Commission is not adopting the Price Improvement Rule at this time.

[379] The NASD commented that it believes the PRA burden estimate should include the time market makers spend analyzing market trends and following quotation and last sale information. The Commission has determined not to revise its burden estimate based on this comment, because market makers otherwise engage in such activities apart from the collection of information requirement. For example, market makers are already required to monitor the markets to ensure that they do not trade ahead of customer limit orders.

[380] 15 U.S.C. 78w(a)(2).

[381] *See* ABA Letter; HHG Letter; NASD Letter.

[382] *See supra* note 124 and accompanying text.

order information to the relevant exchange or association. The Commission believes that such systems upgrades reflect one-time charges. The Commission believes that the ECN amendment to the Quote Rule will impose only limited competitive burdens on ECNs. ECNs which have attributes that differentiate them from other types of electronic order routing and order execution systems, will have a choice whether to disseminate order information to the relevant exchanges or association. While choosing this alternative will result in some system costs, the Commission believes that the alternative will provide ECNs with additional business opportunities, including increased order flow. The ECN amendment should allow ECNs to function as valuable facilities for their subscribers, and should not harm ECNs significantly in their competition with other order execution systems.[383] The Commission also notes that ensuring public dissemination of market makers' and specialists' priced orders entered into ECNs enhances market transparency, pricing efficiency, price competition, and allows investors' orders to interact with all available market interest.

Finally, with respect to the amendments extending the Mandatory Quote Rule to non-Rule 19c-3 securities, the primary burden imposed will be to require certain brokers and dealers to register as CQS market makers and make continuous two-sided quotes available to the public. The Commission believes that the benefit to the investing public of ensuring that available market interest is disseminated to the public will enhance competition by facilitating the routing of investor orders to the market center displaying the best quotation for a security. The Commission believes that the added transparency resulting from the amendment outweighs any burden to competition that may be imposed.

List of Subjects in 17 CFR Part 240

Broker-dealers, Confidential business information, Reporting and recordkeeping requirements, and Securities.

Text of the Rules

For the reasons set out in the preamble, the Commission amends Part 240 of Chapter II of Title 17 of the Code of Federal Regulation as follows:

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

1. The general authority citation for Part 240 is revised to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78f, 78i, 78j, 78k, 78k-1, 78*l*, 78m, 78n, 78o, 78p, 78q, 78s, 78w, 78x, 78*ll*(d), 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4 and 80b-11, unless otherwise noted.

* * * * *

2. Section 240.11Aa3-1 is amended by revising paragraph (a)(4) to read as follows:

§ 240.11Aa3-1 Dissemination of transaction reports and last sale data with respect to transactions in reported securities.

(a) *Definitions.* * * *

(4) The term *reported security* shall mean any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan.

* * * * *

3. Section 240.11Ac1-1 is revised to read as follows:

§ 240.11Ac1-1 Dissemination of quotations.

(a) *Definitions.* For the purposes of this section:

(1) The term *aggregate quotation size* shall mean the sum of the quotation sizes of all responsible brokers or dealers who have communicated on any exchange bids or offers for a covered security at the same price.

(2) The term *association* shall mean any association of brokers and dealers registered pursuant to Section 15A of the Act (15 U.S.C. 78*o*-3).

(3) The terms *best bid* and *best offer* shall mean the highest priced bid and the lowest priced offer.

(4) The terms *bid* and *offer* shall mean the bid price and the offer price communicated by an exchange member or OTC market maker to any broker or dealer, or to any customer, at which it is willing to buy or sell one or more round lots of a covered security, as either principal or agent, but shall not include indications of interest.

(5) The term *consolidated system* shall mean the consolidated transaction reporting system.

(6) The term *covered security* shall mean any reported security and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as described in Section 3(a)(51)(A)(ii) of the Act (15 U.S.C. 78c(a)(51)(A)(ii)).

(7) The term *effective transaction reporting plan* shall have the meaning provided in § 240.11Aa3-1(a)(3).

(8) The term *electronic communications network*, for the purposes of § 240.11Ac1-1(c)(5), shall mean any electronic system that widely disseminates to third parties orders entered therein by an exchange market maker or OTC market maker, and permits such orders to be executed against in whole or in part; except that the term electronic communications network shall not include:

(i) Any system that crosses multiple orders at one or more specified times at a single price set by the ECN (by algorithm or by any derivative pricing mechanism) and does not allow orders to be crossed or executed against directly by participants outside of such times; or

(ii) Any system operated by, or on behalf of, an OTC market maker or exchange market maker that executes customer orders primarily against the account of such market maker as principal, other than riskless principal.

(9) The term *exchange market maker* shall mean any member of a national securities exchange ("exchange") who is registered as a specialist or market maker pursuant to the rules of such exchange.

(10) The term *exchange-traded security* shall mean any covered security or class of covered securities listed and registered, or admitted to unlisted trading privileges, on an exchange; *provided, however,* That securities not listed on any exchange that are traded pursuant to unlisted trading privileges are excluded.

(11) The term *make available,* when used with respect to bids, offers, quotation sizes and aggregate quotation sizes supplied to quotation vendors by an exchange or association, shall mean to provide circuit connections at the premises of the exchange or association supplying such data, or at a common location determined by mutual agreement of the exchanges and associations, for the delivery of such data to quotation vendors.

(12) The term *odd-lot* shall mean an order for the purchase or sale of a covered security in an amount less than a round lot.

(13) The term *OTC market maker* shall mean any dealer who holds itself out as being willing to buy from and sell to its customers, or otherwise, a covered security for its own account on a regular or continuous basis otherwise than on an exchange in amounts of less than block size.

[383] Although the Antitrust Division of the U.S. Department of Justice expressed concerns about the effects of the ECN amendment as originally proposed, the Commission believes that with the quote dissemination alternative, the amendment will not impose any unnecessary or inappropriate burdens on competition.

(14) The term *plan processor* shall have the meaning provided in § 240.11Aa3–2(a)(7).

(15) The term *published aggregate quotation size* shall mean the aggregate quotation size calculated by an exchange and displayed by a quotation vendor on a terminal or other display device at the time an order is presented for execution to a responsible broker or dealer.

(16) The terms *published bid* and *published offer* shall mean the bid or offer of a responsible broker or dealer for a covered security communicated by it to its exchange or association pursuant to this section and displayed by a quotation vendor on a terminal or other display device at the time an order is presented for execution to such responsible broker or dealer.

(17) The term *published quotation size* shall mean the quotation size of a responsible broker or dealer communicated by it to its exchange or association pursuant to this section and displayed by a quotation vendor on a terminal or other display device at the time an order is presented for execution to such responsible broker or dealer.

(18) The term *quotation size*, when used with respect to a responsible broker's or dealer's bid or offer for a covered security, shall mean:

(i) The number of shares (or units of trading) of that covered security which such responsible broker or dealer has specified, for purposes of dissemination to quotation vendors, that it is willing to buy at the bid price or sell at the offer price comprising its bid or offer, as either principal or agent; or

(ii) In the event such responsible broker or dealer has not so specified, a normal unit of trading for that covered security.

(19) The term *quotation vendor* shall mean any securities information processor engaged in the business of disseminating to brokers, dealers or investors on a real-time basis, bids and offers made available pursuant to this section, whether distributed through an electronic communications network or displayed on a terminal or other display device.

(20) The term *reported security* shall mean any security or class of securities for which transaction reports are collected, processed and made available pursuant to an effective transaction reporting plan.

(21) The term *responsible broker or dealer* shall mean:

(i) When used with respect to bids or offers communicated on an exchange, any member of such exchange who communicates to another member on such exchange, at the location (or locations) designated by such exchange for trading in a covered security, a bid or offer for such covered security, as either principal or agent; *provided, however*, That, in the event two or more members of an exchange have communicated on such exchange bids or offers for a covered security at the same price, each such member shall be considered a "responsible broker or dealer" for that bid or offer, subject to the rules of priority and precedence then in effect on that exchange; and further provided, That for a bid or offer which is transmitted from one member of an exchange to another member who undertakes to represent such bid or offer on such exchange as agent, only the last member who undertakes to represent such bid or offer as agent shall be considered the "responsible broker or dealer" for that bid or offer; and

(ii) When used with respect to bids and offers communicated by a member of an association to another broker or dealer or to a customer otherwise than on an exchange, the member communicating the bid or offer (regardless of whether such bid or offer is for its own account or on behalf of another person).

(22) The term *revised bid or offer* shall mean a market maker's bid or offer which supersedes its published bid or published offer.

(23) The term *revised quotation size* shall mean a market maker's quotation size which supersedes its published quotation size.

(24) The term *specified persons*, when used in connection with any notification required to be provided pursuant to paragraph (b)(3) of this section and any election (or withdrawal thereof) permitted under paragraph (b)(5) of this section, shall mean:

(i) Each quotation vendor;

(ii) Each plan processor; and

(iii) The processor for the Options Price Reporting Authority (in the case of a notification for a subject security which is a class of securities underlying options admitted to trading on any exchange).

(25) The term *subject security* shall mean:

(i) With respect to an exchange:

(A) Any exchange-traded security other than a security for which the executed volume of such exchange, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported in the consolidated system; and

(B) Any other covered security for which such exchange has in effect an election, pursuant to paragraph (b)(5)(i) of this section, to collect, process, and make available to quotation vendors, bids, offers, quotation sizes, and aggregate quotation sizes communicated on such exchange; and

(ii) With respect to a member of an association:

(A) Any exchange-traded security for which such member acts in the capacity of an OTC market maker unless the executed volume of such member, during the most recent calendar quarter, comprised one percent or less of the aggregate trading volume for such security as reported in the consolidated system; and

(B) Any other covered security for which such member acts in the capacity of an OTC market maker and has in effect an election, pursuant to paragraph (b)(5)(ii) of this section, to communicate to its association bids, offers and quotation sizes for the purpose of making such bids, offers and quotation sizes available to quotation vendors.

(b) *Dissemination requirements for exchanges and associations.* (1) Every exchange and association shall establish and maintain procedures and mechanisms for collecting bids, offers, quotation sizes and aggregate quotation sizes from responsible brokers or dealers who are members of such exchange or association, processing such bids, offers and sizes, and making such bids, offers and sizes available to quotation vendors, as follows:

(i) Each exchange shall at all times such exchange is open for trading, collect, process and make available to quotation vendors the best bid, the best offer, and aggregate quotation sizes for each subject security listed or admitted to unlisted trading privileges which is communicated on any exchange by any responsible broker or dealer, but shall not include:

(A) Any bid or offer executed immediately after communication and any bid or offer communicated by a responsible broker or dealer other than an exchange market maker which is cancelled or withdrawn if not executed immediately after communication; and

(B) Any bid or offer communicated during a period when trading in that security has been suspended or halted, or prior to the commencement of trading in that security on any trading day, on that exchange.

(ii) Each association shall, at all times that last sale information with respect to reported securities is reported pursuant to an effective transaction reporting plan, collect, process and make available to quotation vendors the best bid, best offer, and quotation sizes communicated otherwise than on an exchange by each member of such association acting in the capacity of an

OTC market maker for each subject security and the identity of that member (excluding any bid or offer executed immediately after communication), except during any period when over-the-counter trading in that security has been suspended.

(2) Each exchange shall, with respect to each published bid and published offer representing a bid or offer of a member for a subject security, establish and maintain procedures for ascertaining and disclosing to other members of that exchange, upon presentation of orders sought to be executed by them in reliance upon paragraph (c)(2) of this section, the identity of the responsible broker or dealer who made such bid or offer and the quotation size associated with it.

(3)(i) If, at any time an exchange is open for trading, such exchange determines, pursuant to rules approved by the Securities and Exchange Commission pursuant to section 19(b)(2) of the Act (15 U.S.C. 78s(b)(2)), that the level of trading activities or the existence of unusual market conditions is such that the exchange is incapable of collecting, processing, and making available to quotation vendors the data for a subject security required to be made available pursuant to paragraph (b)(1) of this section in a manner that accurately reflects the current state of the market on such exchange, such exchange shall immediately notify all specified persons of that determination. Upon such notification, responsible brokers or dealers that are members of that exchange shall be relieved of their obligation under paragraph (c)(2) of this section and such exchange shall be relieved of its obligations under paragraphs (b) (1) and (2) of this section for that security: *provided, however,* That such exchange will continue, to the maximum extent practicable under the circumstances, to collect, process, and make available to quotation vendors data for that security in accordance with paragraph (b)(1) of this section.

