

FEBRUARY 2004

# Notices to Members

## Notices

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Reported for February

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# Notice to Members

FEBRUARY 2004

REQUEST FOR COMMENT

ACTION REQUESTED BY MARCH 12, 2004

## SUGGESTED ROUTING

Legal & Compliance  
Operations  
Senior Management

## Regulation of Compensation, Fees, and Expenses in Public Offerings of Real Estate Investment Trusts; Direct Participation Programs, Including Commodity Pools; and Closed-End Funds

NASD Requests Comment on Proposed Amendments to Rules 2710 (Corporate Financing) and 2810 (Direct Participation Programs); **Comment Period Expires March 12, 2004**

## KEY TOPICS

Closed-End Funds  
Commodity Pools  
Compensation Limitations  
Due Diligence  
Loads on Reinvested Dividends  
Non-Cash Compensation  
Trail Fees  
Rule 2710  
Rule 2810

## Executive Summary

This *Notice* addresses the regulation of certain pooled investment vehicles under NASD Rule 2710 (the Corporate Financing Rule)<sup>1</sup> and NASD Rule 2810 (the Direct Participation Programs Rule or DPP Rule). These pooled investment vehicles include publicly offered limited partnership securities, real estate investment trusts (REITs), and closed-end investment companies. This *Notice* proposes amendments to the Corporate Financing Rule and DPP Rule (together, the Rules), and describes policies in the Corporate Financing Department's Public Offering Review program that will clarify the Rules' application to these products. This *Notice*:

- ◆ Requests comment on the rescission of an NASD interpretive policy regarding trail commissions charged by commodity DPPs;
- ◆ Requests comment on proposed amendments to prohibit sales loads on reinvested dividends in REITs, DPPs, and closed-end funds;

04-07

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- ▶ Requests comment on proposed amendments to the non-cash compensation provisions in the Rules regarding the “appropriate location” for training and education meetings;
  - ▶ Requests comment on proposed amendments to the non-cash compensation provisions in the Rules to include “equal weighting” and “total production” limitations for internal sales contests;
  - ▶ Addresses due diligence practices and disclosure in connection with DPP and REIT programs; and
  - ▶ Addresses the allocation of compensation and organization and offering expenses in the review of DPP and REIT programs by NASD’s Corporate Financing Department (Department).

### Action Requested

NASD encourages all interested parties to comment on the proposal. Comments must be received by March 12, 2004. Members and interested persons can submit their comments using the following methods:

- ▶ mailing in written comments;
- ▶ e-mailing written comments to *pubcom@nasd.com*; or
- ▶ submitting comments online at the NASD Web Site (*www.nasd.com*).

Written comments submitted via hard copy should be mailed to:

Barbara Z. Sweeney  
NASD  
Office of the Corporate Secretary  
1735 K Street, NW  
Washington, DC 20006-1500

**Important Notes:** The only comments that will be considered are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the NASD Web Site. Generally, comments will be posted on the NASD Web Site one week after the end of the comment period. See *Notice to Members 03-73*.

Before becoming effective, any rule change developed as a result of comments received must be adopted by the NASD Regulation Board of Directors, may be reviewed by the NASD Board of Governors, and must be approved by the SEC.

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## Questions/Further Information

As noted on the previous page, written comments should be submitted to Barbara Z. Sweeney. Questions concerning this *Notice* should be directed to Joseph E. Price, Vice President, or Minh Le, Assistant Supervisor, Corporate Financing Department, NASD, at (240) 386-4623.

### 1. Background

The Corporate Financing and DPP Rules require that, prior to participating in a public offering of securities, the participating member, or a participating member that files on behalf of other members, must file information regarding the offering with the Department and receive a "no objections" opinion regarding the proposed terms and arrangements in the offering.

The Rules impose three limitations on compensation and expenses with respect to REIT and DPP programs:

- ◆ Underwriting compensation may not exceed 10 percent of the gross proceeds of the offering, regardless of the source from which it is derived. This limitation applies to all forms of underwriting compensation, including so-called "trail commissions."<sup>2</sup>
- ◆ An additional .5 percent may be reimbursed to members or independent due diligence firms for *bona fide* due diligence expenses.
- ◆ Total issuer organization and offering expenses (O&O expenses) are limited to 15 percent of offering proceeds for programs in which the member is affiliated with the program sponsor. This provision allows an additional 4.5 percent for issuer O&O expenses above the 10 percent underwriting compensation and .5 percent due diligence limitations.<sup>3</sup> (North American Securities Administrators Association guidelines also limit total O&O expenses paid out of offering proceeds to 15 percent.)

Trail commissions for REITs and DPPs are included as part of the 10 percent underwriting compensation. Once members have been paid compensation that reaches this limitation, either in the form of front-end commission payments, trail commissions, loads on reinvested dividends, fee reimbursements, or a combination of these payments, then no member may receive additional compensation.

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## 2. Commodity Pool Trail Commissions

Since 1982, the Department has had a policy to exclude trail commissions from the 10 percent limitation as it applies to commodity DPPs if: (1) the member is registered with the Commodity Futures Trading Commission as a Futures Commission Merchant; (2) the associated person receiving the trail commissions has passed the Series 31 Futures Managed Funds examination; and (3) the associated person receiving the trail commissions provides ongoing investor relations services to investors. NASD did not publish this policy, and the DPP Rule was not amended to exclude these payments from the compensation limitations. NASD proposes to rescind this policy. NASD requests comment on rescission. Commenters should address the following questions:

- ◆ For all DPPs, except commodity DPPs, the Department views trail commissions for servicing securities accounts to be compensation in connection with the public offering. Do Series 31 associated persons who provide commodity-related services to securities accounts that hold commodity DPPs provide services that are significantly different than those provided by associated persons who are not Series 31 registered? For example, in some commodity DPPs, Series 31 associated persons receive "uncapped" trail commissions, while associated persons who have not passed the examination receive trail commissions that are subject to the 10 percent limitation. What additional services are provided by the Series 31 associated persons? If these are necessary services, why are non-Series 31 associated persons permitted to sell shares in such programs?
- ◆ Trail commissions in commodity DPPs often are significantly higher than the trail commissions in any other DPPs, including real estate, oil and gas, and equipment leasing partnerships. The Department has reviewed commodity DPPs with trail commissions as high as four percent. By contrast, Rule 12b-1 fees permitted for mutual funds under NASD Rule 2830 (the Investment Company Rule) may not exceed one percent. Are the higher trail commissions in commodity DPPs justified by the quality and level of service provided to accounts that hold these investments?
- ◆ The 10 percent limitation terminates trail commissions in connection with securities sold in all DPP offerings, except commodity DPPs, after the limitation is reached. For example, in a \$500 million DPP offering, \$40 million (eight percent) may initially be paid out of the offering proceeds, leaving an additional \$10 million (two percent) that may be paid as trail commissions.<sup>4</sup> What effect would this trail commission termination feature have on a commodity DPP?

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### 3. Loads on Reinvested Dividends

NASD proposes to amend the DPP and Corporate Financing Rules to prohibit commissions (sales loads) on reinvested dividends in DPPs, REITs, and closed-end funds. In April 2000, NASD amended the Investment Company Rule to prohibit members from offering or selling shares of an investment company if it has a front-end or deferred sales charge imposed on shares purchased through the reinvestment of dividends.<sup>5</sup> Loads on reinvested dividends may be opaque or confusing to investors and, in certain circumstances, may cause an investor to pay a charge twice on the same assets. For example, an investor who pays a load at the time of purchase based on a net asset value that includes undistributed income or capital gains may pay a second charge on the same assets when those earnings are distributed and reinvested. Although NASD proposes to prohibit loads on reinvested dividends, NASD requests comment on whether less liquid DPP and REIT programs may require members to provide more ongoing services in connection with dividend reinvestment programs than those required for a mutual fund and whether these services justify a sales load on reinvested dividends. NASD requests comment on the extent to which any such services are financed by commissions on reinvested dividends and whether it is appropriate to charge sales commissions in programs in which investors choose to have their dividends automatically reinvested. NASD also requests comment on whether it is appropriate to charge a commission on a dividend reinvestment when the dividend is a return or partial return of the investor's capital.

### 4. Non-Cash Compensation

In April 2003, NASD amended the Corporate Financing Rule and the DPP Rule to codify certain exceptions from the non-cash compensation provisions in the Rules,<sup>6</sup> while maintaining the prohibitions on the receipt of gifts with more than a *de minimis* value from DPP and REIT sponsors, the prohibition of payments or reimbursements preconditioned on the achievement of a sales target, and the prohibition of payments and reimbursements for travel and meetings that are not *bona fide* due diligence meetings or training and education meetings.

NASD has been concerned about conflicts of interest in the retail brokerage business created by a broad range of compensation practices whereby program sponsors provide incentives or rewards to individual broker/dealers and their registered representatives for selling the issuer's products. The use of non-cash compensation can create significant point-of-sale incentives that may compromise suitability determinations and heighten the potential for loss of supervisory control over sales practices.

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### **A. Location of Training and Education Meetings**

The non-cash compensation provisions in the DPP and Corporate Financing Rules permit payments and reimbursements by an offeror in connection with training and education meetings, if the conditions of the Rules are met. Among those conditions is the requirement that:

The location is appropriate to the 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.<sup>7</sup>

NASD proposes to amend the Rules to provide that an “appropriate location” for a training and education meeting may include a location at which a significant DPP or REIT asset is located. Members have informed NASD that an important part of a *bona fide* training and education meeting for REITs and DPPs may be inspecting real estate, oil and gas production facilities, and other types of assets that will be held and managed by the program. NASD requests comment on how difficult it typically is to determine whether an asset is “significant” to a program and whether this determination might complicate the ability of a member’s legal and compliance staff to decide whether associated persons should attend a particular meeting. In addition, commenters should address whether such an amendment would provide a significant risk that locations would be chosen in order to provide incentives or rewards to associated persons for selling the issuer’s products.

### **B. Total Production and Equal Weighting Requirements**

The Investment Company Rule and Rule 2820 (Variable Contracts Rule) non-cash compensation provisions are similar, and, in most cases, identical to the Corporate Financing and DPP Rules. In excepting certain internal sales contests from the general prohibition, however, they impose two limitations that do not appear in the Corporate Financing and DPP Rules. First, the internal sales contest must be based on the total production of associated persons with respect to all variable contracts or investment company securities distributed by the member. Second, the sales contest must require that the credit received for each security be equally weighted. These provisions are designed to prohibit internal non-cash sales contests that encourage associated persons to favor one fund or variable contract over another based on non-cash benefits.

NASD proposes to amend the Rules to add the equal weighting and total production limitations. The proposed amendments would apply to all public offerings governed by the Rules, including DPPs, REITs, closed-end funds, and debt and equity securities. The equal weighting and total production limitations, however, would apply according to the type of securities offered. For example, internal sales contests with respect to DPPs would have to be based on total production of associated persons with respect to all DPP securities distributed by the member, but not all DPP and REIT securities combined.



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NASD requests comment on these limitations. Would they better ensure that improper sales incentives do not favor certain securities, such as proprietary securities of the member or its affiliates?

## 5. Public Offering Review Issues

As discussed above, the Corporate Financing and DPP Rules impose three limitations on compensation and expenses with respect to REIT and DPP programs: (i) underwriting compensation may not exceed 10 percent of the gross proceeds of the offering, regardless of the source from which it is derived; (ii) an additional .5 percent may be reimbursed to underwriters for *bona fide* due diligence expenses; and (iii) total issuer organization and offering expenses are limited to 15 percent of offering proceeds for programs in which the member is affiliated with the program sponsor, which permits an additional 4.5 percent for issuer O&O expenses above the 10 percent underwriting compensation and .5 percent due diligence limitations.

### A. Due Diligence

The Department reminds members that for purposes of the .5 percent allowance for *bona fide* due diligence expenses, "due diligence expenses" relate only to those expenses incurred when the member affirmatively discharges its responsibilities to ensure that all material facts pertaining to a program are adequately and accurately disclosed in the offering document. The Department reminds members of the following principles:

- ◆ For purposes of the .5 percent allowance, members may include only their actual costs incurred for due diligence expenses. Any reimbursement that includes a profit margin to the member will be deemed to be underwriting compensation subject to the 10 percent limitation, whether or not the member claims that the reimbursement was for "due diligence" expenses.<sup>8</sup>
- ◆ The .5 percent allowance applies only to *bona fide* due diligence activities. A sponsor may not pay for activities that are inconsistent with the due diligence objective, such as golf outings, cruises, tours, and other forms of entertainment. Members should expect the Department to request a copy of any due diligence meeting agenda to verify that the meeting served a *bona fide* due diligence purpose.

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- ◆ If a member asserts that a meeting was intended for both due diligence and training and education, the member must be prepared to demonstrate which part of the meeting served each purpose. If the meeting agenda does not clearly delineate between the two, then members should expect the Department to consider whether the *entire* meeting should be designated as one or the other. If meetings include training and education, the meeting must be held at an appropriate location consistent with Rules 2710(d)(2)(C)(ii) and 2810(c)(2)(C)(ii). As discussed in Section 4A above, NASD is proposing to amend the Rules with regard to what constitutes an “appropriate location” under the Rules.
  - ◆ Members should ensure that the persons responsible for conducting due diligence have appropriate training and skills to evaluate the terms of the investment as well as the potential risks and benefits. Only the appropriate personnel with relevant background and training should travel to inspect properties or facilities as part of the due diligence review for member firms.
  - ◆ Any due diligence reimbursement that is mischaracterized as “actual *bona fide* due diligence expenses” in a filing with NASD or in an offering document would be deemed to be undisclosed underwriting compensation, and the mischaracterization would violate NASD rules and the federal securities laws. Moreover, such reimbursement could violate the non-cash compensation prohibitions in the DPP and Corporate Financing Rules.