(ii) During any period an exchange, or any responsible broker or dealer that is a member of that exchange, is relieved of any obligation imposed by this section for any subject security by virtue of a notification made pursuant to paragraph (b)(3)(i) of this section, such exchange shall monitor the activity or conditions which formed the basis for such notification and shall immediately renotify all specified persons when that exchange is once again capable of collecting, processing, and making available to quotation vendors the data for that security required to be made available pursuant to paragraph (b)(1) of this section in a manner that accurately reflects the current state of the market on such exchange. Upon such renotification, any exchange or responsible broker or dealer which had been relieved of any obligation imposed by this section as a consequence of the prior notification shall again be subject to such obligation.

(4) Nothing in this section shall preclude any exchange or association from making available to quotation vendors indications of interest or bids and offers for a subject security at any time such exchange or association is not required to do so pursuant to paragraph (b)(1) of this section.

(5)(i) Any exchange may make an election for purposes of paragraph (a)(25)(i)(B) of this section for any covered security, by collecting, processing, and making available bids, offers, quotation sizes, and aggregate quotation sizes in that security; except that for any covered security previously listed or admitted to unlisted trading privileges on only one exchange and not traded by any OTC market maker, such election shall be made by notifying all specified persons, and shall be effective at the opening of trading on the business day following notification.

(ii) Any member of an association acting in the capacity of an OTC market maker may make an election for purposes of paragraph (a)(25)(ii)(B) of this section for any covered security, by communicating to its association bids, offers, and quotation sizes in that security; except that for any other covered security listed or admitted to unlisted trading privileges on only one exchange and not traded by any other OTC market maker, such election shall be made by notifying its association and all specified persons, and shall be effective at the opening of trading on the business day following notification.

(iii) The election of an exchange or member of an association for any covered security pursuant to this paragraph (b)(5) shall cease to be in effect if such exchange or member ceases to make available or communicate bids, offers, and quotation sizes in such security.

(c) *Obligations of responsible brokers and dealers.* (1) Each responsible broker or dealer shall promptly communicate to its exchange or association, pursuant to the procedures established by that exchange or association, its best bids, best offers, and quotation sizes for any subject security.

(2) Subject to the provisions of paragraph (c)(3) of this section, each responsible broker or dealer shall be obligated to execute any order to buy or sell a subject security, other than an odd-lot order, presented to it by another broker or dealer, or any other person belonging to a category of persons with whom such responsible broker or dealer customarily deals, at a price at least as favorable to such buyer or seller as the responsible broker's or dealer's published bid or published offer (exclusive of any commission, commission equivalent or differential customarily charged by such responsible broker or dealer in connection with execution of any such order) in any amount up to its published quotation size.

(3)(i) No responsible broker or dealer shall be obligated to execute a transaction for any subject security as provided in paragraph (c)(2) of this section to purchase or sell that subject security in an amount greater than such revised quotation if:

(A) Prior to the presentation of an order for the purchase or sale of a subject security, a responsible broker or dealer has communicated to its exchange or association, pursuant to paragraph (c)(1) of this section, a revised quotation size; or

(B) At the time an order for the purchase or sale of a subject security is presented, a responsible broker or dealer is in the process of effecting a transaction in such subject security, and immediately after the completion of such transaction, it communicates to its exchange or association a revised quotation size, such responsible broker or dealer shall not be obligated by paragraph (c)(2) of this section to purchase or sell that subject security in an amount greater than such revised quotation size.

(ii) No responsible broker or dealer shall be obligated to execute a transaction for any subject security as provided in paragraph (c)(2) of this section if:

(A) Before the order sought to be executed is presented, such responsible broker or dealer has communicated to its exchange or association pursuant to paragraph (c)(1) of this section, a revised bid or offer; or

(B) At the time the order sought to be executed is presented, such responsible broker or dealer is in the process of effecting a transaction in such subject security, and, immediately after the completion of such transaction, such responsible broker or dealer communicates to its exchange or association pursuant to paragraph (c)(1) of this section, a revised bid or offer; *provided, however,* That such responsible broker or dealer shall nonetheless be obligated to execute any such order in such subject security as provided in paragraph (c)(2) of this section at its revised bid or offer in any

amount up to its published quotation size or revised quotation size.

(4) Subject to the provisions of paragraph (b)(4) of this section:

(i) No exchange or OTC market maker may make available, disseminate or otherwise communicate to any quotation vendor, directly or indirectly, for display on a terminal or other display device any bid, offer, quotation size, or aggregate quotation size for any covered security which is not a subject security with respect to such exchange or OTC market maker; and

(ii) No quotation vendor may disseminate or display on a terminal or other display device any bid, offer, quotation size, or aggregate quotation size from any exchange or OTC market maker for any covered security which is not a subject security with respect to such exchange or OTC market maker.

(5)(i) Entry of any priced order for a covered security by an exchange market maker or OTC market maker in that security into an electronic communications network that widely disseminates such order shall be deemed to be:

(A) A bid or offer under this section, to be communicated to the market maker's exchange or association pursuant to paragraph (c) of this section for at least the minimum quotation size that is required by the rules of the market maker's exchange or association if the priced order is for the account of a market maker, or the actual size of the order up to the minimum quotation size required if the priced order is for the account of a customer; and

(B) A communication of a bid or offer to a quotation vendor for display on a display device for purposes of paragraph (c)(4) of this section.

(ii) An exchange market maker or OTC market maker that has entered a priced order for a covered security into an electronic communications network that widely disseminates such order shall be deemed to be in compliance with paragraph (c)(5)(i)(A) of this section if the electronic communications network:

(A) Provides to an exchange or association (or an exclusive processor acting on behalf of one or more exchanges or associations) the prices and sizes of the orders at the highest buy price and the lowest sell price for such security entered in, and widely disseminated by, the electronic communications network by exchange market makers and OTC market makers for the covered security, and such prices and sizes are included in the quotation data made available by the exchange, association, or exclusive processor to quotation vendors pursuant to this section; and

(B) Provides, to any broker or dealer, the ability to effect a transaction with a priced order widely disseminated by the electronic communications network entered therein by an exchange market maker or OTC market maker that is:

(*1*) Equivalent to the ability of any broker or dealer to effect a transaction with an exchange market maker or OTC market maker pursuant to the rules of the exchange or association to which the electronic communications network supplies such bids and offers; and

(*2*) At the price of the highest priced buy order or lowest priced sell order, or better, for the lesser of the cumulative size of such priced orders entered therein by exchange market makers or OTC market makers at such price, or the size of the execution sought by the broker or dealer, for the covered security.

(d) *Exemptions.* The Commission may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any responsible broker or dealer, electronic communications network, exchange, or association if the Commission determines that such exemption is consistent with the public interest, the protection of investors and the removal of impediments to and perfection of the mechanism of a national market system.

4. Section 240.11Ac1–4 is added to read as follows:

§ 240.11Ac1–4 Display of customer limit orders.

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

(1) The term *association* shall mean any association of brokers and dealers registered pursuant to Section 15A of the Act (15 U.S.C. 78*o*–3).

(2) The terms *best bid* and *best offer* shall have the meaning provided in § 240.11Ac1–1(a)(3).

(3) The terms *bid* and *offer* shall have the meaning provided in § 240.11Ac1–1(a)(4).

(4) The term *block size* shall mean any order:

(i) Of at least 10,000 shares; or

(ii) For a quantity of stock having a market value of at least $200,000.

(5) The term *covered security* shall mean any "reported security" and any other security for which a transaction report, last sale data or quotation information is disseminated through an automated quotation system as described in section 3(a)(51)(A)(ii) of the Act (15 U.S.C. 78c(a)(51)(A)(ii)).

(6) The term *customer limit order* shall mean an order to buy or sell a covered security at a specified price that is not for the account of either a broker or dealer; *provided, however,* That the term customer limit order shall include an order transmitted by a broker or dealer on behalf of a customer.

(7) The term *electronic communications network* shall have the meaning provided in § 240.11Ac1–1(a)(8).

(8) The term *exchange-traded security* shall have the meaning provided in § 240.11Ac1–1(a)(10).

(9) The term *OTC market maker* shall mean any dealer who holds itself out as being willing to buy from and sell to its customers, or otherwise, a covered security for its own account on a regular or continuous basis otherwise than on a national securities exchange in amounts of less than block size.

(10) The term *reported security* shall have the meaning provided in § 240.11Ac1–1(a)(20).

(b) *Specialists and OTC market makers.* For all covered securities:

(1) Each member of an exchange that is registered by that exchange as a specialist, or is authorized by that exchange to perform functions substantially similar to that of a specialist, shall publish immediately a bid or offer that reflects:

(i) The price and the full size of each customer limit order held by the specialist that is at a price that would improve the bid or offer of such specialist in such security; and

(ii) The full size of each customer limit order held by the specialist that:

(A) Is priced equal to the bid or offer of such specialist for such security;

(B) Is priced equal to the national best bid or offer; and

(C) Represents more than a *de minimis* change in relation to the size associated with the specialist's bid or offer.

(2) Each registered broker or dealer that acts as an OTC market maker shall publish immediately a bid or offer that reflects:

(i) The price and the full size of each customer limit order held by the OTC market maker that is at a price that would improve the bid or offer of such OTC market maker in such security; and

(ii) The full size of each customer limit order held by the OTC market maker that:

(A) Is priced equal to the bid or offer of such OTC market maker for such security;

(B) Is priced equal to the national best bid or offer; and

(C) Represents more than a *de minimis* change in relation to the size associated with the OTC market maker's bid or offer.

(c) *Exceptions.* The requirements in paragraph (b) of this section shall not apply to any customer limit order:

(1) That is executed upon receipt of the order.

(2) That is placed by a customer who expressly requests, either at the time that the order is placed or prior thereto pursuant to an individually negotiated agreement with respect to such customer's orders, that the order not be displayed.

(3) That is an odd-lot order.

(4) That is a block size order, unless a customer placing such order requests that the order be displayed.

(5) That is delivered immediately upon receipt to an exchange or association-sponsored system, or an electronic communications network that complies with the requirements of § 240.11Ac1–1(c)(5)(ii) with respect to that order.

(6) That is delivered immediately upon receipt to another exchange member or OTC market maker that complies with the requirements of this section with respect to that order.

(7) That is an "all or none" order.

(d) *Exemptions.* The Commission may exempt from the provisions of this section, either unconditionally or on specified terms and conditions, any responsible broker or dealer, electronic communications network, exchange, or association if the Commission determines that such exemption is consistent with the public interest, the protection of investors and the removal of impediments to and perfection of the mechanism of a national market system.

Dated: September 6, 1996.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 96–23210 Filed 9–11–96; 8:45 am]

BILLING CODE 8010–01–P

NASD Notice to Members 96-66

SEC Expands Scope Of Conduct Rules And Other NASD Rules To Government Securities; Approves New Suitability Interpretation

Suggested Routing

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Executive Summary

The Government Securities Act Amendments of 1993 (GSAA)[1] eliminated the statutory limitations on NASD® authority to apply sales-practice rules to transactions in exempted securities, including government securities, other than municipals.[2] On August 20, 1996, the Securities and Exchange Commission (SEC) approved amendments implementing the expanded sales-practice authority granted to the NASD pursuant to the GSAA.

General Provisions Rule 0114 is retitled "Effect on Transactions in Municipal Securities" and amended to apply the NASD Conduct Rules and other Rules to transactions in exempted securities, including government securities, other than municipals. Rule 0115 "Applicability" is amended to apply the NASD Conduct Rules and other Rules to members registered with the SEC solely under the provisions of Section 15(C) of the Securities Exchange Act of 1934 (Act), and to persons associated with such members.

The application of the Conduct Rules to government securities transactions is provided in Table 1 of this Notice. Amendments to the text of certain Conduct Rules are amended to further clarify their application to exempted securities, including government securities, other than municipals. As indicated in Table 1, certain Conduct Rules will not immediately apply to transactions in government securities. These are IM-2110-2 "Trading Ahead of Customer Limit Order"; IM-2110-3 "Front-Running Policy"; IM-2110-4 "Trading Ahead of Research Reports"; Rule 2440 "Fair Prices and Commissions"; IM-2440 "Mark-Up Policy"; and Rule 2760 "Offerings At the Market." The NASD intends to review the specific application of these rules to the government securities market. In the interim, NASD members are reminded that actions for conduct generally encompassed by these Rules occurring in the government securities market may be brought under Rule 2110 "Standards of Commercial Honor and Principles of Trade."

Rule 1060 "Persons Exempt from Registration" is amended to eliminate the registration exemption for persons associated with a member whose functions are related solely and exclusively to transactions in exempted securities. Rule 1060, however, continues to exempt persons associated with a member whose functions are related solely and exclusively to transactions in municipal securities.

As indicated in Table 2, the NASD's Government Securities Rules are merged, where applicable, into the NASD's Conduct Rules and other Rules. Conforming amendments also are made throughout the *NASD Manual* to delete references to the Government Securities Rules and to replace the term *exempted securities* with the term *municipal securities.*

The SEC also approved the NASD Board of Governors interpretation regarding Suitability Obligations to Institutional Customers. The interpretation further clarifies how the NASD's Suitability Rule 2310 "Recommendations to Customers" is applicable to institutional customers. The new interpretation applies to all debt and equity securities, except municipals. Changes regarding Rule

[1] Government Securities Act Amendments of 1993, Pub. L. No. 103-202, § 1(a), 107 Stat. 2344 (1993).

[2] The terms *exempted securities, government securities,* and *municipal securities* are defined in Sections 3(a)12, 3(a)42, and 3(a)29 of the Act, respectfully. Rules for municipal securities are promulgative by the Municipal Securities Rulemaking Board.

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2340 "Customer Account Statements," Rule 3010 "Supervision," Rule 3020 "Fidelity Bonds," and Rule 3110 "Books & Records" will be effective on November 18, 1996. All other changes were effective on August 20, 1996.

Please refer to your NASD Manual *Conversion chart for references to the old Rule language if necessary.*

Questions regarding this Notice may be directed to any of the following NASD Regulation℠ staff: Robert M. Broughton, Compliance, at (202) 728-8361, Samuel Luque, Jr., Associate Director, Compliance, at (202) 728-8472, and Thomas R. Cassella, Vice President, Compliance, at (202) 728-8237.

Description Of Amendments

General Provisions

The GSAA eliminated the statutory limitations on the NASD's authority to apply sales-practice rules to transactions in exempted securities, including government securities. To implement the expanded statutory authority granted to the NASD, Rule 0114 has been retitled and amended to apply NASD Conduct Rules and other Rules to transactions in exempted securities, including government securities. Rule 0115 "Applicability" is amended to apply the NASD Conduct Rules and other Rules to members registered with the SEC solely under the provisions of Section 15(C) of the Act and persons associated with such members. Rule 0115, however, continues to exempt persons associated with a member whose functions are related solely and exclusively to transactions in municipal securities.

Registration Rules Of Associated Persons

Rule 1060 "Persons Exempt from Registration" is amended to eliminate the registration exemption for persons associated with a member whose functions are related solely and exclusively to transactions in exempted securities. This amendment, therefore, applies the NASD registration requirements of persons associated with a member, to the personnel of sole-government securities broker/dealers, including persons selling options on government securities. Rule 1060, however, continues to exempt persons associated with a member whose functions are related solely and exclusively to transactions in municipal securities.

Conduct Rules

Paragraph (b) of Rule 2310 requires a member to make reasonable efforts to obtain certain information before the execution of a transaction recommended to a non-institutional customer. A new paragraph (c) is added to Rule 2310 to clarify that for purposes of paragraph (b) of Rule 2310, the definition of a *non-institutional customer* shall mean a customer that does not qualify as an "institutional account" under Rule 3110(c)(4). This clarification is made to distinguish the definition of *institutional account* that is referenced in Rule 2310(b) from the definition of *institutional customer* contained in the new Suitability Interpretation IM-2310-3 in the Conduct Rules.

The interpretation on "Free-Riding and Withholding" (IM-2110-1) is amended **not** to apply to government securities. Rule 3370 "Prompt Receipt and Delivery of Securities" also is amended by expanding the exemptions for corporate debt securities to all debt securities. All members, therefore, in connection with debt security transactions, will not be subject to the affirmative requirements of Rule 3370 before accepting a long-sale order from any customer; accepting a short-sale order for any customer; or effecting a short sale for its own account in any security.

Rule 2320 "Best Execution and Interpositioning" is applicable to transactions in exempted securities, including government securities, other than municipals. The NASD believes members should seek in executing customer transactions in government securities to obtain the best available price for each customer. The NASD's position regarding the applicability of Rule 2320 to government securities is consistent with its position that the concepts of the interpretation apply to all OTC markets that the NASD regulates, including direct participation programs. The NASD will further consider whether an amendment to the Best Execution Rule is necessary to clarify this position as it applies to government securities.

Rule 3110(b) "Marking of Customer Order Tickets" exempted only corporate debt from the marking of the customer order ticket requirement. As amended, all debt securities are exempt from the marking of the customer order ticket requirement. A person associated with a member, therefore, need not indicate on the memorandum for sale of a security whether the order is "long" or "short" if the transaction involves a debt security.

Rules Temporarily Excepted

IM-2110-3 "Front Running Policy" currently applies, by its terms, only to equity securities. In addition, IM-2110-2 "Trading Ahead of Customer Limit Order" and IM-2110-4 "Trading Ahead of Research Reports" are currently drafted to apply only to equity securities. Rule 2760 "Offerings At the Market" also is not applicable to the government securities markets. The NASD believes, however, that the member conduct prohibited by these rules may occur

under certain circumstances in the government securities market, and will review the application of these provisions to the government securities market to determine if specific rulemaking or interpretation is necessary. In the interim, NASD Regulation reminds members that actions for similar conduct occurring in the government securities market is covered under Rule 2110 "Standards of Commercial Honor and Principles of Trade."

NASD Regulation is considering an interpretation of IM-2440 "Mark-Up Policy" for exempted securities and other debt securities. The current application of Rule 2440 "Fair Prices and Commissions" and the Mark-Up Policy will not apply to transactions in exempted securities until adoption of an interpretation of the NASD Mark-Up Policy. NASD Regulation, however, reminds members that conduct in the government securities market is covered under Rule 2110 "Standards of Commercial Honor and Principles of Trade."

Paragraph (b) of Rule 2220 "Options Communications with the Public" requires a Compliance Registered Options Principal to approve in advance all advertisements, sales literature (except completed worksheets), and educational material issued by a member or member organization pertaining to options. NASD Regulation, however, is considering whether the registration of such a Principle should be required under Rule IM-1022-1 "Registered Options Principals" for government securities options. In the interim, the requirements of Rule 2220(b) will not apply to options advertisements, sales materials, and other educational material pertaining to government securities options.

Table 1 below, identifies the applicability of the Conduct Rules to exempted securities, including government securities, other than municipals.

Table 1

CONDUCT RULES

2000. BUSINESS CONDUCT

- 2100. GENERAL STANDARDS
- 2110. Standards of Commercial Honor and Principles of Trade - Applicable
  - IM-2110-1. - "Free-Riding and Withholding"- Amended to Not Apply
  - IM-2110-2. - Trading Ahead of Customer Limit Order - Not Applicable*
  - IM-2110-3. - Front Running Policy - Not Applicable*
  - IM-2110-4. - Trading Ahead of Research Reports - Not Applicable*
- 2120. Use of Manipulative, Deceptive, or Other Fraudulent Devices - Applicable

2200. COMMUNICATIONS WITH CUSTOMERS AND THE PUBLIC

- 2210. Communications with the Public - Applicable
  - IM-2210-1. - Communications with the Public About Collateralized Mortgage Obligations (CMOs) - Applicable
  - IM-2210-2. - Communications with the Public About Variable Life Insurance and Variable Annuities - Applicable
  - IM-2210-3. - Use of Rankings in Investment Companies Advertisements and Sales Literature - Applicable
- 2220. Options Communications with the Public - Not Applicable, Under Review
- 2230. Confirmations - Not Applicable, Superseded by SEC Rules
  - IM-2230. - "Third Market" Confirmations - Not Applicable
- 2240. Disclosure of Control Relationship with Issuer - Not Applicable
- 2250. Disclosure of Participation or Interest in Primary or Secondary Distribution - Applicable
- 2260. Forwarding of Proxy and Other Materials - Not Applicable
  - IM-2260. - Suggested Rates of Reimbursement - Not Applicable
- 2270. Disclosure of Financial Condition to Customers - Applicable

2300. TRANSACTIONS WITH CUSTOMERS - Applicable

- 2310. Recommendations to Customers (Suitability) - Applicable
  - IM-2310-1. - Possible Application of SEC Rule 15c2-6 - Not Applicable (applies only to equity securities)
  - IM-2310-2. - Fair Dealing with Customers - Applicable
  - IM-2310-3. - Suitability Obligations to Institutional Customers - Applicable
- 2320. Best Execution and Interpositioning - Applicable
- 2330. Customers' Securities or Funds - Applicable
  - IM-2330. - Segregation of Customers' Securities - Applicable
- 2340. Customer Account Statements - Applicable

2400. COMMISSIONS, MARK-UPS AND CHARGES

- 2410. Net Prices to Persons Not in Investment Banking or Securities Business - Not Applicable
- 2420. Dealing with Non-Members - Amended to Not Apply
  - IM-2420-1. - Transactions Between Members and Non-Members - Not Applicable
  - IM-2420-2. - Continuing Commissions Policy - Not Applicable - Not Addressed by Board
- 2430. Charges for Services Performed - Applicable
- 2440. Fair Prices and Commissions - Not Applicable**
  - IM-2440. - Mark-Up Policy - Not Applicable**
- 2450. Installment or Partial Sales - Applicable

2500. SPECIAL ACCOUNTS

- 2510. Discretionary Accounts - Applicable
- 2520. Margin Accounts - Applicable
  - IM-2520. - Computation of Elapsed Days - Applicable

2700. SECURITIES DISTRIBUTIONS

- 2710. Corporate Financing Rule—Underwriting Terms and Arrangements - Not Applicable
- 2720. Distribution of Securities of Members and Affiliates—Conflicts of Interest - Not Applicable
- 2730. Securities Taken in Trade - Not Applicable
  - IM-2730. - Safe Harbor and Presumption of Compliance - Not Applicable
- 2740. Selling Concessions, Discounts and Other Allowances - Not Applicable
  - IM-2740. - Services in Distribution - Not Applicable
- 2750. Transactions with Related Persons - Not Applicable
  - IM-2750. - Transactions with Related Persons - Not Applicable
- 2760. Offerings "At the Market" - Not Applicable*
- 2770. Disclosure of Price in Selling Agreements - Applicable only to Traditional Underwriter Arrangements
- 2780. Solicitation of Purchases on an Exchange to Facilitate a Distribution of Securities - Applicable

2800. SPECIAL PRODUCTS

- 2810. Direct Participation Programs - Not Applicable
- 2820. Variable Contracts of an Insurance Company - Not Applicable
- 2830. Investment Company Securities - Not Applicable
  - IM-2830-1. - "Breakpoint" Sales - Was under Investment Company Securities §5266 - Not Applicable
  - IM-2830-2. - Maintaining the Public Offering Price - Not Applicable

2840. Trading in Index Warrants, Currency Index Warrants, and Currency Warrants - Not Applicable

2860. Options - Not Applicable

IM-2860-1. - Position Limits - Not Applicable

IM-2860-2. - Diligence in Opening Options Accounts - Not Applicable

2870. Nasdaq Index Options - Not Applicable

2871. Definitions - Not Applicable

2872. Nasdaq Index Options Services Available - Not Applicable

2873. Registration, Qualification and Other General Requirements Applicable to All Nasdaq Index Options Market Makers - Not Applicable