Some members have inquired about whether reimbursements for *bona fide* due diligence may exceed .5 percent of the offering amount if actual costs exceed .5 percent. Consistent with the DPP and Corporate Financing Rules, members may be reimbursed amounts in excess of the .5 percent limitation when actual costs incurred for *bona fide* due diligence activities exceed that limitation. Due diligence expenses that exceed .5 percent may be allocated to O&O expenses, subject to the 4.5 percent limitation on O&O expenses, but only if the members or due diligence firms have presented the REIT or DPP sponsor with a detailed and itemized invoice for the due diligence expenses.

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## **B. Allocation of Compensation and Organization and Offering Expenses**

### *(i) Dual Employees*

Many DPPs and REITs are structured so that a holding company controls other affiliated entities, including the program sponsor, the securities dealer/manager, equipment leasing or property management entities, and financial advisory service providers. When employees of the securities dealer/manager are registered persons and dual employees of the other entities with multiple job responsibilities, determining whether payments in connection with those job responsibilities should be allocated as underwriting compensation or issuer O&O expenses is very burdensome.

Members have urged the Department not to allocate automatically all payments (e.g., salaries, bonuses, and expense reimbursements) to registered persons as underwriting compensation because their primary or secondary job responsibilities may involve providing non-distribution related services to the sponsor. Accordingly, when the Department reviews DPP and REIT programs for compliance with the compensation guidelines, it analyzes information about the job functions, time spent on those functions, and compensation of these registered persons.

The Department is modifying its review procedures so that any salary, bonus, or other form of compensation paid to the dual employee, and any expense associated with the dual employee, would be allocated to the 10 percent underwriting compensation limitation if any of the employee's compensation is contingent on or varies depending on how much money is raised or the number of securities that are sold in the public offering (transaction-based compensation). In general, if the employee's remuneration is not based on the success of the offering, all payments and expenses associated with the dual employee would be allocated to the issuer's O&O expenses. The exclusion from this general rule is that employees of a member engaged in wholesaling functions will always be deemed to be engaged in underwriting activities. Accordingly, all payments and expenses associated with such a dual employee will be included in the 10 percent underwriting compensation limitation regardless of whether the employees are paid transaction-based compensation.

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***(ii) Legal Fees***

Some DPP and REIT programs use the same attorneys or law firm as issuer's counsel and as counsel for the affiliated dealer/manager. The fees paid for legal services provided to the securities dealer/manager must be separately identified as an item of value in filings with the Department. These fees will be allocated to the dealer/manager and included in the 10 percent underwriting compensation limitation. Legal services on behalf of the dealer/manager typically include filing the offering with NASD and responding to the Department's comments and drafting and reviewing dealer agreements, marketing agreements, and due diligence agreements. Legal services on behalf of the issuer will be allocated to O&O expenses.

***(iii) Training and Education Meetings***

The fees and expenses paid in connection with *bona fide* training and education meetings or for participation in meetings held by broker/dealers that are not affiliated with the program sponsor must be identified as an item of value in filings with the Department. These fees and expenses will be considered underwriting compensation and included in the 10 percent limitation.

***(iv) Advertising and Sales Material***

Costs associated with advertising and sales material generated by a program sponsor will be allocated to the issuer's O&O expenses. Material generated by the dealer/manager will be allocated to the 10 percent underwriting compensation limitation.

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## Endnotes

- 1 The Corporate Financing Rule applies to real estate investment trust (REIT) and closed-end fund offerings.
- 2 See *Notice to Members (NtM) 82-50* (providing that underwriting compensation in connection with DPPs may not exceed NASD guidelines); *NtM 82-51* (announcing the NASD guidelines); and *NtM 85-29* (clarifying the 10 percent guideline for underwriting compensation and .5 percent for due diligence expenses in connection with DPPs). Since REITs and real estate limited partnership are competing alternative forms of investing in real estate securities with equivalent costs of distribution, the Corporate Financing Department has applied the same underwriting compensation and due diligence guidelines to both DPPs and REITs since the early 1980s.
- 3 The 10 percent limitation is applied to all public DPPs and REITs, while the 15 percent limitation on organization and offering expenses is applied only to sponsors that are affiliated with NASD members.
- 4 Some DPPs and REITs conduct registered offerings every year or every other year. New compensation calculations and limitations apply to each offering.
- 5 See *NtM 99-103*.
- 6 See *NtM 03-53*. NASD filed the amendments for immediate effectiveness to codify existing staff interpretations.
- 7 NASD interprets the clause “regional location with respect to regional meetings” in the Corporate Financing and DPP Rules to permit regional meetings held for the convenience of local broker/dealers and their associated persons, not national meetings held in regional locations.
- 8 See *NtM 86-66*. *NtM 86-66* also provides that a member’s actual, reimbursable expenses for due diligence can include the fees charged to the member by an independent due diligence firm that is not a member, or an affiliate of a member, even though the independent due diligence firm includes a profit margin in the fees it charges to the member.

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## ATTACHMENT A

Text of Proposed Amendments to Rules 2710 and 2810  
Proposed additions are underlined; proposed deletions are in brackets.

### Rule 2710. Corporate Financing Rule – Underwriting Terms and Arrangements

(a) - (e) No Change

(f) Unreasonable Terms and Arrangements

(1) General

No member or person associated with a member shall participate in any manner in a public offering of securities after any arrangement proposed in connection with the public offering, or the terms and conditions relating thereto, has been determined to be unfair or unreasonable pursuant to this Rule or inconsistent with any By-Law or any Rule or regulation of NASD.

(2) Prohibited Arrangements

Without limiting the foregoing, the following terms and arrangements, when proposed in connection with a public offering of securities, shall be unfair and unreasonable.

(A) – (M) No Change.

(N) For a member to participate in a public offering of the securities of any real estate investment trust or closed-end investment company that charges a sales load or commission on securities that are purchased through the reinvestment of dividends, unless the registration statement registering the securities under the Securities Act of 1933 became effective prior to (the effective date of this rule amendment).

(g)-(h) No Change

(i) Non-Cash Compensation

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(1) No Change

(2) Restrictions on Non-Cash Compensation

In connection with the sale and distribution of a public offering of securities, no member or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation, except as provided in this provision. Non-cash compensation arrangements are limited to the following:

(A) – (B) No Change

(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) No Change

(ii) the location is appropriate to the purpose of the meeting, which shall mean an office of the issuer or affiliate thereof, the office of the member, [or] a facility located in the vicinity of such office, [or] a regional location with respect to regional meetings, or a location at which a significant asset of the program is located;

(iii) – (iv) No Change

(D) Non-cash compensation arrangements between a member and its associated persons or a company that controls a member company and the member's associated persons, provided that:

(i) the member's or non-member's non-cash compensation arrangement is based on the total production of associated persons with respect to all securities within respective product types distributed by the member;

(ii) the non-cash compensation arrangement requires that the credit received for each security within a security product type is equally weighted; and

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(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

(E) No Change

(j) No Change

### **Rule 2810. Direct Participation Programs**

(a) No Change

(b) Requirements

(1) – (3) No Change

(4) Organization and Offering Expenses

(A) No member or person associated with a member shall underwrite or participate in a public offering of a direct participation program if the organization and offering expenses are not fair and reasonable, taking into consideration all relevant factors.

(B) In determining the fairness and reasonableness of organization and offering expenses for purposes of subparagraph (A) hereof, the arrangements shall be presumed to be unfair and unreasonable if:

(i) – (iii) No Change

(iv) commissions or other compensation are to be paid or awarded either directly or indirectly, to any person engaged by a potential investor for investment advice as an inducement to such advisor to advise the purchaser of interests in a particular program, unless such person is a registered broker/dealer or a person associated with such a broker/dealer; [or]

(v) the program provides for compensation of an indeterminate nature to be paid to members or persons



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associated with members for sales of program units, or for services of any kind rendered in connection with or related to the distribution thereof, including, but not necessarily limited to, the following: a percentage of the management fee, a profit sharing agreement, brokerage commissions, and overriding royalty interest, a net profits interest, a percentage of revenues, a reversionary interest, a working interest, a security or right to acquire a security having an indeterminate value, or other similar incentive items; provided however, that an arrangement which provides for continuing compensation to a member or person associated with a member in connection with a public offering shall not be presumed to be unfair and unreasonable if all of the following conditions are satisfied:

a. – c. No change

d. if any portion of the continuing compensation is to be derived from the limited partners' interest in the program cash distributions, the percentage of the continuing compensation shall be no greater than the percentage of program cash distributions to which limited partners are entitled at the time of the payment; or

(iv) the program charges a sales load or commission on direct participation securities that are purchased through the reinvestment of dividends, unless the registration statement registering the securities under the Securities Act of 1933 became effective prior to (the effective date of this rule amendment).

(C) – (E) No Change

(5) – (6) No Change

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(c) Non-Cash Compensation

(1) No Change

(2) Restrictions on Non-Cash Compensation

In connection with the sale and distribution of direct participation securities, no member or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation, except as provided in this provision. Non-cash compensation arrangements are limited to the following:

(A) – (B) No Change

(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) No Change

(ii) the location is appropriate to the 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, or a location at which a significant asset of the program is located;

(iii) – (iv) No Change

(D) Non-cash compensation arrangements between a member and its associated persons or a company that controls a member company and the member's associated persons, provided that:

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

(ii) the non-cash compensation arrangement requires that the credit received for each direct participation program security is equally weighted; and

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(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

(E) No Change

(d) No Change

# Notice to Members

FEBRUARY 2004

## SUGGESTED ROUTING

Executive Representatives  
Legal & Compliance  
Operations

## KEY TOPICS

NASD Rule 3370  
Short Sale Orders

INFORMATIONAL

## Amendments to NASD Rule 3370, Affirmative Determination Requirements

Effective Date of Amendments to NASD Rule 3370  
(Affirmative Determination Requirements) Extended  
to **April 1, 2004**

### Executive Summary

NASD is delaying the effective date of amendments to Rule 3370 (Prompt Receipt and Delivery of Securities—the "Affirmative Determination" Rule) approved by the SEC in November 2003,<sup>1</sup> until **April 1, 2004**. The amendments expand the scope of the affirmative determination requirements to include orders received from broker/dealers that are not members of NASD ("non-member broker/dealers"). The effective date of the amendments originally was February 20, 2004.<sup>2</sup> NASD understands that some members need to make significant technological changes to their systems to comply with the new requirements; therefore, NASD is extending the effective date to provide members with additional time to make such changes.

### Questions/Further Information

Questions concerning this *Notice* may be directed to Gary L. Goldsholle, Associate General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8104; or Patricia M. Albrecht, Assistant General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8026.

04-08

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## Discussion

As further detailed in *Notice to Members 04-03*, the SEC recently approved amendments to Rule 3370 to require that, prior to accepting a short sale order from a non-member broker/dealer, a member make an affirmative determination that the member will receive delivery of the security from the non-member broker/dealer or that the member can borrow the security on behalf of the non-member broker/dealer for delivery by the settlement date. In addition, the amendments provide exemptions for certain proprietary orders of a non-member broker/dealer if those proprietary orders meet the same conditions for exemptions applicable to proprietary orders of member firms, and the following two conditions are satisfied: (1) the non-member broker/dealer must be registered with the SEC; and (2) if using the market maker exemption, the non-member broker/dealer is registered or qualified as a market maker in the securities and is selling such securities in connection with *bona fide* market making.

As approved, the effective date of the amendments was February 20, 2004; however, NASD is delaying the effective date of these provisions until April 1, 2004. NASD understands that some members will need to make significant technological changes to their systems to comply with the new requirements. NASD believes that delaying the effective date of these amendments until April 1, 2004, will provide members the additional time necessary to make changes to their systems.

## Endnotes

- 1 File No. SR-NASD-2001-85; SEC Release No. 34-48788 (Nov. 14, 2003); 68 F.R. 65978 (Nov. 24, 2003).
- 2 See *Notice to Members 04-03* (January 2004).

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# Notice to Members

FEBRUARY 2004

## SUGGESTED ROUTING

Legal & Compliance  
Operations  
Senior Management

## KEY TOPICS

Forms U4 and U5  
Late Fees  
Section 4 of Schedule A to the  
NASD By-Laws

INFORMATIONAL

## Amendments to Section 4 of Schedule A to the NASD By-Laws

SEC Announces Immediate Effectiveness of Amendments  
to Section 4 of Schedule A to the NASD By-Laws

### Executive Summary

The Securities and Exchange Commission (SEC) has announced the immediate effectiveness of amendments to Section 4 of Schedule A to the NASD By-Laws establishing a late fee of \$10 dollars per day, up to a maximum of \$300, to be assessed by NASD against members that fail timely to report a new disclosure event or a change in the status of a disclosure event previously reported on an initial Form U5, an amendment to a Form U5, or an amendment to a Form U4.<sup>1</sup> NASD will assess this fee starting on the day following the last date on which the event was required to be reported under NASD rules.

The amendments to Section 4 become operative on March 8, 2004. As described below, starting on March 8, 2004, there will be a six-month transition period during which NASD will waive certain fees.

The text of Section 4, as amended, is set forth in Attachment A.

### Questions/Further Information

Questions concerning this *Notice* may be directed to Ann E. Bushey, Director, Registration and Disclosure, at (240) 386-4724; and Scott Trilling, Assistant Director, Registration and Disclosure, at (240) 386-5113.

04-09

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## Background and Discussion

Timely and complete reporting of all information required by the NASD By-Laws and rules and the federal securities laws is critical. NASD relies on information reported by its members for, among other things, determining compliance with net capital and reporting requirements and registration requirements. Information reported by members may form the basis for examinations and investigations and, ultimately, disciplinary action. The receipt of timely and complete information about members and their registered persons is essential to NASD's fulfillment of its role as a self-regulatory organization.

Accurate disclosure information is of particular importance to investors who are or who may be interested in doing business with a registered person and are seeking information regarding that person through the NASD BrokerCheck Program. NASD has established the late filing fee discussed in this *Notice* to act as an additional disincentive to late filing and to encourage members to timely update Forms U4 and U5, as required. Of course, firms that fail timely to file amendments to Forms U4 and U5 may, in addition to paying a late fee, be subject to disciplinary action.

The amendments to Section 4 of Schedule A to the NASD By-Laws establish a late fee of \$10 dollars per day, up to a maximum of \$300, to be assessed by NASD against members that fail timely to report a new disclosure event or a change in the status of a disclosure event previously reported on an initial Form U5, an amendment to a Form U5, or an amendment to a Form U4. NASD will assess this fee starting on the day following the last date on which the event was required to be reported under NASD rules.

This late fee is an additional mechanism to help ensure that members make required disclosures on Forms U4 and U5 in a timely manner. In this context, disclosure events generally refer to events that require affirmative answers to the questions on Forms U4 and U5 that elicit information about criminal actions, regulatory disciplinary actions, civil judicial actions, customer complaints, terminations, and financial matters (currently, Questions 14A-M on the Form U4 and Questions 7A-F on the Form U5). Disclosure events must be reported either 30 days or 10 days after the triggering event, depending on the type of information to be reported.

Article V, Section 2(c) of the NASD By-Laws requires that every application for registration (Form U4) filed with NASD be kept current at all times by supplementary amendments that must be filed with NASD not later than 30 days after learning of the facts or circumstances giving rise to a reporting obligation. If such filing involves a statutory disqualification as defined in Section 3(a)(39) and Section 15(b)(4) of the Securities Exchange Act of 1934, such amendment must be filed not later than 10 days after such disqualification occurs. Article V, Section 3(a) of the By-Laws requires a member, not later than 30 days following the termination of the association with a member of a person who is registered with it, to give notice of the termination of such association to NASD (Form U5). Article V, Section 3(b) of the By-Laws requires members to file an amendment to the Form U5 in the event that the member learns of facts

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or circumstances causing any information in the Form U5 to become inaccurate or incomplete, not later than 30 days after the member learns of the facts or circumstances giving rise to the amendment.<sup>2</sup> Under the amended schedule, when a member submits a late disclosure filing, NASD, through the Central Registration Depository (CRD® or Web CRD), will calculate the late fee and debit the firm's CRD account \$10 per day, up to a maximum charge of \$300.

### March 8, 2004, Operative Date and Transition Period

The amendments to Section 4 become operative on March 8, 2004; however, there will be a six-month transition period starting on March 8, during which time NASD will waive the late fee for the first 10 days the filing is late, provided the filing is made during those 10 days. Accordingly, NASD will not assess the first \$100 (at \$10 per day) if the filing is made during those 10 days. Instead, during those six months, the member's CRD account will indicate that NASD has waived the late fee, thereby alerting the member of instances where it has not timely reported disclosure information.

NASD will **not** waive any portion of the late fee for members making filings that are between 11 and 30 days late during this transition period. Such members will be charged \$10 for each late day, up to \$300. For example, a member reporting a disclosure event eight days late during the transition period will receive a report showing the number of days late, but will not be assessed a late fee. Conversely, a member reporting a disclosure event 11 days late during these six months will be charged \$10 per late day, for a total of \$110. At the end of the six-month transition period, members will be charged the \$10 fee beginning each day the filing is late, up to a maximum of \$300.

### Endnotes

1 File No. SR-NASD-2003-192; SEC Release No. 49224 (Feb. 11, 2004).

2 Some examples of events that trigger a reporting requirement include: notice of an NASD decision or order containing findings that a registered person violated NASD rules or receipt of a customer complaint or arbitration claim that meets the reporting criteria on Forms U4 or U5.



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## ATTACHMENT A

Additions are underlined; deletions are in brackets.

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### Schedule A to the NASD By-Laws

Assessments and fees pursuant to the provisions of Article VI of the By-Laws of NASD shall be determined on the following basis.

\* \* \* \* \*

#### Section 4 - Fees

(a) through (l) No change.

(m) NASD shall assess each member a fee of \$10 per day, up to a maximum of \$300, for each day that a new disclosure event or a change in the status of a previously reported disclosure event is not timely filed as required by NASD on an initial Form U5, an amendment to a Form U5, or an amendment to a Form U4, with such fee to be assessed starting on the day following the last date on which the event was required to be reported.

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# Notice to Members

FEBRUARY 2004

## SUGGESTED ROUTING

Legal & Compliance  
Membership  
Senior Management

## KEY TOPICS

New Membership Applications  
Continuing Membership Applications  
Rule 1011  
Rule 1014  
Rule 1017  
Pending Arbitration Awards and Claims

INFORMATIONAL

## Membership Application and Continuation Rules

SEC Approves Amendments to Membership Application and Continuation Rules (Rules 1011, 1014, and 1017)

### Executive Summary

On December 22, 2003, the Securities and Exchange Commission (SEC) approved amendments to Rules 1011, 1014, and 1017 to add additional criteria for NASD's Department of Member Regulation (Department) to consider when reviewing an application for membership.<sup>1</sup> The Rule 1010 Series governs the membership application and membership continuation processes.

The amendments to Rule 1011 expand the definition of "associated persons" for purposes of the Rule 1010 Series to include non-natural persons. Rule 1014 provides the decisional criteria used by the Department in reviewing new and continuing membership applications. Amendments to Rule 1014 clarify that pending arbitrations and civil actions against the applicant or its associated persons are considered as part of the application process. In addition, the amendments to Rule 1014 require the Department to consider unpaid arbitration awards and other adjudicated customer awards against the applicant, its control persons, principals, registered representatives, other associated persons, any lender of 5% or more of the applicant's net capital, and any other member with respect to which these persons were a control person or a 5% lender of its net capital. Amendments to Rule 1017 expand NASD's authority to review asset transfers to include any transfer involving 25% or more of assets and/or revenues that contribute 25% or more to earnings (measured on a rolling 36-month basis) and require all non-New York Stock Exchange (NYSE) selling members to file an application for asset transfers covered by the rule. In addition, the amendments to Rules 1014 and 1017 create a rebuttable presumption that certain membership applications should be denied if the applicant possesses certain specified regulatory history.

04-10

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Rules 1011, 1014, and 1017, as amended, are set forth in Attachment A. The amendments are effective as of March 24, 2004.

Questions concerning this *Notice* may be directed to Mary Sue Fisher, Special Counsel, Regulation Policy, Department of Member Regulation, Regulatory Policy and Oversight, NASD, at (212) 858-4754; or Kosha K. Dalal, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-6903.

## Background and Discussion

The membership application and membership continuation processes have played an important role in investor protection by helping to ensure that new members and current members that make material changes to their businesses comply or continue to comply with rigorous standards. Rule 1014 establishes the standards for approval of both new member applications under Rule 1013 and continuing membership applications under Rule 1017.

NASD has experienced an increase in the number of member consolidations, company restructurings, and asset sales. Asset transfer applications filed pursuant to Rule 1017 are often time-sensitive and may be the first step in a member's withdrawal from the securities business. While asset transfers often serve legitimate business purposes, they also can raise customer protection issues. NASD has encountered several instances where the effect of a member attempting to restructure by transferring assets is to insulate the member and its owners from responsibility for payment of pending or unpaid arbitrations. In some cases, the member will transfer its assets without a corresponding transfer of its liabilities. Because the corporate format used by many members operates to insulate the owners from liabilities of the member, a customer with an award or judgment against the member may only be able to be paid from the member's assets. Thus, an asset transfer may transform the member from an operating business that can generate value over time to a shell holding the firm's liquidated value, leaving behind customers with arbitration claims pending against, or arbitration awards unsatisfied by, the member.

To address concerns raised in such transactions, NASD has amended Rules 1011, 1014 and 1017 to: (1) expand NASD's authority to review asset transfers to include any transfer involving 25% or more of the assets and/or revenues that contribute 25% or more to earnings (measured on a rolling 36-month basis); (2) require that any seller that is not a member of the NYSE file an application for approval of proposed asset transfers covered by the rule even in the case where the buyer to the transaction is an NYSE member (which currently is a situation excluded from the application requirements of Rule 1017); (3) clarify that pending arbitration claims and civil actions against an applicant and its associated persons are considered as part of the application process; (4) create a new standard of admission explicitly identifying as decisional criteria unpaid arbitration awards or other adjudicated customer awards against the applicant, its control persons, principals, registered representatives, other associated persons, any lender of 5% or more of the applicant's net capital, and any other

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member with respect to which these persons were a control person or a 5% lender of its net capital; and (5) expand the definition of "associated persons" for purposes of the Rule 1010 Series to include non-natural persons.

### **1. Review of Transfers Involving 25% or More of Assets/Revenues**

NASD believes it is important that it has the opportunity to review all member transactions that can adversely affect current and former customers in a material way. Currently, Rule 1017(a)(3) requires a member to submit an application only upon the transfer of "substantially all" of the member's assets. However, this may potentially eliminate from NASD's review a member's piecemeal transfer of its assets that, while not "substantially all" in amount, may nevertheless have a material impact on the operations or profitability of the selling member. While NASD ultimately has authority to require an application under the Rule once it becomes clear that a member is in the process of transferring "substantially all" of its assets, there is potential for customer harm in the interim. The amendments to Rule 1017 broaden the scope of Rule 1017(a)(3). First, the amendments clarify that Rule 1017(a)(3) applies to transfers as well as sales of a firm's assets, including sales and transfers of assets to an affiliated entity. Second, the amendments to Rule 1017(a)(3) require members to submit applications to NASD prior to the sale or transfer of 25% or more of the member's assets or any asset, business or line of operation that generates revenues of 25% or greater of the selling member's earnings over a rolling 36-month period.<sup>2</sup> The 36-month period will be measured backwards from the date that the member initially notifies NASD of its intent to sell or transfer assets by submitting an application pursuant to Rule 1017.<sup>3</sup>

### **2. Clarification of Members Required to Submit Applications**

Because of concerns that a selling member's customers may be left unprotected following an asset transfer, NASD believes that the seller's remaining ability to meet liabilities and other obligations should be reviewed in connection with all such transactions. Rule 1017(a) currently exempts selling members from the requirement to submit applications if the acquiring firm is a member of the NYSE. As amended, Rule 1017(a) requires all non-NYSE selling members to submit an application regardless of whether the buyer is a NYSE member. NASD does not intend to put applicants through duplicative approval processes where the transaction is otherwise subject to adequate customer protection safeguards. Rather, in requiring an application regardless of whether the acquirer is a member of the NYSE, NASD will be assured of receiving notice and will be in a position to target particular aspects of the transaction for review, if necessary.

### **3. Consideration of Arbitrations in Application Process**

Rule 2110 applies to efforts by a firm and its owners to unfairly prejudice customers seeking relief in arbitration proceedings. This protective principle also applies in the membership process: NASD has authority to restrict or deny an application if the

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transaction would have the effect of unfairly prejudicing customer claims. The amendments to Rule 1014 have the effect of making it explicit that NASD consider the following in reviewing new and continuing membership applications: pending arbitration claims and civil actions against the applicant and its associated persons, as well as unpaid arbitration awards and other adjudicated customer awards against the applicant or other persons that may have significant control or influence over the applicant, including its control persons, principals, registered representatives, other associated persons, any lender of 5% or more of the applicant's net capital, and any other member with respect to which these persons were a control person or a 5% lender of its net capital.

#### **4. Rebuttable Presumption to Deny Application**

NASD has seen instances where an applicant (both new member and change of ownership/control) and/or its associated persons have a disciplinary history of some concern that falls short of a statutory disqualification. Many of these cases involve applications from closely held firms where, even if the broker/dealer establishes heightened supervisory procedures, the influence of an associated person on the broker/dealer is not appropriately restricted by the supervisory structures and procedures. Rule 1014(a)(3) requires NASD to determine whether an applicant and its associated persons "are capable of complying with" the federal securities laws and the rules of NASD. A variety of specific events, including past and current disciplinary actions and customer claims, are among the considerations referenced in the Rule. It is NASD's view that, when the applicant or its associated persons have experienced an event enumerated within the Rule as raising a question of capacity to comply with the federal securities laws and the rules of NASD, it should result in a rebuttable presumption to deny the application.