2874. Character of Index Options Quotations Entered into the Nasdaq Index Options Service by all Nasdaq Index Options Market Makers - Not Applicable

2875. Commitment Rules Applicable to Options Market Makers in Nasdaq Index Options - Not Applicable

2876. Sanctions Applicable to Nasdaq Index Options Market Makers - Not Applicable

2877. Requirements Applicable to Nasdaq Index Options Order Entry Firms - Not Applicable

2878. Transaction Reporting and Other Reporting Requirements - Not Applicable

2879. Authorization of Nasdaq Index Option Market Making - Not Applicable

2880. Nasdaq Index Option Contracts Authorized for Trading - Not Applicable

2881. Series of Nasdaq Index Options for Trading - Not Applicable

2882. Unit of Trading - Not Applicable

2883. Suspension of Authorization of Nasdaq Index Option Contracts - Not Applicable

2884. Trade Comparison Procedures for Nasdaq Index Options - Not Applicable

2885. Clearance and Settlement Procedures for Nasdaq Index Options - Not Applicable

2900. RESPONSIBILITIES TO OTHER BROKERS OR DEALERS

2910. Disclosure of Financial Condition to Other Members - Applicable

3000. RESPONSIBILITIES RELATING TO ASSOCIATED PERSONS, EMPLOYEES, AND OTHERS' EMPLOYEES

3010. Supervision - Applicable

3020. Fidelity Bonds - Applicable

3030. Outside Business Activities of an Associated Person - Applicable

3040. Private Securities Transactions of an Associated Person - Applicable

3050. Transactions for or by Associated Persons - Applicable

3060. Influencing or Rewarding Employees of Others - Applicable

3070. Reporting Requirements - Applicable

3100. BOOKS AND RECORDS, AND FINANCIAL CONDITION

3110. Books and Records - Applicable

IM-3110. - Customer Account Information - Applicable

3120. Use of Information Obtained in Fiduciary Capacity - Applicable

3130. Regulation of Activities of Members Experiencing Financial and/or Operational Difficulties - Applicable

IM-3130. - Restrictions on a Member's Activity - Applicable

3131. Regulation of Activities of Section 15(C) Members Experiencing Financial and/or Operational Difficulties - Applicable

3140. Approval of Change in Exempt Status Under SEC Rule 15c3-3 - Applicable

3200. SETTLEMENTS

3210. Securities "Failed to Receive" and "Failed to Deliver" - Not Applicable

3220. Adjustment of Open Orders - Not Applicable

3230. Clearing Agreements - Applicable

3300. TRADING

3310. Publication of Transactions and Quotations - Applicable

IM-3310. - Manipulative and Deceptive Quotations - Applicable

3320. Offers at Stated Prices - Applicable

IM-3320. - Firmness of Quotations - Applicable

3330. Payment Designed to Influence Market Prices, Other than Paid Advertising -Applicable

3340. Prohibition on Transactions During Trading Halts - Not Applicable

3350. Short Sale Rule - Not Applicable

IM-3350. - Short Sale Rule - Not Applicable

3360. Short Interest Reporting - Not Applicable

3370. Prompt Receipt and Delivery of Securities - Not Applicable

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* The NASD is reviewing the application of this interpretation to the government securities market.

Currently, the NASD Front Running Interpretation applies only to equity securities. The NASD believes, however, that the member conduct prohibited by the Front Running Interpretation may occur under certain circumstances in the government securities market. In the interim, the NASD believes that actions for similar front running conduct occurring in the government securities market is covered under Rule 2110.

Trading ahead of customer limit orders and trading ahead of research reports, also are currently drafted to apply only to equity securities. The NASD believes the conduct addressed by these interpretations also may occur under certain circumstances in the government securities market and intends to review the application of these interpretations to the government securities market. The NASD also believes that actions for similar conduct occurring in the government securities market is covered under Rule 2110.

** The NASD is developing an Interpretation of IM-2440 "Mark-Up Policy" for exempted securities and other debt securities. The current application of Rule 2440 "Fair Prices and Commissions" and the NASD Mark-Up Policy will not apply to transactions in exempted securities until adoption of an Interpretation of the NASD Mark-Up Policy. The NASD clarified, however, that conduct violating the Mark-Up Policy is covered under Rule 2110.

Amendments Merging Government Securities Rules Into Conduct Rules

Provisions of the Government Securities Rules are added to Rules 3110(c)(3), 3130, 3140, 8110, 8120, 8130, 8140, and 8310 of the Conduct Rules. Section 6 of the Government Securities Rules is new Rule 3131. References are also added, where applicable, to certain Conduct Rules regarding Section 402.2(c) of the Treasury Department. To effect the amendments, a number of the provisions contained in the above-referenced Rules are reorganized and renumbered.

Table 2 indicates the Conduct Rule and any related rule to which each Government Securities Rule has been merged. Table 2 also indicates the paragraph of the Conduct Rule or related rule to which any provision of a Government Securities Rule has been added.

Table 2

Government Securities Rules

Government Securities Rules		*New Codified Citation*
Sec. 1	Adoption of Rules	Rule 0111 – No change
Sec. 2	Applicability	
	Subsection (a)	Rule 0114 and 0115(a)
	Subsection (b)	Rule 0115 (b) and (c) – No change
Sec. 3	Definitions in By–Laws and Rules of Fair Practice	Rule 0120 and 0121 – No change
Sec. 4	Books and Records	Rule 3110
Sec. 5	Supervision	Rule 3010 – No change
Sec. 6	Regulation and Activities of Members Experiencing Financial and/or Operational Difficulties	Rule 3131
	Explanation of Board of Governors—Restrictions on a Member's Activities	IM-3130(d)
Sec. 7	Approval of Change in Exempt Status under SEC Rule 15c3–3	Rule 3140
Sec. 8	Communications with the Public	Rule 2210 – No change.
Sec. 9	Availability to Customer of Certificate, By–Laws, Rules, and Code of Procedure	Rule 8110 – No change.
Sec. 10	Complaints:	
	Subsection (a) Complaints by Public Against Members	Rule 8120
	Subsection (b) Complaints by District Business Conduct Committees	Rule 8130
	Subsection (c) Complaints by the Board of Governors	Rule 8140
Sec. 11	Reports and Inspection of Books for Purpose of Investigating Complaints	Rule 8210 – No change.
	Resolution of Board of Governors—Suspension of Members for Failure to Furnish Information Duly Requested	Rule 8220 – No change.
Sec. 12	Sanctions for Violation of the Rules	Rule 8310
Sec. 13	Payment of Fines or Costs	Rule 8320 – No change
Sec. 14	Costs of Proceedings	Rule 8330 – No change

IM- 2310-3 "Suitability Obligations To Institutional Customers"[3]

Rule 2310 "Recommendations to Customers" has set forth NASD's requirements relative to members' suitability obligations when making recommendations since the inception of the NASD. Rule 2310(a) "Suitability Rule" requires that in recommending to a customer the purchase, sale, or exchange of any security, a member must have reasonable grounds for believing that the recommendation is suitable for such customer based on the facts, if any, disclosed by such customer as to his or her other security holdings and financial situation and needs. With the enactment of the GSAA, the NASD has decided to provide further guidance to members on their suitability obligations and has proposed guidelines for its members regarding how members may fulfill their "customer specific" suitability obligations when making recommendations to institutional customers.[4]

The new Suitability Interpretation (Interpretation) is predicated on a determination that the two most important considerations in determining the scope of a member's suitability obligation in making recommendations to an institutional customer are (1) the customer's capability to evaluate investment risk independently, and (2) the extent to which the customer is exercising independent judgment. The Interpretation further describes factors that may be relevant in a member's evaluation of these two important considerations. The NASD has emphasized that these factors are guidelines that will determine whether a member has fulfilled its suitability obligations for a specific institutional customer transaction and that the absence or inclusion of any of these factors is not dispositive of the suitability determination.

The NASD's approach to determining the scope of a member's suitability obligation in making recommendations to an institutional customer appropriately responds to the varied nature of institutional customers and the varied significance of a member's recommendation by different institutional customers. In the latter circumstance, a broker/dealer frequently has knowledge about the investment and its risks and costs that are not possessed by or easily available to the investor. Some sophisticated institutional customers, however, may in fact possess both the capability to understand how a particular securities investment could perform, as well as the desire to make their own investment decisions, without reliance on the knowledge or resources of the broker/dealer. However, other investors that meet a definition of *institutional customer* may not possess the requisite capability to understand the particular investment risk, or may not be exercising independent judgment in making a particular investment decision, and so may be largely dependent on the broker/dealer's analysis and recommendation in evaluating whether to purchase a recommended security.

The Interpretation recognizes the varied nature of institutional investor profiles, even among investors that meet some definition of *institutional investor*. It accommodates a wide range of relationships because it does not establish rigid thresholds or requirements, but rather provides its members with some reasonable factors by which a member can determine the nature of its relationship with a customer. The Interpretation recognizes that there can be instances in which an institutional customer possesses a general capability to understand certain kinds of investments, but does not have the requisite capability to understand the particular investment under consideration. In such a circumstance, the Interpretation notes that a broker/dealer's suitability obligation would not be diminished based solely on the financial wherewithal of the customer.

The factors enumerated in the Interpretation, which could be relevant to the two considerations referenced above, provide members with appropriate points to consider in satisfying their suitability obligations. However, members should understand that these considerations are not necessarily the only relevant factors, but merely guidelines to use when determining whether a member has fulfilled its suitability obligations for a specific institutional customer transaction. They neither create nor reduce a member's suitability obligation and their relevance would vary depending on numerous circumstances. Moreover, these enumerated factors are not meant to create a checklist, which would be inappropriate in these circumstances because it could lead to a mechanical application of the Interpretation without adequate consideration by the broker/dealer of whether the customer understands the transaction or product or whether its customer-specific suitability obligations are being met.

[3] The following discussion regarding IM-2310-3 has been generally excerpted from the SEC Discussion of this Interpretation in Release 34-37588 (August 20, 1996); [FR 44160 (August 27, 1996) at 44110.] NASD Regulation has edited and shortened the original language when appropriate for purposes of this Notice.

[4] The NASD Interpretation will apply to all securities, except for municipals. Municipal Securities Rulemaking Board (MSRB) Rule G-19 governs the suitability obligations for municipal securities. Like Rule 2310(a), MSRB Rule G-19 makes no distinction between institutional and non-institutional customers in requiring that a broker, dealer, or municipal securities dealer must have reasonable grounds for believing that a recommendation is suitable.

In keeping with its purpose to provide guidance and not create or reduce a member's suitability obligations, the NASD intentionally did not create a safe harbor or provide for a rebuttable presumption in the Interpretation. The decision not to create a safe harbor or rebuttable presumption is consistent with the purposes of the Act. A safe harbor or a rebuttable presumption that applied to institutions that were likely to rely on a broker/dealer's guidance regarding a security could lead to serious abuses that are inconsistent with the purposes of the Act. For example, a safe harbor could allow a broker/dealer to recommend a risky security to an institutional investor without consideration of the appropriateness of the investment for the investor, and despite knowing that the customer did not understand the product. Moreover, a safe harbor or a rebuttable presumption assumes that all institutions with similar amounts to invest possess similar or equal financial acumen, which has not proven to be the case.

The NASD, however, has not sought to define such a class. Rather, the Interpretation has taken a flexible approach in defining the term *institutional investor* by **not** including financial criteria in the term; for purposes of the Interpretation, an institutional customer may be any entity other than a natural person. The Interpretation potentially would apply to all institutional investors, though more appropriately to institutional investors with portfolios of at least $10 million in securities.[5] The NASD believes that excluding institutional investors from the protections of the suitability rule based on objective financial criteria would arbitrarily discriminate among institutional investors based on factors such as asset size, portfolio size, or institutional type that are not necessarily determinative of financial sophistication. The NASD choice not to rely on objective criteria that may mask what is really an unsophisticated investor is believed reasonable in the context of a standard that incorporates factors that reflect the nature of the investor, and where the suitability of the recommendation itself depends on the nature of the investor. Categorizing investors by isolated financial criteria may improperly attribute the capability to evaluate investment risk independently, and exercise independent judgment, to a customer without an appropriate analysis of the investor's true characteristics.