Consequently, the existence of any of the events enumerated in Rule 1014(a)(3)(A) and (C) through (E) will create a rebuttable presumption that the application should be denied. The enumerated events include: (1) adverse actions taken by a state or federal authority or self-regulatory organization with respect to registration or licensing regarding the applicant or its associated persons; (2) the applicant or an associated person is the subject of a pending, adjudicated, or settled regulatory action or investigation by the SEC, CFTC, a federal, state or foreign regulatory agency, or self-regulatory organization; (3) the applicant or an associated person is the subject of an adjudicated or settled investment-related civil action, or pending or adjudicated criminal action; (4) an applicant, its control persons, registered representatives, other associated persons, or any lender of 5% or more of the applicant's net capital, and any other member with respect to which these persons were a control person or a 5% lender of its net capital is subject to unpaid arbitration awards, other adjudicated customer awards, or unpaid arbitration settlements; (5) an associated person of the applicant was terminated for cause or permitted to resign after an investigation of an alleged violation of a federal or state securities law, or rule or regulation thereunder, a self-regulatory organization rule, or industry standard of conduct; and (6) a state or federal authority or self-regulatory organization has imposed remedial action, such as

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special training, continuing education requirements, or heightened supervision, on an associated person. The rebuttable presumption will not apply where the only matters on the record of an applicant or its associated persons are sales practice events, pending arbitrations, or pending civil actions.

An applicant may overcome the presumption by demonstrating to NASD that it can meet each of the standards in Rule 1014(e), notwithstanding the existence of the event(s) of concern. In determining whether an applicant has overcome the presumption, NASD staff will consider the applicant's submission in light of the specific standards of Rule 1014(a), the public interest, protection of investors, and NASD's responsibility to provide a fair procedure in accordance with membership rules. The rebuttable presumption does not create a new standard for admission, but merely clarifies that applicants with certain regulatory history must affirmatively demonstrate that they should be allowed admission.

#### **5. Expand Definition of "Associated Persons" to Non-Natural Persons**

The amendments to Rule 1011 expand the definition of "Associated Person" in subsection (b) to include non-natural persons. The amended definition applies to the entire Rule 1010 Series. NASD believes applying the definition to the entire Rule 1010 Series provides for consistency in the membership application process.

#### **Effective Date**

The rule amendments become effective on March 24, 2004. The rule amendments will apply to all applications that are pending with NASD as of such date or filed with NASD on or after such date.

#### **Endnotes**

- 1 See Release No. 34-48969 (December 22, 2003), 68 FR 75681 (December 31, 2003), File No. SR-NASD-2003-007.
- 2 For purposes of Rule 1017, NASD construes the term "assets" in accordance with Generally Accepted Accounting Principles.
- 3 In situations where NASD does not receive notice, the 36-month period will be measured from the date when notice was due. See Rule 1017(c)(1).

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## ATTACHMENT A

New language is underlined; deletions are in brackets.]

### 1010. Membership Proceedings

#### 1011. Definitions

(a) No Change.

**(b) "Associated Person"**

[The term "Associated Person" means: (1) a natural person registered under the Rules of the Association; or (2) a sole proprietor, partner, officer, director, branch manager, or other natural person occupying a similar status or performing similar functions who will be or is anticipated to be associated with the Applicant, or a natural person engaged in the investment banking or securities business who will be or is anticipated to be directly or indirectly controlling or controlled by the Applicant, whether or not any such person is registered or exempt from registration under the NASD By-Laws or the Rules of the Association.]

The term "Associated Person" means: (1) a natural person registered under NASD Rules; or (2) a sole proprietor, or any partner, officer, director, branch manager of the Applicant, or any person occupying a similar status or performing similar functions; (3) any company, government or political subdivision or agency or instrumentality of a government controlled by or controlling the Applicant; (4) any employee of the Applicant, except any person whose functions are solely clerical or ministerial; (5) any person directly or indirectly controlling the Applicant whether or not such person is registered or exempt from registration under NASD By-Laws or NASD Rules; (6) any person engaged in investment banking or securities business controlled directly or indirectly by the Applicant whether such person is registered or exempt from registration under NASD By-Laws or NASD Rules; or (7) any person who will be or is anticipated to be a person described in (1) through (6) above.

(c) through (n) – No Change.

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## 1014. Department Decision

### (a) Standards for Admission

After considering the application, the membership interview, other information and documents provided by the Applicant, other information and documents obtained by the Department, and the public interest and the protection of investors, the Department shall determine whether the Applicant meets each of the following standards:

(1) through (2) - No Change.

(3) The Applicant and its Associated Persons are capable of complying with the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association], including observing high standards of commercial honor and just and equitable principles of trade. In determining whether this standard is met, the Department [~~may~~]shall take into consideration whether:

(A) a state or federal authority or self-regulatory organization has taken permanent or temporary adverse action with respect to a registration or licensing determination regarding the Applicant or an Associated Person;

(B) an Applicant's or Associated Person's record reflects a sales practice event, a pending arbitration, or a pending private civil action;

(C) an Applicant or Associated Person is the subject of a pending, adjudicated, or settled regulatory action or investigation by the Commission, the Commodity Futures Trading Commission, a federal, state, or foreign regulatory agency, or a self-regulatory organization; [~~a pending,~~]an adjudicated, or settled investment-related private civil action for damages or an injunction; or a criminal action (other than a minor traffic violation) that is pending, adjudicated, or that has resulted in a guilty or no contest plea; or an Applicant, its control persons, principals, registered representatives, other Associated Persons, any lender of 5% or more of the Applicant's net capital, and any other member with respect to which these persons were a control person or a 5% lender of its net capital is subject to unpaid arbitration awards, other adjudicated customer awards, or unpaid arbitration settlements;



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(D) an Associated Person was terminated for cause or permitted to resign after an investigation of an alleged violation of a federal or state securities law, a rule or regulation thereunder, a self-regulatory organization rule, or industry standard of conduct;

(E) a state or federal authority or self-regulatory organization has imposed remedial action, such as special training, continuing education requirements, or heightened supervision, on an Associated Person; and

(F) a state or federal authority or self-regulatory organization has provided information indicating that the Applicant or an Associated Person otherwise poses a threat to public investors.

(4) The Applicant has established all contractual or other arrangements and business relationships with banks, clearing corporations, service bureaus, or others necessary to:

(A) initiate the operations described in the Applicant's business plan, considering the nature and scope of operations and the number of personnel; and

(B) comply with the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association].

(5) The Applicant has or has adequate plans to obtain facilities that are sufficient to:

(A) initiate the operations described in the Applicant's business plan, considering the nature and scope of operations and the number of personnel; and

(B) comply with the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association].

(6) – (7) No Change.

(8) The applicant has financial controls to ensure compliance with the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association].

(9) No Change.

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(10) The Applicant has a supervisory system, including written supervisory procedures, internal operating procedures (including operational and internal controls), and compliance procedures designed to prevent and detect, to the extent practicable, violations of the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association]. In evaluating the adequacy of a supervisory system, the Department shall consider the overall nature and scope of the Applicant's intended business operations and shall consider whether:

(A) the number, location, experience, and qualifications of supervisory personnel are adequate in light of the number, location, experience, and qualifications of persons to be supervised; the Central Registration Depository record or other disciplinary history of supervisory personnel and persons to be supervised; and the number and locations of the offices that the Applicant intends to open and the nature and scope of business to be conducted at each office;

(B) the Applicant has identified specific Associated Persons to supervise and discharge each of the functions in the Applicant's business plan, and to supervise each of the Applicant's intended offices, whether or not such offices are required to be registered under [the] NASD Rules [of the Association];

(C) the Applicant has identified the functions to be performed by each Associated Person and has adopted procedures to assure the registration with NASD [the Association] and applicable states of all persons whose functions are subject to such registration requirements[.];

(D) each Associated Person identified in the business plan to discharge a supervisory function has at least one year of direct experience or two years of related experience in the subject area to be supervised;

(E) the Applicant will solicit retail or institutional business;

(F) the Applicant will recommend securities to customers;

(G) the location or part-time status of a supervisor or principal will affect such person's ability to be an effective supervisor;

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(H) the Applicant should be required to place one or more Associated Persons under heightened supervision pursuant to Notice to Members 97-19;

(I) any remedial action, such as special training or continuing education requirements or heightened supervision, has been imposed on an Associated Person by a state or federal authority or self-regulatory organization; and

(J) any other condition that will have material impact on the Applicant's ability to detect and prevent violations of the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association].

(11) No Change.

(12) The Applicant has completed a training needs assessment and has a written training plan that complies with the continuing education requirements imposed by the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association].

(13) NASD [The Association] does not possess any information indicating that the Applicant may circumvent, evade, or otherwise avoid compliance with the federal securities laws, the rules and regulations thereunder, or [the] NASD Rules [of the Association].

(14) The application and all supporting documents otherwise are consistent with the federal securities laws, the rules and regulations thereunder, and [the] NASD Rules [of the Association].

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**(b) Granting or Denying Application**

(1) In reviewing an application for membership, the Department shall consider whether the Applicant and its Associated Persons meet each of the standards in paragraph (a). Where the Department determines that the Applicant or its Associated Persons are the subject of any of the events set forth in Rule 1014(a)(3)(A) and (C) through (E), a presumption exists that the application should be denied. The Applicant may overcome the presumption by demonstrating that it can meet each of the standards in paragraph (a), notwithstanding the existence of any of the events set forth in Rule 1014(a)(3)(A) and (C) through (E).

(2) [(1)] If the Department determines that the Applicant meets each of the standards in paragraph (a), the Department shall grant the application for membership.

(3) [(2)] If the Department determines that the Applicant does not meet one or more of the standards in paragraph (a) in whole or in part, the Department shall:

(A) grant the application subject to one or more restrictions reasonably designed to address a specific financial, operational, supervisory, disciplinary, investor protection, or other regulatory concern based on the standards for admission in Rule 1014(a); or

(B) deny the application.

(c) – (d) No Change.

**(e) Service and Effectiveness of Decision**

The Department shall serve its decision and the membership agreement on the Applicant in accordance with Rule 1012. The decision shall become effective upon service and shall remain in effect during the pendency of any review until a decision constituting final action of NASD [the Association] is issued under Rule 1015 or 1016, unless otherwise directed by the National Adjudicatory Council, the NASD Board, or the Commission.

(f) No Change.

**(g) Final Action**

Unless the Applicant files a written request for a review under Rule 1015, the Department's decision shall constitute final action by NASD [the Association].

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## 1017. Applications for Approval of Change in Ownership, Control, or Business Operations

### (a) Events Requiring Application

A member shall file an application for approval of any of the following changes to its ownership, control, or business operations:

(1) a merger of the member with another member, unless both are members of the New York Stock Exchange, Inc. or the surviving entity will continue to be a member of the New York Stock Exchange, Inc.;

(2) a direct or indirect acquisition by the member of another member, unless the acquiring member is a member of the New York Stock Exchange, Inc.;

(3) [a] direct or indirect acquisitions or transfers of 25% or more in the aggregate [substantially all] of the member's assets or any asset, business or line of operation that generates revenues comprising 25% or more in the aggregate of the member's earnings measured on a rolling 36-month basis, unless both the seller and acquirer are members [the acquirer is a member] of the New York Stock Exchange, Inc.;

(4) a change in the equity ownership or partnership capital of the member that results in one person or entity directly or indirectly owning or controlling 25 percent or more of the equity or partnership capital; or

(5) a material change in business operations as defined in Rule 1011(i).

(b) – (f) No Change.

### (g) Department Decision

(1) The Department shall consider the application, the membership interview, other information and documents provided by the Applicant or obtained by the Department, the public interest, and the protection of investors. In rendering a decision on an application submitted under Rule 1017(a), the Department shall consider whether the Applicant and its Associated Persons meet each of the standards in Rule 1014(a). Where the Department determines that the Applicant or its Associated Persons are the subject of any of the events set forth in Rule 1014(a)(3)(A) and (C) through (E), a presumption exists that the application should be denied. The Applicant may

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overcome the presumption by demonstrating that it can meet each of the standards in Rule 1014(a), notwithstanding the existence of any of the events set forth in Rule 1014(a)(3)(A) and (C) through (E).

(A) In rendering a decision on an application for approval of a change in ownership or control, or an application for approval of a material change in business operations that does not involve modification or removal of a membership agreement restriction, the Department shall determine if the Applicant would continue to meet the standards in Rule 1014(a) upon approval of the application.

(B) In rendering a decision on an application requesting the modification or removal of a membership agreement restriction, the Department shall consider whether the maintenance of the restriction is appropriate in light of:

- (i) the standards set forth in Rule 1014;
- (ii) the circumstances that gave rise to the imposition of the restriction;
- (iii) the Applicant's operations since the restriction was imposed;
- (iv) any change in ownership or control or supervisors and principals; and
- (v) any new evidence submitted in connection with the application.

(2) – (4) No Change.

**(h) Service and Effectiveness of Decision**

The Department shall serve its decision on the Applicant in accordance with Rule 1012. The decision shall become effective upon service and shall remain in effect during the pendency of any review until a decision constituting final action of NASD [the Association] is [served]issued under Rule 1015 or 1016, unless otherwise directed by the National Adjudicatory Council, the NASD Board, or the Commission.