Moreover, in view of the great diversity of institutional customers, the Interpretation affords broker/dealers the flexibility to negotiate understandings and terms with a particular customer. Such agreements, freely negotiated between consenting parties, can be useful in establishing, prior to a transaction, the obligations and responsibilities of both parties. The NASD approach assists broker/dealers and customers to define their own expectations and roles with respect to their specific relationship.

In response to arguments that if an investor employs an investment professional, that professional should wholly bear the responsibility for the investment decision it makes, the Interpretation clarifies that while the institution would still be covered by the suitability rule, the factors analysis of the Interpretation would apply to any delegated agents of customers, including any professional advisers that an investor may employ.

The Interpretation does not impose additional duties on members that are not already imposed by NASD suitability rules, general anti-fraud provisions of the federal securities laws, or Rule 2129 "Use of Fraudulent Devices." The Interpretation does not impose a books and records requirement nor does it create an evidentiary checklist for NASD compliance review. These considerations are provided merely for guidance purposes and do not impose any additional duties or reduce any existing obligations. Moreover, the Interpretation does not make the broker/dealer a guarantor of the investment.

Implementation

Rules 2340, 3010, 3020, and 3110 will **not** be effective until November 20, 1996. All other amendments were effective as of August 20, 1996.

Text Of Amendments

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

BY-LAWS

ARTICLE I

DEFINITIONS

(a) through (r) No change.

(s) "rules of the Corporation" means all rules of the Corporation including the Certificate of Incorporation, By-Laws, Rules of Fair Practice, [Government Securities Rules,] Code of Procedure, Uniform Practice Code, any other rules, and any interpretations thereunder.

[5] The $10 million portfolio designation does not create a presumption that institutions that exceed the $10 million portfolio amount satisfy the Interpretation's factors and thus are not covered by the protections of the suitability rule. Rather, the Interpretation indicates that the analysis of the suitability obligation to be conducted using the factors set forth in the interpretation is more appropriate for these larger institutions than for institutions with a smaller portfolio.

RULES OF THE ASSOCIATION

0114. Effect on Transactions in [Exempted] Municipal Securities

The Rules shall not be construed to apply to contracts made prior to the effective date of the Rules or to transactions in [exempted] municipal securities (as defined in Section 3(a)([12]29) of the Act).

0115. Applicability

(a) These Rules shall apply to all members and persons associated with a member[, other than those members registered with the Commission solely under the provisions of Section 15C of the Act and persons associated with such members]. Persons associated with a member shall have the same duties and obligations as a member under these Rules.

(b) through (c) No change.

1022. Categories of Principal Registration

(a) No change.

(b) Limited Principal—Financial and Operations

(1) through (3) No change.

(4) A member, or an applicant for membership in the Association, may upon written request, be exempted by the President of the Association, or his delegate, from the requirement to have a Limited Principal—Financial and Operations if:

(A) it has been expressly exempted by the Commission from SEC Rule 15c3-1(b)([3]1)(iii);

(B) it is subject to the provisions of SEC Rule 15c3-1(a)(2) [or (3)] or to Section 402.2(c) of the rules of the Treasury Department.

(5) No change.

(c) through (g) No change.

1060. Persons Exempt from Registration

(a) The following persons associated with a member are not required to be registered with the Association:

(1) through (3) No change.

(4) persons associated with a member whose functions are related solely and exclusively to:

(A) effecting transactions on the floor of a national securities exchange and who are registered as floor members with such exchange;

(B) transactions in [exempted] municipal securities[, except as provided in Rule 1110 hereof,]; or

(C) transactions in commodities.

(b) No change.

IM-2110-1. "Free-Riding and Withholding"

(a) Introduction

(1) through (3) No change.

(4) This interpretation will not apply to government securities as defined in Section 3(a)(42) of the Act.

(b) through (m) No change.

2210. Communications with the Public

(a) through (b) No change.

(c) Filing Requirements and Review Procedures

(1) - (2) No change.

(3)(A) No change.

(B) Except for advertisements related to exempted securities (as defined in Section 3(a)(12) of the Act), municipal securities, direct participation programs or investment company securities, members subject to the requirements of paragraph (c)(3)(A) or (B) of this Rule 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 Rule.

(4) No change.

(5) In addition to the foregoing requirements, every member's advertising and sales literature shall be subject to a routine spot-check procedure. Upon written request from the Department, each member shall promptly submit the material requested. Members will not be required to submit material under this procedure which has been previously submitted pursuant to one of the foregoing requirements and, except for material related to exempted securities (as defined in Section 3(a)(12) of the Act), municipal securities, direct participation programs or investment company securities, the procedure will not be applied to members who have been, within the Association's current examination cycle subjected to a spot-check by a registered securities exchange or other self-regulatory organization using procedures comparable to those used by the Association.

(6) No change.

(7) Material which refers to investment company securities or direct participation programs, or exempted securities (as defined in Section 3(a)(12) of the Act) solely as part of a listing of products and/or services offered by the member, is excluded from the requirements of subparagraphs (1) and (2).

(d) through (f) No change.

2310. Recommendations to Customers (Suitability)

(a) through (b) No change.

(c) For purposes of this Rule, the term "non-institutional customer" shall mean a customer that does not qualify as an "institutional account" under Rule 3110(c)(4).

IM-2310-3. Suitability Obligations to Institutional Customers

Preliminary Statement as to Members' Obligations

As a result of broadened authority provided by amendments to the Government Securities Act adopted in 1993, the Association is extending its sales practice rules to the government securities market, a market with a particularly broad institutional component. Accordingly, the Association believes it is appropriate to provide further guidance to members on their suitability obligations when making recommendations to institutional customers. The Association believes this interpretation is applicable not only to government securities but to all debt securities, excluding municipals.[*] Furthermore, because of the nature and characteristics of the institutional customer/member relationship, the Association is extending this interpretation to apply equally to the equity securities markets as well.

The Association's suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct. Members' responsibilities include having a reasonable basis for recommending a particular security or strategy, as well as having reasonable grounds for believing the recommendation is suitable for the customer to whom it is made. Members are expected to meet the same high standards of competence, professionalism, and good faith regardless of the financial circumstances of the customer.

Rule 2310(a) requires that,

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

This interpretation concerns only the manner in which a member determines that a recommendation is suitable for a particular institutional customer. The manner in which a member fulfills this suitability obligation will vary depending on the nature of the customer and the specific transaction. Accordingly, this interpretation deals only with guidance regarding how a member may fulfill such "customer-specific suitability obligations" under Rule 2310(a).[**]

While it is difficult to define in advance the scope of a member's suitability obligation with respect to a specific institutional customer transaction recommended by a member, the Board has identified certain factors which may be relevant when considering compliance with Rule 2310(a). These factors are not intended to be requirements or the only factors to be considered but are offered merely as guidance in determining the scope of a member's suitability obligations.

Considerations Regarding the Scope of Members' Obligations to Institutional Customers

The two most important considerations in determining the scope of a member's suitability obligations in making recommendations to an institutional customer are the customer's capability to evaluate investment risk independently and the extent to which the customer is exercising independent judgment in evaluating a member's recommendation. A member must determine, based on the information available to it, the customer's capability to evaluate investment risk. In some cases, the member may conclude that the customer is not capable of making independent investment decisions in general. In other cases, the institutional customer may have general capability, but may not be able to understand a particular type of instrument or its risk. This is more likely to arise with relatively new types of instruments, or those with significantly different risk or volatility characteristics than other investments generally made by the institution. If a customer is either generally not capable of evaluating investment risk or lacks sufficient capability to evaluate the particular product, the scope of a member's customer-specific obligations under the suitability rule would not be diminished by the fact that the member was dealing with an institutional customer. On the other hand, the fact that a customer initially needed help understanding a potential investment need not necessarily imply that the customer did not ultimately develop an understanding and make an independent investment decision.

A member may conclude that a customer is exercising independent

[*] Rules for municipal securities are promulgated by the Municipal Securities Rulemaking Board.

[**] This interpretation does not address the obligation related to suitability that requires that a member have "... a 'reasonable basis' to believe that the recommendation could be suitable for at least some customers." In the Matter of the Application of F.J. Kaufman and Company of Virginia and Frederick J. Kaufman, Jr., 50 SEC 164 (1989).

judgment if the customer's investment decision will be based on its own independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations. Where the broker-dealer has reasonable grounds for concluding that the institutional customer is making independent investment decisions and is capable of independently evaluating investment risk, then a member's obligation to determine that a recommendation is suitable for a particular customer is fulfilled.[***] Where a customer has delegated decision-making authority to an agent, such as an investment adviser or a bank trust department, this interpretation shall be applied to the agent.

A determination of capability to evaluate investment risk independently will depend on an examination of the customer's capability to make its own investment decisions, including the resources available to the customer to make informed decisions. Relevant considerations could include:

- the use of one or more consultants, investment advisers or bank trust departments;

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

- the customer's ability to understand the economic features of the security involved;

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

- the complexity of the security or securities involved.

A determination that a customer is making independent investment decisions will depend on the nature of the relationship that exists between the member and the customer. Relevant considerations could include:

- any written or oral understanding that exists between the member and the customer regarding the nature of the relationship between the member and the customer and the services to be rendered by the member;

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

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

- the extent to which the member has received from the customer current comprehensive portfolio information in connection with discussing recommended transactions or has not been provided important information regarding its portfolio or investment objectives.

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

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

IM-2420-1. Transactions Between Members and Non-Members

(a) No change.

(b) Transactions in "Exempted Securities"

[Rule 0114 provides that the Rules shall not apply to transactions, whether between members or between members and non-members, in] Rule 2420 shall not apply to "exempted securities," which are defined by Section 3(a)(12) of the Act. The Rule[s] therefore does not apply to transactions in government or municipal securities if within the definition of "exempted securities." Members may join with non-members or with banks in a joint account, syndicate or group to purchase and distribute an issue of "exempted securities" and may trade such securities with non-members or with banks at different prices or on different terms and conditions than are accorded to members of the general public.

(c) through (d) No change.

3110. Books and Records

(a) No change.

[***] *See* note 2.

(b) Marking of Customer Order Tickets

(1) A person associated with a member shall indicate on the memorandum for the sale of any security whether the order is "long" or "short," except that this requirement shall not apply to transactions in [corporate] debt securities. An order may be marked "long" if (A) the customer's account is long the security involved or (B) the customer owns the security and agrees to deliver the security as soon as possible without undue inconvenience or expense.

(2) A person associated with a member shall indicate on the memorandum for each transaction in a non-Nasdaq security, as that term is defined in the Rule 6700 Series, the name of each dealer contacted and the quotations received to determine the best inter-dealer market.

(c) Customer Account Information

Each member shall maintain accounts opened after January 1, 1991 as follows:

(1) through (2) No change.

(3) for discretionary accounts, in addition to compliance with subparagraphs (1) and (2) above, and Rule 2510(b) of these Rules, the member shall:

(A) obtain the signature of each person authorized to exercise discretion in the account; [and]

(B) record the date such discretion is granted[.]; and

(C) in connection with exempted securities other than municipals, record the age or approximate age of the customer.

(d) through (g) No change.

(4) No change.

3130. Regulation of Activities of Members Experiencing Financial and/or Operational Difficulties

(a) Application—For the purposes of this Rule, the term "member" shall be limited to any member of the Association who is not designated to another self-regulatory organization by the Commission for financial responsibility pursuant to Section 17 of the Act and SEC Rule 17d-1 thereunder. Further, the term shall not be applicable to any member who is subject to paragraphs (a)(2)(iv), (a)(2)(v) or (a)(2)(vi) [and (a)(3)] of SEC Rule 15c3-1, or is otherwise exempt from the provisions of said rule.

(b) through (c) No change.