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**(i) Request for Review; Final Action**

An Applicant may file a written request for review of the Department's decision with the National Adjudicatory Council pursuant to Rule 1015. The procedures set forth in Rule 1015 shall apply to such review, and the National Adjudicatory Council's decision shall be subject to discretionary review by the NASD Board pursuant to Rule 1016. If the Applicant does not file a request for review, the Department's decision shall constitute final action by NASD [the Association].

(j) – (k) No Change.

# Notice to Members

FEBRUARY 2004

## SUGGESTED ROUTING

Legal & Compliance  
Senior Management

## KEY TOPICS

Arbitration  
Sanctions  
Uniform Submission Agreements

INFORMATIONAL

## Uniform Submission Agreements

NASD Reminds Members and Associated Persons of Their Duty to File Uniform Submission Agreements

### Executive Summary

NASD's Code of Arbitration Procedure (Code) requires respondents in NASD arbitrations to serve an answer and an executed Uniform Submission Agreement (USA) at the time the answer to the Statement of Claim is due. NASD has learned that some members and associated persons named as respondents in arbitration proceedings are neglecting or refusing to submit a signed USA in a timely manner. Failing to sign and submit the USA may cause confusion, lead to ancillary litigation, and undermine the enforceability of arbitration awards. The purpose of this *Notice* is to remind members and associated persons named as respondents that, absent a specific jurisdictional challenge, submission of a USA is mandatory, and that failure to comply may result in sanctions or disciplinary action.

### Questions/Further Information

Questions regarding this *Notice* may be directed to Laura Gansler, Counsel, NASD Dispute Resolution, at (202) 728-8275, or via e-mail at [laura.gansler@nasd.com](mailto:laura.gansler@nasd.com).

### Discussion

NASD Rule 10314 requires all parties to NASD arbitrations to submit an executed USA agreeing to arbitrate under NASD rules. A claimant's USA is due at the time the Statement of Claim is filed; NASD will not serve the claim until it is received. Respondents must serve an executed USA at the time the answer to the Statement of Claim is due or served, whichever is earlier.

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NASD staff has learned that some members and associated persons named as respondents are neglecting or refusing to sign the USA. While these members and associated persons may believe that signing the USA is unnecessary since they are required to submit to arbitration under the Code in any event, failure to sign the USA may cause needless confusion or even ancillary litigation by the opposing party, and may place the eventual award in jeopardy. For example, Section 13 of the Federal Arbitration Act (FAA) requires that a motion to confirm an arbitration award must include the parties' agreement to arbitrate. Although a claimant may be able to demonstrate that a member that failed to execute a USA was nonetheless required to arbitrate pursuant to NASD rules, failure to execute the USA can unnecessarily hinder the ability of a claimant to seek confirmation of an award pursuant to Section 13 of the FAA.

The purpose of this *Notice* is to remind members and associated persons who are named as respondents in NASD arbitrations that filing a USA is mandatory. Absent a specific and colorable objection that the respondent is not subject to arbitration under Rules 10101, 10201, or 10301 of the Code, a respondent's failure to file a USA in a timely manner can lead to sanctions by the arbitration panel, and, in certain circumstances, may be considered a violation of just and equitable principle of trade and NASD Rule 2110. In addition to publishing this *Notice*, NASD Dispute Resolution will initiate a practice of notifying all parties of the status of each party's USA before the Initial Prehearing Conference (IPHC), so that every party will know whether every other party has properly executed the USA before the IPHC begins. This will allow the parties to ask the arbitrators to require USAs from any party that has not yet executed one. Finally, NASD Dispute Resolution will amend the script used by arbitrators at the IPHC to address this issue. Specifically, the script will include a statement by the arbitrators that any party that has not yet filed a USA must do so, or object in writing to NASD jurisdiction on the bases described above, within 30 days, and that failure to do so may result in sanctions, as provided by the Code, as well as possible disciplinary action.

NASD hopes that these measures will serve as an effective reminder to members and associated persons named as respondents in NASD arbitrations that they must file USAs in a timely manner, as required by the Code, and thereby alleviate the need for future rule changes or other additional steps to address the problem.

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# Notice to Members

FEBRUARY 2004

## SUGGESTED ROUTING

Continuing Education  
Legal & Compliance  
Registration  
Senior Management

## KEY TOPICS

Regulatory Element

INFORMATIONAL

## Continuing Education

Change in Policy of Granting Foreign Deferrals to Registered Supervisors and Principals from the Continuing Education Regulatory Element

### Executive Summary

NASD is providing the Regulatory Element Supervisor Program (S201) in several new international locations. This will affect NASD's policy of granting foreign deferrals to registered supervisors and principals from the Continuing Education Regulatory Element.

### Questions/Further Information

Questions about this *Notice* may be directed to Heather Bevans, Continuing Education, NASD, at (240) 386-4685.

### Background

#### Foreign Deferral Policy

Effective February 16, 2004, the S201 Supervisor Program is now available at 13 international Pearson VUE Centers, including Frankfurt, Singapore, Hong Kong, Taiwan, South Korea, Tokyo, and Sydney (see Table 1). Accordingly, NASD is amending its policy of granting foreign deferrals to registered supervisors and principals from the Continuing Education Regulatory Element requirement. Supervisors and principals residing approximately 350 miles or less from these Pearson VUE centers and whose anniversary requirement windows open after Wednesday, March 24, 2004, will no longer be eligible for foreign deferrals.<sup>1</sup>

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Table 1

**Pearson VUE Centers Outside the U.S. and Canada that Deliver Continuing Education**

<b>American Samoa</b>	Pago Pago	
<b>Asia</b>	Hong Kong:	Wan Chai
	Japan:	Tokyo
	Singapore	
	South Korea:	Chongno-gu
	Taiwan:	Taipei
<b>Australia</b>	Sydney:	St. Leonards, NSW
<b>Europe</b>	France:	Paris
	Germany:	Frankfurt
	United Kingdom:	London
<b>Guam</b>	Tamuning	
<b>Saipan</b>	Garapan	
<b>U.S. Virgin Islands</b>	St. Thomas	

**Note:** To view a list of all Pearson VUE and Prometric testing centers that deliver Qualifications Exams and Continuing Education, please see: [www.nasdr.com/exam/listexamlocs.asp](http://www.nasdr.com/exam/listexamlocs.asp).

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## Endnote

- 1 A foreign deferral defers a Continuing Education Regulatory Element requirement until the individual's next Regulatory Element anniversary, and is granted only for those persons residing in locations outside a 350-mile radius of a Pearson VUE Center. NASD established the foreign deferral policy for registered persons residing outside the United States and Canada in July 1996, when NASD opened a testing/training center in London (see *Notice to Members 96-48*). NASD has amended the foreign deferral policy on three previous occasions as testing centers became available. See *Notice to Members 03-40* (July 2003); *Notice to Members 01-73* (November 2001); and *Notice to Members 01-50* (August 2001).

Foreign deferral requests must be in writing, signed by a principal of the firm, and mailed or faxed to: NASD, Continuing Education Department, 9509 Key West Avenue, Rockville, MD 20850; fax: (240) 386-4675. Requests must contain the individual's name, CRD number, and the city and country of residence. Firms must proactively request a foreign deferral for each anniversary date that subjects a registered person to a Regulatory Element requirement. NASD does not automatically renew foreign deferrals.

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# Notice to Members

FEBRUARY 2004

## SUGGESTED ROUTING

Legal & Compliance  
Operations  
Senior Management

## KEY TOPICS

Bridge Loans  
Compensation Limitations  
Derivatives  
Investment Banking  
Rule 2710  
Rule 2810  
Venture Capital

INFORMATIONAL

## Amendments to the Corporate Financing Rule

SEC Approves Amendments to Rule 2710 (Corporate Financing Rule) and Rule 2720 (Distribution of Securities of Members and Affiliates—Conflicts of Interest);

**Effective Date: March 22, 2004**

### Executive Summary

On December 23, 2003, the Securities and Exchange Commission (SEC) approved amendments to Rule 2710 (Corporate Financing Rule or Rule) and Rule 2720 (Distribution of Securities of Members and Affiliates—Conflicts of Interest Rule) that modernize and simplify the Rules to better reflect the various financial activities of multi-service firms (Rule Amendments).<sup>1</sup> The Corporate Financing Rule regulates underwriting compensation and prohibits unfair arrangements in connection with public offerings of securities. The Rule requires members to file with NASD information about initial public offerings (IPOs) and certain secondary offerings. The Corporate Financing Department (Department) reviews this information prior to commencement of the offering to determine whether the underwriting compensation and other terms and arrangements meet the requirements of applicable NASD rules.

The SEC Approval Order, which includes the text of the Rules, is available at [www.nasdr.com/filings/lrf00\\_04.asp](http://www.nasdr.com/filings/lrf00_04.asp). The Approval Order contains a detailed discussion of the application of the Rule Amendments. Members with questions regarding the application of the Rules should review the information in the Approval Order in addition to the information provided in this *Notice*.

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## Questions/Further Information

Questions regarding the *Notice* may be directed to Minh Le or Joani Ward, Assistant Supervisors, Corporate Financing Department, NASD, at (240) 386-4623.

### A. Background and Discussion

In recent years, many NASD members have expanded the variety of services that they provide to their corporate financing clients. These services may include venture capital investment, financial consulting, commercial lending, hedging risk through derivative transactions, and investment banking. In addition, the pace of corporate financing activity has accelerated, and the typical time between private fundraising and an issuer's IPO has been shortened. As a result of these developments, NASD proposed amendments to the Corporate Financing Rule to ensure that the Rule would accommodate the modern, legitimate corporate financing activities of members, while protecting issuers and investors from unreasonable or coercive practices.

### B. Underwriting Compensation

The Corporate Financing Rule, prior to the amendments discussed in this *Notice*, provides that any "item of value" acquired by the underwriter and related persons within the 12-month period before the filing date of a public offering will be examined by the Department to determine whether it was acquired "in connection with the public offering," and, as such, deemed to be underwriting compensation. Moreover, the Rule currently presumes that any item of value acquired within the six-month period before filing is underwriting compensation; this presumption, however, may be rebutted based on information provided to the Department.

As amended, the Corporate Financing Rule contains a more objective standard for members and the Department to use to determine whether "items of value," such as fees and securities received by underwriters and related persons, must be included in the calculation of underwriting compensation under the Rule. In this regard, Rule 2710(c)(3)(A) sets forth a non-exclusive list of specific types of "items of value" that, along with all other items of value received or to be received by underwriters and related persons in connection with or related to the distribution of the public offering, will be included for purposes of determining the amount of underwriting compensation received or to be received. Rule 2710(c)(3)(B), in turn, provides a list of items that will not be considered "items of value" for purposes of the Rule.

"Items of value" received by an underwriter or related person during the 180-day period before filing the registration statement or other information with the Department and up to the time of the offering's effectiveness or commencement of sales (Review Period) are deemed to be underwriting compensation unless the securities were received in a transaction that meets one of five exceptions contained in the Rule. These exceptions are described below.

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## C. Exceptions From Underwriting Compensation

The Rule Amendments provide five exceptions, which identify types of transactions in which securities acquired in connection with the transactions, though items of value, will not be considered to be underwriting compensation. The exceptions are intended to cover identified *bona fide* capital-raising transactions.

### 1. Purchases and Loans by Certain Entities

This exception applies to securities received as consideration for certain investments and loans by entities that are affiliates of members. To fall within this exception, these affiliated entities must meet certain capital and other requirements that are designed to ensure that they are engaged in *bona fide* businesses providing loans to, or venture capital investments in, other companies. This exception limits the amount of securities of an issuer that may be acquired in transactions during the Review Period to 25 percent.

### 2. Investment in and Loans to Certain Issuers

This exception applies to the acquisition of securities of issuers that have significant institutional investor involvement in their corporate governance. The exception is available for acquisitions by qualifying related entities in a private placement or as compensation for a loan or credit facility. To fall within this exception, the entities also must meet certain capital and other requirements to ensure that the entities have been primarily engaged in the business of making investments in or loans to other companies. The exception limits the amount of securities of an issuer that may be acquired in a transaction to 25 percent. Unlike the first exception, however, it applies the 25 percent threshold to each acquisition of securities under the exception.

### 3. Private Placements with Institutional Investors

This exception applies to venture capital investments or the receipt of securities as compensation for acting as a placement agent in transactions that include significant institutional investor participation. The exception includes the requirement that an institutional investor that is not affiliated with any member participating in the public offering must have negotiated, established or approved the terms of the investment. In addition, underwriters and related persons, in the aggregate, may not purchase or receive as placement agent compensation securities in an amount that exceeds 20 percent of the amount of securities sold in the private placement.

### 4. Acquisitions and Conversions to Prevent Dilution

This exception applies to acquisitions of securities that are acquired as the result of: (1) a qualifying right of preemption or a stock-split or a pro-rata rights or similar offering, or (2) the conversion of securities that have not been deemed by NASD to be underwriting compensation. The only terms of the purchased securities that could be different from the terms of securities purchased by other investors would be pre-existing contractual rights that were granted in connection with a prior purchase.

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Further, the opportunity to purchase or receive additional securities must have been provided to all similarly situated security holders. Finally, the amount of securities purchased or received must not have increased the recipient's percentage ownership of the same generic class of securities of the issuer, except in the case of conversions and passive increases that result from another investor's failure to exercise its own rights. The Rule Amendments include a definition of a "right of preemption" and list the circumstances under which a purchaser might receive a preemptive right.

#### **5. Purchases Based on a Prior Investment History**

This exception applies to acquisitions made in private placements during the Review Period in order to prevent dilution of a long-standing equity interest in the issuer. To be eligible for the exception, the investor must have made at least two prior purchases of the issuer's securities: at least one investment must have been made at least 24 calendar months before the required filing date and a second investment must have been made more than 180 days before the required filing date.

### **D. Securities Excluded as an Item of Value**

The Rule Amendments also list securities, fees, and expenses that are excluded from the definition of "item of value." Securities, fees, and expenses that are not items of value are not deemed to be underwriting compensation and, as further discussed below, are not subject to the Rule's lock-up restrictions.

#### **1. Listed Securities**

The Rule Amendments provide that listed securities purchased in public market transactions are not treated as items of value. In addition, the Rule Amendments provide a definition of "listed securities" that specifies the eligible markets and exchanges on which such securities must be listed to meet the definition.

#### **2. Debt Securities and Derivative Instruments**

The Rule Amendments provide that nonconvertible or non-exchangeable debt securities and derivative instruments are not items of value if acquired or entered into: (1) for a fair price; (2) in the ordinary course of business; and (3) in transactions unrelated to the public offering. In addition, any securities received in settlement of a derivative that is entered into at a fair price also do not have a compensation value.

##### **a. Fair Price Definition**

The Rule Amendments define "fair price" debt securities and derivative instruments to be those that the underwriters and related persons have priced in good faith, on an arms' length basis, in a commercially reasonable manner, and in accordance with pricing methods and models and procedures used in the ordinary course of their business for pricing similar transactions. This "fair price" definition is intended to distinguish covered debt and derivative transactions from a transaction in which the benefit to the underwriter or related person is related to the underwriting or similar



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services provided to the issuer. The fair price definition excludes a derivative instrument or other security received for acting as a private placement agent for the issuer, for providing or arranging a loan, credit facility, merger, acquisition, or any other service, including underwriting services. The Rule Amendments provide that any debt or derivative transaction acquired or entered into at a fair price and any item of value received or receivable in the exercise or settlement of such debt or derivative transaction shall have no underwriting compensation value.

**b. Filing Requirement**

To be excluded from the definition of “item of value,” the Rule Amendments require that the debt securities and derivative instruments be acquired or entered into “in transactions unrelated to the public offering.” Generally, a transaction occurring within the Review Period that is negotiated by personnel in a member’s investment banking department would not be considered to be “unrelated to the public offering.”<sup>2</sup>

The Rule Amendments provide that information regarding debt and derivative transactions that are *related to the public offering* must be filed if the related public offering is subject to the filing requirements of the Rule (e.g., a derivative transaction designed to hedge the interest rate risk in a non-investment grade rated debt offering). The information initially filed may be limited to a brief description of the transaction and a representation that the transaction was (or if the pricing terms have not been set will be) entered into at a fair price as defined in the Rule. The required information must be submitted only with respect to the particular public offering to which a particular debt security or derivative instrument relates. The Department will evaluate the information submitted on a case-by-case manner. In this regard, the Department will determine that a debt security or derivative instrument acquired in a transaction at a fair price has a compensation value only if facts and circumstances indicate that the transaction is structured so that the risk to the underwriter or related person and the benefit to the customer is minimal, in comparison to the benefit received by the underwriter or related person.<sup>3</sup>

**c. Fair Price Derivatives or Debt Securities Acquired in Transactions Related to an Offering that is Exempt from the Filing Requirements**

The Corporate Financing Rule also specifies that offerings exempt from the Rule’s filing requirements, such as offerings of investment-grade rated debt or shelf offerings by issuers with a 36-month reporting history and \$150 million public float, nevertheless must comply with other provisions of the Rule. Accordingly, members must ensure that the underwriting terms and arrangements comply with the Rule. If a participating member has entered into a fair price derivative transaction in connection with an offering that is exempt from the Rule’s filing requirements, members or their counsel must evaluate the facts and circumstances and reasonably determine that the transaction was executed at a fair price and, therefore, has no compensation value. In making such determination, members or their counsel would apply the same test as that applied by the Department (and discussed in subsection b above)—*i.e.*, whether

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the transaction was, in fact, not entered into at a fair price because the risk to the underwriter or related person and the benefit to the customer is minimal, in comparison to the benefit received by the underwriter or related person.

### **3. Pooled Investment Vehicles**

The Rule Amendments provide that securities acquired through stock bonus, pension, or profit-sharing plans that qualify under Section 410 of the Internal Revenue Code and shares of an investment company registered under the Investment Company Act of 1940, will not be considered items of value.

### **4. Cash Compensation**

The Rule Amendments clarify that cash compensation for acting as placement agent for a private placement or for providing a loan, credit facility, or for services in connection with merger and acquisitions, will not be considered items of value.

## **E. Lock-up Restriction**

The Rule Amendments narrow the application of the lock-up restriction to public equity offerings. The Rule Amendments provide that common or preferred stock, options, warrants, and other equity securities of the issuer that are unregistered and acquired by an underwriter or related person within 180 days before the filing of the registration statement, or acquired after the filing of the registration statement and deemed to be compensation by NASD, are subject to a 180-day lock-up. All securities that are acquired in transactions that meet the requirements of the five exceptions discussed above also are subject to the lock-up. The Rule Amendments prohibit any hedging, short sale, derivative, put, or call transaction that would result in the effective economic disposition of the securities subject to the lock-up, in order to prevent circumvention of the lock-up restrictions.

The Rule Amendments contain several exceptions to the lock-up restriction. If the aggregate amount of securities of the issuer held by the underwriter or related persons does not exceed 1 percent of the securities being offered, the securities are not subject to the lock-up. In addition, the Rule Amendments provide exceptions for certain investment funds, transfers of securities that are not considered to be an item of value, transfers by operation of law or reorganization of the issuer, and transfers of securities that were previously, but no longer are, subject to a lock-up restriction in connection with a prior public offering. The Rule Amendments also: (1) provide an exception for transfers of securities to any member participating in the offering and officers or partners thereof if all the securities so transferred remain subject to the lock-up restriction and (2) allow the exercise or conversion of any security if all the securities received remain subject to the lock-up restriction for the remainder of the time period.

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The Rule Amendments also provide an exception to the lock-up for fair price derivatives acquired in connection with a public offering that are not deemed to be underwriting compensation.<sup>4</sup> Nevertheless, when an underwriter or related person acquires unregistered equity securities of an issuer as the result of the settlement of such a fair price derivative contract, the unregistered equity securities are subject to the lock-up provision of the Rule to the same extent as any other unregistered equity securities. Some members urged NASD to exempt such acquisitions from the lock-up, noting, for example, that issuer puts in connection with repurchase programs and certain shareholder hedging transactions could be adversely affected when settled in unregistered equity securities during the 180-day period. NASD is concerned, however, that underwriters holding significant amounts of unregistered equity could dilute or manipulate the market for an issuer's securities immediately following a public offering, especially in the case of thinly traded issuers. Accordingly, the Department will consider, on a case-by-case basis, whether to exempt from the Rule those unregistered equity securities necessary as the result of settlement of fair price derivatives. In conducting such reviews, the Department will consider whether the lock-up restriction is interfering with *bona fide* hedging activity that benefits an issuer and its shareholders.

The Rule Amendments also provide an exception from the lock-up restrictions for Rule 144A securities acquired after the completion of the issuer's IPO.

#### F. NASD Affiliation

The Rule Amendments eliminate the requirement to file information on the NASD affiliation or association of every shareholder of the issuer. Instead, the Rule Amendments require members to file information on the NASD affiliation of any: (1) officer or director of the issuer; (2) beneficial owner of 5 percent or more of any class of the issuer's securities; and (3) beneficial owner of the issuer's unregistered equity securities purchased during the 180-day period immediately preceding the filing date of the public offering (except purchases through an issuer's employee stock purchase plan).

#### G. Required Filing Date

The Rule Amendments provide that the required filing date is no later than one business day after the registration statement or other offering documents are filed or submitted to the SEC, state securities commission or other regulatory authority, or if not filed, 15 days prior to the anticipated date on which offers will commence. Offerings submitted to the SEC for review on a confidential basis will be considered filed with the SEC as of the date of the confidential submission.

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## H. Review Period for Pre-Offering Compensation

The Rule Amendments provide that the receipt of securities for purposes of the Review Period will be deemed to be: (1) the date of the closing of a private placement; (2) the date a loan or credit agreement is executed; or (3) the date beneficial ownership is transferred as consideration for financial advisory or consulting services, merger or acquisition services, acting as a finder, or for any other service.

## I. Undisclosed Items of Value or Those Received After Completion of an Offering

The Rule Amendments require members to file information with the Department regarding the receipt of items of value by participating members during the 90-day period following the effective date of a registration statement. In addition, all items of value received and all arrangements entered into for the future receipt of an item of value that are not disclosed to NASD prior to the issuance of a "no objections" letter must be disclosed in order for the Department to determine whether such items of value are in fact underwriting compensation for the public offering.

## J. Valuation of Securities

The Rule, prior to the amendments discussed in this *Notice*, prohibits underwriters or related persons from receiving warrants as compensation that have an exercise price below the public offering price. The Rule Amendments eliminate this prohibition, but require such warrants to be valued in accordance with the valuation provisions in the Rule, to be included in the compensation calculations, and to be subject to the compensation limitations.

The Rule Amendments clarify that an underwriter or related person may not receive as compensation a security, a warrant, or a convertible security unless the security received or the security underlying the warrant or convertible security is identical to the security offered to the public or to a security with a *bona fide* independent market, or the security can be accurately valued in accordance with the valuation provisions in the Rule.

The Rule Amendments also clarify that the application of the valuation method depends on whether the security has an exercise or conversion price. Convertible securities with no conversion price are valued in the same manner as common stock.

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The valuation methods in the Rule provide a minimum compensation value to securities with a high exercise price. Otherwise, securities with, for example, an exercise price of 165 percent of the public offering price would have a zero valuation. The Rule Amendments provide that securities with an exercise price must have a minimum compensation value of .2 percent of the offering proceeds for each amount of securities that is up to 1 percent of the securities being offered, excluding securities subject to an overallotment option.

The Rule Amendments provide lower valuations of securities with longer lock-up restrictions. A lower value of 10 percent of the value of securities acquired as underwriting compensation will be deducted for each 180-day lock-up period beyond the mandatory 180-day lock-up period.<sup>5</sup> Transfers permitted by certain exceptions to the lock-up provisions are not permitted for securities whose valuation has been reduced by undertaking to abide by the longer lock-up periods.

#### **K. Exemptive Authority**

In reviewing the proposed Rule Amendments, commenters noted that financial services transactions are complex and sometimes have unusual or unique structures not contemplated by the Rule Amendments as drafted. These commenters urged NASD to retain flexibility in its application of the rule provisions.

In response to these comments, Rule 2710(j) provides NASD staff with the authority to provide exemptions from the Rule. Pursuant to the Rule 9600 Series, the staff, for good cause shown after taking into consideration all relevant factors, may conditionally or unconditionally grant an exemption from any provision of the Rule to the extent that such exemption is consistent with the purposes of the Rule, the protection of investors, and the public interest. In its Approval Order, the SEC concluded that this exemptive authority is reasonable and provides NASD staff the authority to exempt transactions that, although covered by the Rule, the Rule was not intended to address.<sup>6</sup>

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## Endnotes

- 1 See Release No. 34-48989 (SR-NASD-2000-04) (December 23, 2003), 68 FR 75684 (December 31, 2003) (Approval Order).
- 2 An exception to this general principle would be a put option or other derivative instrument that is entered into by an issuer with an underwriter or related person in connection with a publicly disclosed share repurchase program. The public disclosure and transparent nature of the repurchase program distinguish the derivative transaction in support of the program from other privately negotiated transactions between the investment bankers and the issuer during the Review Period.
- 3 NASD staff recognizes that the fact that a debt security or derivative instrument turns out to be more or less favorable to a party as the result of unanticipated market movements or other events subsequent to entry into a transaction would not necessarily mean that the transaction was done at an unfair price or that it could necessarily be characterized as underwriting compensation.
- 4 Fair price derivatives acquired in transactions unrelated to a public offering are not "items of value," and accordingly not subject to the lock-up restrictions.
- 5 For example, the underwriting compensation value of securities with a value of 2.50 percent will be reduced to 2.25 percent if the securities are restricted for one year from the effective date and to 2 percent if the securities are restricted for 18 months following the effective date.
- 6 See Approval Order, 68 FR at 75701. The Department generally would not use its exemptive authority to exclude transactions that narrowly fail to meet one or more criteria of the Rule.

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## ATTACHMENT A

New text is underlined; deletions are in brackets.

### 2710. Corporate Financing Rule - Underwriting Terms and Arrangements

(a) Definitions

For purposes of this Rule, the following terms shall have the meanings stated below. The definitions in Rule 2720 are incorporated herein by reference.