IM-3130. Restrictions on a Member's Activity

(a) This explanation outlines and discusses some of the financial and operational deficiencies which could initiate action under Rules 3130 and 3131. Paragraphs (b)(2) and (c)(2) of [the Rule] Rules 3130 and 3131 recognize that there are various unstated financial and operational reasons for which the Association may impose restrictions on a member so as to prohibit its expansion or to require a reduction in overall level of business. These provisions are deemed necessary in order to provide for the variety of situations and practices which do arise and which, if allowed to persist, could result in increased exposure to customers and to broker/dealers.

(b) through (c) No change.

(d) For purposes of paragraphs (b)(2) and (c)(2) of Rule 3131, a member may be considered to be in or approaching financial or operational difficulty in conducting its operations and therefore subject to restrictions if it is determined by the Association that any of the parameters specified therein are exceeded or one or more of the following conditions exist:

(1) The member has experienced significant reduction in excess liquid capital in the preceding month or in the three-month period immediately preceding such computation.

(2) The member has experienced a substantial change in the manner in which it processes it business which, in the view of the Association, increases the potential risk of loss to customers and members.

(3) The member's books and records are not maintained in accordance with the provisions of Section 404.2 of the Treasury Department rules.

(4) The member is not in compliance, or is unable to demonstrate compliance, with applicable capital requirements of Section 402 of the Treasury Department rules.

(5) The member is not in compliance, or is unable to demonstrate compliance, with Section 403.4 of the Treasury Department rules (Customer Protection—Reserve and Custody of Securities).

(6) The member is unable to clear and settle transactions promptly.

(7) The member's overall business operations are in such a condition, given the nature and kind of its business that, notwithstanding the absence of any of the conditions enumerated in subparagraphs (1) through (6), a determination of financial or operational difficulty should be made.

(8) The member is registered as a Futures Commission Merchant and its net capital is less than required by Section 402.1(d) of the Treasury Department rules.

[(d)](e) If the Association determines that any of the conditions specified in paragraphs (c) or (d) of this explanation exist, it may require that the member take appropriate action by effecting one or more of the following actions until such time as the Association determines they are no longer required:

(1) through (13) No change.

3131. Regulation of Activities of Section 15C Members Experiencing Financial and/or Operational Difficulties

(a) Application—For the purposes of this Rule, the term "member" shall be limited to any member of the Association registered with the Commission pursuant to Section 15C of the Act that is not designated to another self-regulatory organization by the Commission for financial responsibility pursuant to Section 17 of the Act and Rule 17d-1 thereunder. Further, the term shall not be applicable to any member that is subject to Section 402.2(c) of the rules of the Treasury Department, or is otherwise exempt from the provisions of said rule.

(b) A member, when so directed by the Association, shall not expand its business during any period in which:

(1) Any of the following conditions continue to exist, or have existed, for more than fifteen (15) consecutive business days:

(A) A firm's liquid capital is less than 150 percent of the total haircuts or such greater percentage thereof as may from time to time be prescribed by the Association.

(B) A firm's liquid capital minus total haircuts is less than 150 percent of its minimum dollar capital requirement.

(C) The deduction of ownership equity and maturities of subordinated debt scheduled during the next six months would result in any one of the conditions described in (A) or (B) of this subparagraph (1).

(2) The Association restricts the member for any other financial or operational reason.

(c) A member, when so directed by the Association, shall forthwith reduce its business:

(1) To a point enabling its available capital to comply with the standards set forth in subparagraphs (b)(1)(A), (B), or (C) of this Rule if any of the following conditions continue to exist, or have existed, for more than fifteen (15) consecutive business days:

(A) A firm's liquid capital is less than 125 percent of total haircuts or such greater percentage thereof as may from time to time be prescribed by the Association.

(B) A firm's liquid capital minus total haircuts is less than 125 percent of its minimum dollar capital requirement.

(C) The deduction of ownership equity and maturities of subordinated debt scheduled during the next six months would result in any one of the conditions described in (A) or (B) of this subparagraph (1).

(2) As required by the Association when it restricts a member for any other financial or operational reason.

3140. Approval of Change in Exempt Status Under SEC Rule 15c3-3

(a) Application—For the purposes of this Rule, the term "member" shall be limited to any member of the Association who is subject to SEC Rule 15c3-3 and is not designated to another self-regulatory organization by the Commission for financial responsibility pursuant to Section 17 of the Act and SEC Rule 17d-1 promulgated thereunder. Further, the term shall not be applicable to any member that is subject to Section 402.2(c) of the rules of the Treasury Department.

(b) A member operating pursuant to any exemptive provision as contained in subparagraph (k) of SEC Rule 15c3-3 under the Act (Rule 15c3-3), shall not change its method of doing business in a manner which will change its exemptive status from that governed by subparagraph (k)(1) or (k)(2)([b]ii) to that governed by subparagraph (k)(2)([a]i); or from subparagraph (k)(1), (k)(2)([a]i) or (k)(2)([b]ii) to a fully computing firm that is subject to all provisions of Rule 15c3-3; or commence operations that will disqualify it for continued exemption under Rule 15c3-3 without first having obtained the prior written approval of the Association.

(c) No change.

3370. Prompt Receipt and Delivery of Securities

(a) No change.

(b) Sales

(1) Long Sales

No member or persons associated with a member shall accept a long sale order from any customer in any security (except exempt securities other than municipals) unless:

(A) through (D) No change.

(2) through (5) No change.

8120. Complaints by Public Against Members for Violations of Rules

Any person feeling aggrieved by any act, practice or omission of any member or any person associated with a member of the Association, which such person believes to be in violation of the Act, the rules and regulations thereunder, the rules of the Municipal Securities Rulemaking Board, or any of the Rules of the Association, may, on the form to be supplied by the Board of Governors, file a complaint against such member or such persons associated with a member in regard thereto with any District Business Conduct Committee of the Association, and any such complaint shall be handled in accordance with the Code of Procedure, as set forth in the Rule 9000 Series.

8130. Complaints by District Business Conduct Committees

Any District Business Conduct Committee which, on information and belief, is of the opinion that any act, practice, or omission of any member of the Association or any person associated with a member is in violation of the Act, the rules and regulations thereunder, the rules of the Municipal Securities Rulemaking Board, or any of the Rules of the Association, may, on the form to be supplied by the Board of Governors, file a complaint against such member or such person associated with a member in regard thereto with itself or with any other District Business Conduct Committee of the Association, as the necessities of the complaint may require, and any such complaint shall be handled in accordance with the Rule 9000 Series and in the same manner as if it had been filed by an individual or member.

8140. Complaints by the Board of Governors

The Board of Governors shall have authority when on the basis of information and belief it is of the opinion that any act, practice or omission of any member of the Association or of any person associated with a member is in violation of the Act, the rules and regulations thereunder, the rules of the Municipal Securities Rulemaking Board, or any Rule of the Association to file a complaint against such member or such person associated with a member in respect thereto or to instruct any District Business Conduct Committee to do so, and any such complaint shall be handled in accordance with the Rule 9000 Series.

8310. Sanctions for Violation of the Rules

Any District Business Conduct Committee, Market Surveillance Committee, the National Business Conduct Committee (NBCC), any other committee exercising powers assigned by the Board, or the Board, in the administration and enforcement of these Rules, the Act, the rules and regulations thereunder, or the rules of the Municipal Securities Rulemaking Board, and after compliance with the Rule 9000 Series, may:

(a) through (f) No change.

[GOVERNMENT SECURITIES RULES]

[Deleted in their entirety.]

NASD Notice to Members 96-67

Bank Secrecy Act Recordkeeping Rule For Funds Transfers And Transmittals Of Funds

Suggested Routing

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

Executive Summary

The Department of the Treasury's (Treasury) amendments to the Bank Secrecy Act (BSA), which facilitate tracing funds through the funds-transmittal process, became effective May 28, 1996. For transmittals of funds of $3,000 or more, broker/dealers are required to obtain and keep certain specified information concerning the transmitter and the recipient of those funds. In addition, broker/dealers must include this information on the actual transmittal order.

Questions regarding this Notice may be directed to Samuel Luque, Jr., Associate Director, Compliance, NASD Regulation, at (202) 728-8472 or Susan DeMando, District Coordinator, Compliance, NASD Regulation, at (202) 728-8411.

Background

The BSA authorizes Treasury to require financial institutions, including broker/dealers, to keep records and file reports about the source, volume, and movement of funds into and out of the country and through domestic financial institutions. In 1992, the Annunzio-Wylie Anti-Money Laundering Act (1992 Amendment) amended the BSA to give Treasury and the Board of Governors of the Federal Reserve System (Fed.) joint authority to prescribe regulations for maintaining records of domestic and international transmittals of funds.

In April 1993, Treasury and the Fed. published a joint proposal with amendments to the BSA for funds transfers, which was adopted in final form in early 1995 (Joint Rule). The Joint Rule requires additional recordkeeping related to certain funds transmittals and transfers by broker/dealers and other financial institutions. At the same time, Treasury adopted a companion rule (Travel Rule) that requires financial institutions to include on transmittal orders certain information that must be retained under the new recordkeeping requirements. Members may refer to *Notice to Members 95-69*, *Notice to Members 95-88*, and "For Your Information" in the April 1996 *Notices to Members* for additional information on these amendments.

Questions And Answers

Listed below are frequently asked questions about the new recordkeeping rules for transmittals of funds and funds transfers under the BSA. They are not meant to be comprehensive and do not replace or supersede the terms of the Rules. These questions and answers were originally issued by Treasury's Financial Crimes Enforcement Network (FinCEN) and the Fed., with terminology associated with funds transfers through banks. The questions and answers have been modified for broker/dealer use with the cooperation of FinCEN.

31 CFR Part 103-Joint Rule

Section 103.11—Meaning of Terms

Q1: Recipient, Recipient's Financial Institution. Who are the recipient's financial institution and the recipient with respect to a transmittal of funds in which payment is made to a customer of a foreign broker/dealer?

A1: The foreign broker/dealer receiving a payment transmittal order for payment to its customer is the recipient's financial institution. The foreign broker/dealer's customer is the recipient.

Q2: Financial Institution. What types of "financial institutions" are covered by the Rule?

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A2: The Rule applies to all financial institutions subject to the BSA regulations. Financial institutions, as defined in §103.11(n), include banks and nonbank financial institutions (NBFIs), which include securities broker/dealers required to be registered with the Securities and Exchange Commission (SEC). The definition of financial institution is limited to those institutions located within the United States.

Q3: Transmittal of Funds. Does the Rule apply only to "wire transfers"?

A3: No. The Rule applies to transmittals of funds and funds transfers, which covers a broad range of methods for moving funds. The Rule includes certain internal transfers, e.g., when a broker/dealer transmits funds (typically via journal entry) from a transmitter's account to a recipient's account at the same broker/dealer (if the transmitter and recipient are different parties), as well as transmittal orders or instructions made in person or by telephone, facsimile, or electronic messages sent or delivered by a customer. The definition includes all transmittals of funds that are made within the United States, regardless of whether the transmittal originates or terminates abroad. The term *transmittal of funds* includes funds transfers, which can only be made by banks.

Q4: Transmitter. If a corporation has one or several individuals who are authorized by the corporation to order transmittals of funds through the corporation's account, who is the transmitter in such a transmittal?

A4: The corporation, not the individual(s) authorized to issue the order on behalf of the corporation, is the transmitter. Accordingly, the information must be retrievable by name of the corporation, not by the name of the individual ordering the transmittal of funds.

Q5: Transmitter, Transmitter's Financial Institution. Who are the transmitter and the transmitter's broker/dealer with respect to a transmittal of funds initiated by a customer of a foreign broker/dealer?

A5: The customer of the foreign broker/dealer (i.e., the sender of the first transmittal order) is the transmitter. The foreign broker/dealer accepting the transmittal order from that customer is the transmitter's financial institution.

Q6: Transmitter, Transmitter's Financial Institution. Who is the transmitter in a transaction where a trustee initiates a transmittal of funds from an account at a broker/dealer held by the trust?

A6: The trustee is merely the person authorized to act on behalf of the trust, which is a separate legal entity. The trust itself, is the transmitter of the transmittal of funds and the broker/dealer holding the account is the transmitter's financial institution.

Q7: Transmitter's Financial Institution. If a customer initiates a transmittal of funds through broker/dealer 1, which uses broker/dealer 2 as its correspondent, which broker/dealer is considered the transmitter's financial institution?

A7: The customer is the transmitter; broker/dealer 1 is the transmitter's financial institution; broker/dealer 2 is an intermediary financial institution.

Section 103.33—Records to be made and retained by financial institutions

Section 103.33(f)(1)—Recordkeeping Requirements

Q8: What is the effective date of the recordkeeping rule?

A8: May 28, 1996.

Q9: Are all transmittals of funds subject to the recordkeeping rule, regardless of the size of the transactions?

A9: No. Only transmittals equal to or greater than $3,000 are subject to the Rule.

Q10: How long must the information collected under the Rule be kept?

A10: Pursuant to §103.38(d), all information required to be collected under the Rule must be retained for at least five years.

Q11: Does the Rule require any reporting to the government of any information?

A11: No. Broker/dealers should contact appropriate regulators or law enforcement agencies if they suspect that certain transmittals are illicit or when otherwise required.

Q12: May a broker/dealer use a code or pseudonym for its customer?

A12: Broker/dealers might, for a number of reasons, use various classification schemes in con-

nection with their transmittal of funds records. A broker/dealer must be able to retrieve the records, however, based on its customer's true name, rather than the code name or pseudonym. Note that the use of codes or pseudonyms is allowed only for recordkeeping purposes. Under the Travel Rule only the true name may be used.

Q13: Is retaining the city and state (or country) considered a sufficient address?

A13: Broker/dealers should obtain a complete address including street information when possible.

Q14: If a customer arranges to have his or her mail held for pick up at a broker/dealer location, may the broker/dealer's address be used as the address of the customer?

A14: No. The broker/dealer should retain a record of the customer's address, rather than the address of the broker/dealer location at which the customer's mail is held for pickup.

Q15: Are there any differences in recordkeeping requirements for broker/dealers compared to banks?

A15: There is one incremental recordkeeping requirement on broker/dealers. Broker/dealers, but not banks, must keep the original or a copy of any form relating to the transmittal of funds that is completed or signed by the person placing the transmittal order. *See* §103.33(f)(1)(i)(G). The transmitter's financial institution (e.g., broker/dealer) may either keep the original or a microfilm, other copy, or electronic record of the information contained on the form.

Section 103.33(f)(2) - Transmitters other than established customers.

Q16: Is a broker/dealer obligated to accept a transmittal order from someone that is not an established customer?

A16: No. This Rule merely sets forth the requirements for transmittal orders accepted by a financial institution.

Section 103.33(f)(3) - Recipients other than established customers.

Q17: If a recipient's broker/dealer attempts to obtain identification from a recipient who is not an established customer, and the person is unable or unwilling to provide the identification, should the broker/dealer refuse the transaction?

A17: If the recipient's broker/dealer is instructed to make payment to the recipient in person and the person claiming to be the recipient fails to provide identification required by the Rule, the recipient's broker/dealer's responsibility to make that payment may be affected. If the recipient's broker/dealer does not believe, however, that the lack of cooperation of the person claiming to be the recipient provides an adequate basis for withholding payment, the broker/dealer should note in the record lack of identification required by the Rule.

The Rule does not require identification when proceeds are not delivered in person to the recipient. The recipient's broker/dealer should retain a copy of the check or other instrument used to effect payment, or the information contained thereon, as well as the name and address of the person to which it was sent.

Section 103.33(f)(4) - Retrievability Requirements.

Q18: How quickly must records be retrieved?

A18: The retrievability standard is set forth in §103.38(d). Under this standard, the expected timeliness of retrievability will vary based on the circumstances. Generally, records should be accessible within a reasonable period of time, considering the quantity of records requested, the nature and age of the record, the amount and type of information provided by the law enforcement agency making the request, as well as the particular broker/dealer's volume and capacity to retrieve the records. As a practical matter, the expected timeliness for retrievability will depend on the terms of the request.

Q19: How must records be retrievable?

A19: Information retained by a transmitter's broker/dealer must be retrievable by the transmitter's name and, if the transmitter maintains an account that has been used for transmittal of funds, by the transmitter's account number. A recipient's financial institution must retain and retrieve information by the recipient's name and, if the recipient is an established customer with an account, by account number.

The information need not be retained in any particular manner, as long as the broker/dealer retains the required records in such a way that it is able to meet the retrieval requirements of the Rule. A broker/dealer may take intermediary steps as necessary to retrieve a requested record. For example, if a broker/dealer were directed to retrieve a transmittal based on the name of its customer, the broker/dealer may first look up the account number for that customer, and then review the customer account statements for the specific transmittal. Using the transaction number identifying the specific transmittal that is included on the customer statement, the broker/dealer may then retrieve that transfer from its transmittal records. In addition, if the broker/dealer accepts transmittals from non-customers, the broker/dealer also must retrieve records of any non-customer transfers based on the name provided.

Q20: When there are two or more names on an account, must broker/dealers be able to retrieve records by all names on the account or just the primary account holder(s)?

A20: Whenever a broker/dealer is obligated to provide records under this Rule and the request contains the specific name of an individual, the broker/dealer must be able to retrieve records by that name, regardless of whether the person is a primary account holder.

Q21: Must records retained under the Rule be maintained on-site?

A21: No. There is no requirement for records to be maintained on-site.

Q22: Must a broker/dealer automate its transmittal records and retrieval systems in order to comply with the regulation?

A22: No. Although an automated recordkeeping and retrieval system is not required by the Rule, a broker/dealer may wish to consider implementing an automated system, depending on the demand for transmittal records and its current means of keeping the records. Based on the volume of law enforcement requests, a broker/dealer should weigh the costs of implementing an automated system versus the costs of searching manual records. The Rule does not require that information be maintained in any particular order. For example, a broker/dealer may retain information about its customers in its customer file and information about transmittals of funds in a separate file and may cross reference and retrieve the information.

Section 103.33(f)(6) Exceptions.

Q23: What types of transmittals are excepted from the Rule?

A23: The following transmittals are excepted from the Rule:

i) transmittals of less than $3,000;

ii) debit transfers;

iii) transmittals governed by the Electronic Fund Transfer Act, as well as any other transmittals of funds made through ATM, ACH, and POS systems;

iv) transmittals where both the transmitter and the recipient are any of the following:

(A) A domestic bank;

(B) A wholly owned domestic subsidiary of a domestic bank;

(C) A domestic broker or dealer in securities;

(D) A wholly owned domestic subsidiary of a domestic broker or dealer in securities;

(E) The United States;

(F) A state or local government; or

(G) A federal, state, or local government agency or instrumentality;

v) transmittals where the transmitter and the recipient are the same person and the transmitter's financial institution and the recipient's financial institution are the same domestic financial institution.

Q24: Does the Rule apply to transfers from a person's individual brokerage account to the person's joint brokerage account at the same domestic broker/dealer?

A24: Generally no, because the transmitter and recipient are the same person, and the transmitter's and recipient's broker/dealer are the same domestic broker/dealer. Therefore these transfers are excepted from the Rule. (**Note:** there is a rare exception to this. In certain

cases, due to laws in various states and estate planning considerations, it is possible to have an account registered in joint name but the holders are not jointly entitled to the assets, or the ultimate beneficiary is a third party. If the broker/dealer is aware that a transfer is intended to achieve this result, the transfer **would** be subject to the Rule.)

Q25: Does the Rule apply to intra-broker/dealer transfers where the transmitter and the recipient are different persons?

A25: Yes. Intra-broker/dealer transfers are excepted from the Rule only if the transmitter and recipient are the same person. In addition, an intra-broker/dealer transfer is excepted from the Rule if both are excepted entities as described in A23(iv) above.

Q26: Does the Rule apply to transfers where the transmitter and the recipient are the same person and the transmitter's financial institution and recipient's financial institution are separate financial institutions (e.g., a broker/dealer and a registered investment adviser) owned by the same holding company?

A26: Yes. The Rule applies to these transfers, because although the financial institutions are affiliated, they are separate legal entities. Transfers between U.S. branches of the same domestic financial institution, even across state lines, are excepted, however, if the transmitter and the recipient are the same person.

Q27: Please clarify the application of the exceptions for transmittals of funds contained in §103.33(f)(6).

A27: If both counterparties (transmitter and recipient) to a transmittal of funds are any of the listed excepted entities in A23(iv), the transaction is excepted provided the funds belong to the entity and are not customer funds.

NASD NOTICE TO MEMBERS 96-68

NASD Solicits Member Comment On Proposed Rules Relating To Prospectus Disclosure Of Cash And Non-Cash Compensation For The Sale Of Investment Company Securities

Suggested Routing

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

Executive Summary

The NASD requests member comment on proposed amendments to Rule 2830 (formerly Article III, Section 26 of the NASD® Rules of Fair Practice) of the NASD's Conduct Rules (Investment Company Rule) that would: (1) expand the current definitions of cash compensation and non-cash compensation, (2) revise the current prospectus disclosure provisions to prohibit a member from participating in the sale of investment company securities or providing services to an offeror of such securities unless the cash or non-cash compensation that is or may be received by the member or its associated persons is described in a current prospectus of the investment company, and (3) provide specific guidance regarding what must be disclosed and where in the prospectus the disclosure must be located.

Questions concerning this Notice should be directed to R. Clark Hooper, Senior Vice President, Office of Disclosure and Investor Protection, NASD Regulation, at (202) 728-8325; or Robert J. Smith, Senior Attorney, Office of General Counsel, NASD Regulation, at (202) 728-8176.

Background

The proposed amendments are an outgrowth of an NASD proposed rule change to regulate the receipt of cash and non-cash compensation (Non-Cash Proposal) for the sale of investment company securities and variable products currently under review by the Securities and Exchange Commission (SEC).[1] Many comment letters received from members in response to the publication of the Non-Cash Proposal in *Special Notice to Members 94-67* raised issues concerning the scope of prospectus disclosure for *cash compensation* and *special cash compensation arrangements*. Some commenters were concerned in particular about whether and to what extent disclosure was required of various cash compensation practices (sometimes referred to as *revenue sharing*) that are common in the investment company industry and involve payments by offerors to member firms in exchange for, e.g., placement of an offeror's funds onto the member's "preferred" list, sales of no-load funds or large volume sales of front-end load funds sold at net asset value, or subaccounting or administrative services provided by a member to an offeror.

In developing the proposed amendments, NASD Regulation, Inc. (NASD Regulation) received comment from both its Investment Companies Committee and Insurance Affiliated Committee (IAC) and from other sources regarding revenue sharing and cash compensation industry practices.[2] The proposed amendments are drafted as if the Non-Cash Proposal currently were approved.

Description

Definitions

The definition of *cash compensation*, which, as proposed in the Non-Cash Proposal, includes any discount, concession, fee, service fee, commission, asset-based sales charge, loan or override, is proposed to be broadened to include a "finder's fee, administra-

[1] Securities Exchange Act Release No. 37374 (June 26, 1996); 61 FR 35822 (July 8, 1996).

[2] The IAC has recently proposed similar rules for prospectus disclosure of cash and non–cash compensation received in connection with the sale and distribution of variable life insurance and annuity contracts, which were approved by the NASD Regulation Board of Directors in July 1996, and published for member comment in *Notice to Members 96–52*.

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tive fee, marketing support fee, contribution to non-cash or cash incentive arrangements, and any other payment or expense reimbursement" received "by a member" in connection with the sale and distribution of investment company securities "or for providing services to the offeror." These proposed changes reflect a recognition of the wide array of cash payments received by member firms from investment company offerors, in addition to the sales loads or other charges described in the prospectus. Such payments generally are not paid directly by investment company investors or from investment company assets and may not be required to be disclosed in investment company prospectuses under the federal securities laws.

The definition of *non-cash compensation* is proposed to be amended by deleting the phrase "and payment of" from the clause "and payment of travel expenses, meals and lodging" of the definition. The phrase is unnecessary and inconsistent with the general prohibition on the receipt of, rather than payment of, compensation.