(1) Issuer

The issuer of the securities offered to the public, any selling security holders offering securities to the public, any affiliate of the issuer or selling security holder, and the officers or general partners, directors, employees and security holders thereof[;].

(2) Net Offering Proceeds

Offering proceeds less all expenses of issuance and distribution[;].

(3) Offering Proceeds

Public offering price of all securities offered to the public, not including securities subject to any overallotment option, securities to be received by the underwriter and related persons, or securities underlying other securities[;].

(4) Participating Member(s)

Any NASD member that is participating in a public offering, any associated person of the member, any members of their immediate family, and any affiliate of the member.

[(4)] (5) Participation or Participating in a Public Offering

Participation in the preparation of the offering or other documents, participation in the distribution of the offering on an underwritten, non-underwritten, or any other basis, furnishing of customer and/or broker lists for solicitation, or participation in any advisory or consulting capacity to the issuer related to the offering, but not the preparation of an appraisal in a savings and loan conversion or a bank offering or the preparation of a fairness opinion pursuant to SEC Rule 13e-3[; and].

[(5)] (6) Underwriter and Related Persons

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[Includes underwriters,] Consists of underwriter's counsel, financial consultants and advisors, finders, [members of the selling or distribution group,] any participating member [participating in the public offering], and any [and all] other persons [associated with or] related to any participating member [and members of the immediate family of any of the aforementioned persons].

(7) Listed Securities

Securities meeting the listing standards to trade on the national securities exchanges identified in SEC Rule 146, markets registered with the SEC under Section 6 of the Exchange Act, and any offshore market that is a "designated offshore securities market" under Rule 902(b) of SEC Regulation S.

(8) Derivative Instruments

A derivative instrument is any "eligible OTC derivative instrument" as defined in SEC Rule 3b-13(a)(1), (2) and (3).

(9) Fair Price

A derivative instrument or non-convertible or non-exchangeable debt security has been acquired or entered into at a fair price for purposes of subparagraphs (b)(6)(A)(iv), (c)(3)(B)(vi) and (vii), and (e)(5) if the underwriters and related persons have priced the debt security or derivative instrument in good faith; on an arm's length, commercially reasonable basis; and in accordance with pricing methods and models and procedures used in the ordinary course of their business for pricing similar transactions. A derivative instrument or other security received for acting as a private placement agent for the issuer, for providing or arranging a loan, credit facility, merger, acquisition or any other service, including underwriting services, is not included within this "fair price" definition.

(10) Required Filing Date

The required filing date shall be the dates provided in subparagraph (b)(4), and for a public offering exempt from filing under subparagraph (b)(7), the required filing date for purposes of subparagraph (d) and (g) shall be the date the public offering would have been required to be filed with the NASD but for the exemption.

(b) Filing Requirements



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(1) - (3) No change.

(4) Requirement for Filing

(A) Unless filed by the issuer, the managing underwriter, or another member, a member that anticipates participating in a public offering of securities subject to this Rule shall file with [the Association] NASD the documents and information with respect to the offering specified in subparagraphs (5) and (6) below:

(i) no later than one business day after [the filing of] any such documents are filed with or submitted to:

[(i)] a. [with]the Commission; or

[(ii)] b. [with the] any state securities commission or  
other regulatory authority; or

[(iii)] with any other regulatory authority; or

[(iv)] [(ii)] if not filed with or submitted to any regulatory authority, at least fifteen [(15)] business days prior to the anticipated [offering] date on which offers will commence.

(B) No [offering] sales of securities subject to this Rule shall commence unless:

(i) the documents and information specified in subparagraphs (5) and (6) below have been filed with and reviewed by [the Association] NASD; and

(ii) No change.

(C) No change.

(5) No change.

(6) Information Required to be Filed

(A) Any person filing documents with the NASD that are required to be filed under paragraph (b)(4) above shall provide the following information with respect to the offering through [the Association's] NASD's electronic filing system:

(i) - (ii) No change.

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(iii) a statement of the association or affiliation with any member of any officer[,], or director of the issuer, of any [or security holder] beneficial owner of [the issuer in an initial public offering of equity securities, and with respect to any other offering provide such information with respect to any officer, director or security holder of five percent] 5% or more of any class of the issuer's securities, and of any beneficial owner of the issuer's unregistered equity securities that were acquired during the 180-day period immediately preceding the required filing date of the public offering, except for purchases described in subparagraph (c)(3)(B)(iv) below. This statement must identify [to include]:

a. [the identity of] the person;

b. [the identity of] the member and whether such member is participating in any capacity in the public offering; and

c. the number of equity securities or the face value of debt securities owned by such person, the date such securities were acquired, and the price paid for such securities.

(iv) [a statement addressing the factors in subparagraphs (c)(4)(C) and (D), where applicable;]

[(v)] a detailed explanation of any other arrangement entered into during the [12-month] 180-day period immediately preceding the required filing date of the public offering, which arrangement provides for the receipt of any item of value [and/]or the transfer of any warrants, options, or other securities from the issuer to the underwriter and related persons, provided however: [;and]

a. information regarding debt securities and derivative instruments not considered an item of value under subsection (c)(3)(B)(vi) and (vii) is not required to be filed; and

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b. information initially filed in connection with debt securities and derivative instruments acquired or entered into for a "fair price" as defined in subsection (a)(9), but not excluded from items of value under subsection (c)(3)(B)(vi) or (vii), may be limited to a brief description of the transaction (additional information may be required in the review process) and a representation by the member that a registered principal or senior manager on behalf of the member has determined that the transaction was or (if the pricing terms have not been set) will be entered into at a fair price as defined in subsection (a)(9).

(v) a statement demonstrating compliance with all of the criteria of an exception from underwriting compensation in subparagraph (d)(5) below, when applicable; and

(vi) a detailed explanation and any documents related to:

a. the modification of any information or representation previously provided to the NASD or of any item of underwriting compensation, including the information required in subparagraph (b)(6)(A)(iii) above with respect to any securities of the issuer acquired subsequent to the required filing date and prior to the effectiveness or commencement of the offering[,] ; or

b. any new arrangement that provides for the receipt of any additional item of value by any participating member subsequent to the [review and approval of such compensation] issuance of an opinion of no objections to the underwriting terms and arrangements by [the Association] NASD and within 90 days immediately following the date of effectiveness or commencement of sales of the public offering, provided, however, that information filed in

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connection with debt securities and derivative instruments acquired or entered into for a "fair price" as defined in subsection (a)(9) may be limited as described in subsection (b)(6)(A)(iv)b.

(vii) any other information required to be filed under this Rule.

(B) No change.

(7) - (11) No change.

(c) Underwriting Compensation and Arrangements

(1) General

No member or person associated with a member shall participate in any manner in any public offering of securities in which the underwriting or other terms or arrangements in connection with or relating to the distribution of the securities, or the terms and conditions related thereto, are unfair or unreasonable.

(2) Amount of Underwriting Compensation

(A) No member or person associated with a member shall receive an amount of underwriting compensation in connection with a public offering [which] that is unfair or unreasonable and no member or person associated with a member shall underwrite or participate in a public offering of securities if the underwriting compensation in connection with the public offering is unfair or unreasonable.

(B) – (D) No change.

(E) The maximum amount of compensation (stated as a percentage of the dollar amount of the offering proceeds) [which] that is considered fair and reasonable generally will vary directly with the amount of risk to be assumed by [the underwriter and related persons] participating members and inversely with the dollar amount of the offering proceeds.

(3) Items of [Compensation] Value

(A) For purposes of determining the amount of underwriting compensation received or to be received by the underwriter and related persons pursuant to subparagraph (c)(2) above, the following items and all

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other items of value received or to be received by the underwriter and related persons in connection with or related to the distribution of the public offering, as determined pursuant to [sub]paragraph [(4)] (d) below shall be included:

(i) - (iii) No change.

(iv) finder's fees, whether in the form of cash, securities or any other item of value;

(v) wholesaler's fees;

(vi) financial consulting and advisory fees, whether in the form of cash, securities, or any other item of value;

(vii) common or preferred stock, options, warrants, and other equity securities, including debt securities convertible to or exchangeable for equity securities, [including securities] received [as underwriting compensation, for example]:

a. [in connection with a] for acting as private placement agent [of securities] for the issuer;

b. for providing or arranging a loan, credit facility [bridge financing] merger or acquisition services, or any other service for the issuer;

[c. as a finder's fee;]

[d. for consulting services to the issuer; and]

[e.] c. [securities purchased] as an investment in a private placement made by the issuer; or

d. at the time of the public offering.

(viii) special sales incentive items [in compliance with subparagraph (6)(B)(xi)];

(ix) any right of first refusal provided to [the underwriter and related persons] any participating member to underwrite or participate in future public offerings, private placements or other financings, which will have a compensation value of 1% of the offering proceeds or that dollar amount contractually agreed to by the issuer and underwriter to waive or terminate the right of first refusal;

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(x) No change.

(xi) commissions, expense reimbursements, or other compensation to be received by the underwriter and related persons as a result of the exercise or conversion, within twelve [(12)] months following the effective date of the offering, of warrants, options, convertible securities, or similar securities distributed as part of the public offering;

(xii) fees of a qualified independent underwriter; and

(xiii) compensation, including expense reimbursements, previously paid [in the six (6) months prior to the initial or amended filing of the prospectus or similar documents] to any member in connection with a [or person associated with a member for a] proposed public offering that was not completed[.], unless the member does not participate in the revised public offering.

(B) Notwithstanding subparagraph (c)(3)(A) above, the following shall not be considered an item of value:

(i) [E] expenses customarily borne by an issuer, such as printing costs; SEC, "blue sky" and other registration fees; [the Association] NASD filing fees; and accountant's fees, [shall be excluded from underwriter's compensation] whether or not paid through [an underwriter] a participating member;

(ii) cash compensation for acting as placement agent for a private placement or for providing a loan, credit facility, or for services in connection with a merger/acquisition;

(iii) listed securities purchased in public market transactions;

(iv) securities acquired through any stock bonus, pension, or profit-sharing plan that qualifies under Section 401 of the Internal Revenue Code;

(v) securities acquired by an investment company registered under the Investment Company Act of 1940;

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(vi) non-convertible or non-exchangeable debt securities acquired for a fair price in the ordinary course of business in transactions unrelated to the public offering; and

(vii) derivative instruments entered into for a fair price in the ordinary course of business in a transaction unrelated to the public offering.

[(4)] (d) Determination of Whether [Compensation Is Received in Connection with the Offering] Items of Value Are Included In Underwriting Compensation

[(A)] (1) Pre-Offering Compensation

All items of value received [or to be received] and all arrangements entered into for the future receipt of an item of value by the underwriter and related persons during the [twelve (12) month] period commencing 180 days immediately preceding the required filing date of the registration statement or similar document pursuant to subparagraph (b)(4) above[, and at the time of and subsequent to] until the date of effectiveness or commencement of sales of the public offering[, ] will be [examined to determine whether such items of value are] considered to be underwriting compensation in connection with the public offering [and, if received during the six (6) month period immediately preceding the filing of the registration statement or similar document, will be presumed to be underwriting compensation received in connection with the offering, provided, however, that such presumption may be rebutted on the basis of information satisfactory to the Association to support a finding that the receipt of an item is not in connection with the offering and shall not include cash discounts or commissions received in connection with a prior distribution of the issuer's securities].

(2) Undisclosed and Post-Offering Compensation

All items of value received and all arrangements entered into for the future receipt of an item of value by any participating member that are not disclosed to the NASD prior to the date of effectiveness or commencement of sales of a public offering, including items of value received subsequent to the public offering, are subject to post-offering review to determine whether such items of value are, in fact, underwriting compensation for the public offering.

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[(B) Items of value received by an underwriter and related person more than twelve (12) months immediately preceding the date of filing of the registration statement or similar document will be presumed not to be underwriting compensation. However, items received prior to such twelve (12) month period may be included as underwriting compensation on the basis of information to support a finding that receipt of the item is in connection with the offering.]

[(C) For purposes of determining whether any item of value received or to be received by the underwriter and related persons is in connection with or related to the distribution of the public offering, the following factors, as well as any other relevant factors and circumstances, shall be considered:]

[(i) the length of time between the date of filing of the registration statement or similar document and:]

[a. the date of the receipt of the item of value;]

[b. the date of any contractual agreement for services for which the item of value was or is to be received; and]

[c. the date the performance of the service commenced, with a shorter period of time tending to indicate that the item is received in connection with the offering;]

[(ii) the details of the services provided or to be provided for which the item of value was or is to be received;]

[(iii) the relationship between the services provided or to be provided for which the item of value was or is to be received and:]

[a. the nature of the item of value;]

[b. the compensation value of the item; and]

[c. the proposed public offering;]

[(iv) the presence or absence of arm's length bargaining or the existence of any affiliate relationship between the issuer and the recipient of the item of value, with the absence of arm's length bargaining or the presence of any affiliation tending to indicate that the item of value is received in connection with the offering.]