Prospectus Disclosure Of Cash And Non-Cash Compensation

The Non-Cash Proposal prohibits a member from accepting any cash compensation from an offeror unless such compensation is described in a current prospectus, and prohibits a member from entering into "special cash compensation arrangements" that are not made available on the same terms to all members who distribute the investment company securities of the offeror unless the name of the member and the details of the special cash compensation arrangements are disclosed in the prospectus. Current Rule 2830 and the Non-Cash Proposal do not contain a definition of *special cash compensation* and members have interpreted the term differently. In some instances, offerors have taken the position that cash compensation arrangements with individual dealers do not constitute "special" cash compensation arrangements and therefore do not have to be disclosed in the prospectus with the required specificity. These offerors specifically assert that such arrangements are "generally available" to all dealers upon request and, therefore, are not "special" arrangements. This interpretive ambiguity has resulted in a wide array of disclosure practices by offerors regarding special cash compensation, ranging from specific to very general disclosure or, in some cases, no disclosure.

The proposed amendments would replace the cash compensation disclosure provisions in the Non-Cash Proposal to provide that "no member shall participate in the sale of investment company securities or provide services to an offeror unless the compensation, cash or non-cash, that is or may be received by the member or its associated persons, is described in a current prospectus of the investment company." The proposed amendments also provide specific guidance regarding what shall be disclosed and where in the prospectus the disclosure must be located.

The disclosure provision applies to both cash and non-cash compensation. As detailed above, cash compensation is defined broadly to include discounts, concessions, fees, service fees, commissions, asset-based sales charges, loans or overrides, finder's fees, administrative fees, marketing support fees, contributions to non-cash or cash incentive arrangements, and any other payment or expense reimbursement received in connection with the sale and distribution of investment company securities or for providing services to the offeror of such securities. Non-cash compensation is defined as any form of compensation, other than cash compensation, that is received in connection with the sale and distribution of investment company securities and includes, but is not limited to, merchandise, gifts and prizes, travel expenses, meals and lodging.

The specific prospectus disclosure provisions require that the following statement be placed, either as a footnote to, or in the narrative following the expense/fee table in the prospectus with respect to cash or non-cash compensation: "In addition to the compensation itemized above, certain broker/dealers and/or their salespersons may receive certain compensation for the sale and distribution of the securities or for services to the fund." The proposal would require a description of such payments, which may be placed either in the narrative after the expense/fee in the prospectus or in the section describing the underwriters in the Statement of Additional Information (SAI) and must include: (1) a brief description of all categories of cash and non-cash compensation arrangements, (2) identification of the party(ies) making the payment(s), and (3) where possible, the basis on which each payment is calculated, such as a percentage of assets sold, a fixed dollar amount, or another appropriate basis. If the description of payments is contained in the SAI rather than the prospectus, the following statement must be placed, either as a footnote to, or in the narrative following the expense/fee table in the prospectus: "For additional information regarding such compensation, reference the description of the underwriters in the Statement of Additional Information."

The proposed rule change also preserves the current provisions in Rule 2830 of the Conduct Rules and the Non-Cash Proposal exempting from the prospectus disclosure requirements compensation arrangements between the principal underwriters of

the same security and those between the principal underwriter of a security and the sponsor of a unit investment trust that utilizes such security as an underlying investment.

The receipt of cash and non-cash compensation by members and associated persons for the sale and distribution of investment company securities has the potential to provide significant incentives to members and salespersons, and NASD Regulation is concerned that investors generally are not aware of such incentives. The proposed rules are designed to ensure that investors have access to information to make them aware of all sources of compensation and payments that a member or associated person receives or may receive for the sale of investment company securities. Although not deducted directly from the investor's purchases or investment company assets, such payments may provide point-of-sale or other incentives that could compromise proper customer suitability determinations or otherwise create a general perception that a member's interests might not, in some circumstances, be fully aligned with the interests of customers. However, the NASD has determined that a disclosure approach, rather than substantive regulation such as the imposition of maximum payment limits, is appropriate for cash and non-cash payments that are not paid by the investor or deducted from the assets of the investment company.

Request For Comment

The NASD encourages all members and other interested parties to comment on the proposed amendments to Rule 2830. Comments should be forwarded to: Joan Conley, Office of the Secretary, NASD, 1735 K Street, NW, Washington DC, 20006-1500.

Comments must be received **by December 2, 1996**.

Text Of Proposed Amendments

(**Note:** New text is underlined; deletions are bracketed; text from pending Non-Cash Proposal is treated as if adopted.)

Rule 2830. Investment Company Securities

(a) No change.

(b) Definitions

(1) The terms "affiliated member," "cash compensation," "non-cash compensation," and "offeror" as used in Subsection (l) of this section shall have the following meanings:

"Affiliated Member" shall mean a member which, directly or indirectly, controls, is controlled by, or is under common control with a non-member company.

"Cash compensation" shall mean any discount, concession, fee, service fee, commission, asset-based sales charge, loan or override<u>, finder's fee, administrative fee, marketing support fee, contribution to non-cash or cash incentive arrangements, and any other payment or expense reimbursement</u> received <u>by a member</u> in connection with the sale and distribution of investment company securities <u>or for providing services to the offeror</u>.

"Non-cash compensation" shall mean any form of compensation received in connection with the sale and distribution of investment company securities that is not cash compensation, including but not limited to merchandise, gifts and prizes, [and payment of] travel expenses, meals and lodging.

"Offeror" shall mean an investment company, an adviser to an investment company, a fund administrator, an underwriter and any affiliated person (as defined in Section 2(a)(3) of the Investment Company Act of 1940) of such entities.

(2) through (10) No change.

(c) through (k) No change.

(l) Member Compensation

In connection with the sale and distribution of investment company securities <u>or providing services to the offeror of such securities</u>:

(1) Except as described below, no associated person of a member shall accept any compensation, cash or non-cash, from anyone other than the member with which the person is associated. This requirement will not prohibit arrangements where a company pays compensation directly to associated persons of the member, provided that:

(A) the arrangement is agreed to by the member;

(B) the member relies on an appropriate rule, regulation, interpretive release, interpretive letter, or "no-action" letter issued by the Securities and Exchange Commission or its staff that applies to the specific fact situation of the arrangement;

(C) the receipt by associated persons of such compensation is treated as compensation received by the member for purposes of NASD rules; and

(D) the recordkeeping requirement in Subsection (l)(3) is satisfied.

(2) No member or person associated with a member shall accept any compensation from an offeror which is in the form of securities of any kind.

(3) Except for items described in Subsections (l)(5)(A) and (B), a member shall maintain records of all compensation, cash and non-cash, received by the member or its associated persons from offerors. The records shall include the names of the offerors, the names of the associ-

ated persons, and the amount of cash, and the value or nature of non-cash compensation received.

(4) [No member shall accept any cash compensation from an offeror unless such compensation is described in a current prospectus of the investment company. When special cash compensation arrangements are made available by an offeror to a member, which arrangements are not made available on the same terms to all members who distribute the investment company securities of the offeror, a member shall not enter into such arrangements unless the name of the member and the details of the arrangements are disclosed in the prospectus. Prospectus disclosure requirements shall not apply to cash compensation arrangements between:]

[(A) principal underwriters of the same security; and]

[(B) the principal underwriter of a security and the sponsor of a unit investment trust which utilizes such security as its underlying investment.] No member shall participate in the sale or distribution of investment company securities or provide services to an offeror unless the compensation, cash or non-cash, that is or may be received by the member or its associated persons, is described in a current prospectus of the investment company.

(A) The description in the prospectus shall:

(i) include, either as a footnote to, or in the narrative following, the expense/fee table in the prospectus the following statement: "In addition to the compensation itemized above, certain broker-dealers and/or their salespersons may receive certain compensation for the sale and distribution of the securities or for services to the fund"; and

(ii) include either in the narrative following the expense/fee table in the prospectus, or in the section describing the underwriters in the Statement of Additional Information, the following information:

(1) a brief description of all categories of additional compensation arrangements, e.g., finder's fees, administrative fees, marketing support fees, loan, override, and contributions to non-cash and cash incentive arrangements permitted under Subsections (l)(5)(C) and (D) and (l)(6);

(2) identification of the party making the payment(s) of additional compensation; and

(3) where possible, the basis on which each payment is calculated (e.g., as a percentage of investment company assets sold, a fixed dollar amount, or another appropriate basis), provided, however, that such statement need not disclose the specific amount of any payment made under a cash compensation arrangement in terms of either dollars or percentage of assets or sales; and

(iii) include, either as a footnote to, or in the narrative following, the expense/fee table in the prospectus, the following statement when the information contained in (A)(ii)(1), (2), and (3) is contained in the Statement of Additional Information: "For additional information regarding such compensation, reference the description of the underwriters in the Statement of Additional Information."

(B) This provision shall not apply to compensation arrangements:

(i) between the principal underwriters of the same security; and

(ii) between the principal underwriter of a security and the sponsor of a unit investment trust which utilizes such security as an underlying investment.

(5) No member or person associated with a member shall directly or indirectly accept any non-cash compensation offered or provided to such member or its associated persons, except as provided in this provision. Notwithstanding the provisions of subparagraph (1), the following items of non-cash compensation may be accepted:

(A) Gifts to associated persons of members that do not exceed an annual amount per person fixed periodically by the Board of Governors* and are not preconditioned on achievement of a sales target.

(B) An occasional meal, a ticket to a sporting event or the theater, or comparable entertainment for persons associated with a member and, if appropriate, their guests, which is neither so frequent nor so extensive as to raise any question of propriety and is not preconditioned on achievement of a sales target.

(C) Payment or reimbursement by offerors in connection with meetings held by an offeror or by a member for the purpose of training or education of associated persons of a member, provided that:

(i) the recordkeeping requirement in subparagraph (3) is satisfied;

(ii) associated persons obtain the member's prior approval to attend the meeting and attendance by a member's associated persons is not preconditioned by the member on the achievement of a sales target or any other non-cash compensation arrangement permitted by subparagraph (5)(D);

(iii) the location is appropriate to the

* The current annual amount fixed by the Board of Governors is $100.

purpose of the meeting, which shall mean an office of the offeror or the member, or a facility located in the vicinity of such office, or a regional location with respect to regional meetings;

(iv) the payment or reimbursement is not applied to the expenses of guests of the associated person; and

(v) the payment or reimbursement by the offeror is not preconditioned by the offeror on the achievement of a sales target or any other non-cash compensation arrangement permitted by subparagraph (5)(D).

(D) Non-cash compensation arrangements between a member and its associated persons or a non-member company and its sales personnel who are associated persons of an affiliated member, provided that:

(i) the member's or non-member's non-cash compensation arrangement, if it includes investment company securities, is based on the total production of associated persons with respect to all investment company securities distributed by the member;

(ii) the non-cash compensation arrangement requires that the credit received for each investment company security is equally weighted;

(iii) no unaffiliated non-member company or other unaffiliated member directly or indirectly participates in the member's or non-member's organization of a permissible non-cash compensation arrangement; and

(iv) the recordkeeping requirement in subparagraph (3) is satisfied.

(E) Contributions by a non-member company or other member to a non-cash compensation arrangement between a member and its associated persons, provided that the arrangement meets the criteria in subparagraph (5)(D).

(6) No person associated with a member shall accept any cash compensation offered or provided to such person that is preconditioned on such person achieving a sales target, except that the following arrangements are permitted:

(A) Cash compensation arrangements preconditioned on the achievement of a sales target between a member and its associated persons or a non-member company and its sales personnel who are associated persons of an affiliated member, provided that:

(i) the member's or non-member's arrangement, if it includes investment company securities, is based on the total production of associated persons with respect to all investment company securities distributed by the member;

(ii) the arrangement requires that the credit received for each investment company security is equally weighted;

(iii) no unaffiliated non-member company or other unaffiliated member directly or indirectly participates in the member's or non-member's organization of a permissible arrangement; and

(iv) the recordkeeping requirement in subparagraph (3) is satisfied.

(B) Contributions by a non-member company or other member to a cash compensation arrangement preconditioned on the achievement of a sales target between a member and its associated persons, provided that the arrangement meets the criteria in subparagraph (6)(A).