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[(D) For purposes of determining whether securities received or to be received by the underwriter and related persons are in connection with or related to the distribution of the public offering, the factors in subparagraph (C) above and the following factors shall be considered:]

[ (i) any disparity between the price paid and the offering price or the market price, if a bona fide independent market exists at the time of acquisition, with a greater disparity tending to indicate that the securities constitute compensation;]

[ (ii) the amount of risk assumed by the recipient of the securities, as determined by:]

[ a. the restrictions on exercise and resale;]

[ b. the nature of the securities (e.g., warrant, stock, or debt); and]

[ c. the amount of securities, with a larger amount of readily marketable securities without restrictions on resale or a warrant for securities tending to indicate that the securities constitute compensation; and]

[ (iii) the relationship of the receipt of the securities to purchases by unrelated purchasers on similar terms at approximately the same time, with an absence of similar purchases tending to indicate that the securities constitute compensation.]

[(E) Notwithstanding the provisions of subparagraph (3)(A)(vi) above, financial consulting and advisory fees may be excluded from underwriting compensation upon a finding by the Association, on the basis of information satisfactory to it, that an ongoing relationship between the issuer and the underwriter and related person has been established at least twelve (12) months prior to the filing of the registration statement or similar document or that the relationship, if established subsequent to that time, was not entered into in connection with the offering, and that actual services have been or will be rendered which were not or will not be in connection with or related to the offering.]

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(3) Date of Receipt of Securities

Securities of the issuer acquired by the underwriter and related persons will be considered to be received for purposes of subparagraphs (d)(1) and (d)(5) as of the date of the:

(A) closing of a private placement, if the securities were purchased in or received for arranging a private placement; or

(B) execution of a written contract with detailed provisions for the receipt of securities as compensation for a loan, credit facility, or put option; or

(C) transfer of beneficial ownership of the securities, if the securities were received as compensation for consulting or advisory services, merger or acquisition services, acting as a finder, or for any other service.

(4) Definitions

For purposes of subparagraph (d)(5) below, the following terms will have the meanings stated below.

(A) An entity:

(i) includes a group of legal persons that either:

a. are contractually obligated to make co-investments and have previously made at least one such investment; or

b. have filed a Schedule 13D or 13G with the SEC that identifies the legal persons as members of a group that have agreed to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer in connection with a previous investment; and

(ii) may make its investment or loan through a wholly owned subsidiary (except when the entity is a group of legal persons).

(B) An institutional investor is any individual or legal person that has at least \$50 million invested in securities in the aggregate in its portfolio or under management, including investments held by its wholly owned subsidiaries; provided that no participating members direct or otherwise manage the institutional investor's investments or have an equity interest in the institutional

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investor, either individually or in the aggregate, that exceeds 5% for a publicly owned entity or 1% for a nonpublic entity.

(C) A bank or insurance company is only the regulated entity, not its subsidiaries or other affiliates.

(D) A right of preemption means the right of a shareholder to acquire additional securities in the same company in order to avoid dilution when additional securities are issued, pursuant to:

(i) any option, shareholder agreement, or other contractual right entered into at the time of a purchase of securities;

(ii) the terms of the security purchased;

(iii) the issuer's charter or by-laws; or

(iv) the domestic law of a foreign jurisdiction that regulates the issuance of the securities.

(E) "Total equity securities" means the aggregate of the total shares of:

(i) common stock outstanding of the issuer; and

(ii) common stock of the issuer underlying all convertible securities outstanding that convert without the payment of any additional consideration.

#### (5) Exceptions From Underwriting Compensation

Notwithstanding subparagraph (d)(1) above, the following items of value are excluded from underwriting compensation (but are subject to the lock-up restriction in subparagraph (g)(1) below), provided that the member does not condition its participation in the public offering on an acquisition of securities under an exception and any securities purchased are purchased at the same price and with the same terms as the securities purchased by all other investors.

(A) Purchases and Loans by Certain Entities - Securities of the issuer purchased in a private placement or received as compensation for a loan or credit facility before the required filing date of the public offering pursuant to subparagraph (b)(4) above by certain entities if:

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(i) each entity:

a. either:

1. manages capital contributions or commitments of \$100 million or more, at least \$75 million of which has been contributed or committed by persons that are not participating members;

2. manages capital contributions or commitments of \$25 million or more, at least 75% of which has been contributed or committed by persons that are not participating members;

3. is an insurance company as defined in Section 2(a)(13) of the Securities Act or is a foreign insurance company that has been granted an exemption under this Rule; or

4. is a bank as defined in Section 3(a)(6) of the Act or is a foreign bank that has been granted an exemption under this Rule; and

b. is a separate and distinct legal person from any member and is not registered as a broker/dealer;

c. makes investments or loans subject to the evaluation of individuals who have a contractual or fiduciary duty to select investments and loans based on the risks and rewards to the entity and not based on opportunities for the member to earn investment banking revenues;

d. does not participate directly in investment banking fees received by any participating member for underwriting public offerings; and

e. has been primarily engaged in the business of making investments in or loans to other companies; and

(ii) all entities related to each member in acquisitions that

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qualify for this exception do not acquire more than 25% of the issuer's total equity securities during the review period in subparagraph (d)(1), calculated immediately following the transaction.

(B) Investments In and Loans to Certain Issuers - Securities of the issuer purchased in a private placement or received as compensation for a loan or credit facility before the required filing date of the public offering pursuant to subparagraph (b)(4) above by certain entities if:

(i) each entity:

a. manages capital contributions or commitments of at least \$50 million;

b. is a separate and distinct legal person from any member and is not registered as a broker/dealer;

c. does not participate directly in investment banking fees received by the member for underwriting public offerings;  
and

d. has been primarily engaged in the business of making investments in or loans to other companies; and

(ii) institutional investors beneficially own at least 33% of the issuer's total equity securities, calculated immediately prior to the transaction;

(iii) the transaction was approved by a majority of the issuer's board of directors and a majority of any institutional investors, or the designees of institutional investors, that are board members; and

(iv) all entities related to each member in acquisitions that qualify for this exception do not acquire more than 25% of the issuer's total equity securities, calculated immediately following the transaction.

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(C) Private Placements With Institutional Investors - Securities of the issuer purchased in, or received as placement agent compensation for, a private placement before the required filing date of the public offering pursuant to subparagraph (b)(4) above if:

(i) institutional investors purchase at least 51% of the "total offering" (comprised of the total number of securities sold in the private placement and received or to be received as placement agent compensation by any member);

(ii) an institutional investor was the lead negotiator or, if the terms were not negotiated, was the lead investor with the issuer to establish or approve the terms of the private placement; and

(iii) underwriters and related persons did not, in the aggregate, purchase or receive as placement agent compensation more than 20% of the "total offering" (excluding purchases by any entity qualified under subparagraph (d)(5)(A) above).

(D) Acquisitions and Conversions to Prevent Dilution - Securities of the issuer if:

(i) the securities were acquired as the result of:

a. a right of preemption that was granted in connection with securities that were purchased either:

1. in a private placement and the securities are not deemed by the NASD to be underwriting compensation; or

2. from a public offering or the public market; or

b. a stock-split or a pro-rata rights or similar offering;

or

c. the conversion of securities that have not been deemed by the NASD to be underwriting compensation; and

(ii) the only terms of the purchased securities that are different

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from the terms of securities purchased by other investors are pre-existing contractual rights that were granted in connection with a prior purchase;

(iii) the opportunity to purchase in a rights offering or pursuant to a right of preemption, or to receive additional securities as the result of a stock-split or conversion was provided to all similarly situated securityholders; and

(iv) the amount of securities purchased or received did not increase the recipient's percentage ownership of the same generic class of securities of the issuer or of the class of securities underlying a convertible security calculated immediately prior to the investment, except in the case of conversions and passive increases that result from another investor's failure to exercise its own rights.

(E) Purchases Based On A Prior Investment History - Purchases of securities of the issuer if:

(i) the amount of securities purchased did not increase the purchaser's percentage ownership of the same generic class of securities of the issuer or of the class of securities underlying a convertible security calculated immediately prior to the investment; and

(ii) an initial purchase of securities of the issuer was made at least two years and a second purchase was made more than 180 days before the required filing date of the public offering pursuant to subparagraph (b)(4) above.

[(5)] (e) Valuation of Non-Cash Compensation

For purposes of determining the value to be assigned to securities received as underwriting compensation, the following criteria and procedures shall be applied[:].

[(A)] No underwriter and related person may receive a security or a warrant for a security as compensation in connection with the distribution of a public offering that is different than the security to be offered to the public

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unless the security received as compensation has a bona fide independent market, provided, however, that: (i) in exceptional and unusual circumstances, upon good cause shown, such arrangement may be permitted by the Association; and (ii) in an offering of units, the underwriter and related persons may only receive a warrant for the unit offered to the public where the unit is the same as the public unit and the terms are no more favorable than the terms of the public unit.]

(1) Limitation on Securities Received Upon Exercise or Conversion of Another Security

An underwriter and related person may not receive a security (including securities in a unit), a warrant for a security, or a security convertible into another security as underwriting compensation in connection with a public offering unless:

(A) the security received or the security underlying the warrant or convertible security received is identical to the security offered to the public or to a security with a bona fide independent market; or

(B) the security can be accurately valued, as required by subparagraph (f)(2)(l) below.

[(B)] (2) Valuation of Securities That Do Not Have an Exercise or Conversion Price [s] Securities that [are not options, warrants or convertible securities] do not have an exercise or conversion price shall have a compensation value [be valued on the basis of] based on:

[(i)] (A) the difference between [the per security cost and]:

(i) either the market price per security on the date of acquisition, [where a] or, if no bona fide independent market exists for the security, [or] the [proposed (and actual)] public offering price per security; and

(ii) the per security cost;

[(ii)] (B) multiplied by the number of securities received or to be received as underwriting compensation;



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[(iii)] (C) divided by the offering proceeds; and

[(iv)] (D) multiplied by one hundred [(100)].

(3) Valuation of Securities That Have an Exercise or Conversion Price

[(C) o] Options, warrants or convertible securities that have an exercise or conversion price ("warrants") shall [be valued on the basis of] have a compensation value based on the following formula:

[(i)] (A) the [proposed (and actual)] public offering price per security multiplied by .65 [(65%)];

[(ii)] (B) minus the [difference between] resultant of the exercise or conversion price per [security] warrant [and] less either:

(i) the market price per security on the date of acquisition, where a bona fide independent market exists for the security, or

(ii) the [proposed (and actual)] public offering price per security;

[(iii)] (C) divided by two [(2)];

[(iv)] (D) multiplied by the number of securities underlying the warrants[, options, and convertible securities received or to be received as underwriting compensation];

[(v)] (E) less the total price paid for the [securities] warrants;

[(vi)] (F) divided by the offering proceeds; and

[(vii)] (G) multiplied by one hundred [(100)].;

(H) provided, however, that, notwithstanding subparagraph (e)(4) below, such warrants shall have a compensation value of at least .2% of the offering proceeds for each amount of securities that is up to 1% of the securities being offered to the public (excluding securities subject to an overallotment option).

(4) Valuation Discount For Securities With a Longer Resale Restriction

[(D) a lower value equal to 80% and 60% of the calculated value shall be assigned if securities, and where relevant, underlying securities, are or will be restricted from sale, transfer, assignment or other disposition for a period of

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one and two years, respectively, beyond the one-year period of restriction required by subparagraph (7)(A)(i) below.]

A lower value equal to 10% of the calculated value shall be deducted for each 180-day period that the securities or underlying securities are restricted from sale or other disposition beyond the 180-day period of the lock-up restriction required by subparagraph (g)(1) below. The transfers permitted during the lock-up restriction by subparagraphs (g)(2)(A)(iii)-(iv) are not available for such securities.

(5) Valuation of Items of Value Acquired in Connection with a Fair Price Derivative or Debt Transaction

Any debt or derivative transaction acquired or entered into at a "fair price" as defined in subsection (a)(9) and item of value received in or receivable in the settlement, exercise or other terms of such debt or derivative transaction shall not have a compensation value for purposes of determining underwriting compensation. If the actual price for the debt or derivative security is not a fair price, compensation will be calculated pursuant to this subsection (e) or based on the difference between the fair price and the actual price.

[(6)] (f) Unreasonable Terms and Arrangements

[(A)] (1) General

No member or person associated with a member shall participate in any manner in a public offering of securities after any arrangement proposed in connection with the public offering, or the terms and conditions relating thereto, has been determined to be unfair or unreasonable pursuant to this Rule or inconsistent with any By-Law or any Rule or regulation of [the Association] NASD.

[(B)] (2) Prohibited Arrangements

Without limiting the foregoing, the following terms and arrangements, when proposed in connection with [the distribution of] a public offering of securities, shall be unfair and unreasonable[;].

[(i)] (A) [a]Any accountable expense allowance granted by an issuer to the underwriter and related persons [which] that includes payment for general overhead, salaries, supplies, or similar expenses of the underwriter incurred in the normal conduct of business[;].

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[(ii)] (B) [a]Any non-accountable expense allowance in excess of [three (3) percent;] 3% of offering proceeds.

[(iii)] (C) [a]Any payment of commissions or reimbursement of expenses directly or indirectly to the underwriter and related persons prior to commencement of the public sale of the securities being offered, except a reasonable advance against out-of-pocket accountable expenses actually anticipated to be incurred by the underwriter and related persons, which advance is reimbursed to the issuer to the extent not actually incurred[;].

[(iv)] (D) [t]The payment of any compensation by an issuer to a member or person associated with a member in connection with an offering of securities [which] that is not completed according to the terms of agreement between the issuer and underwriter, except those negotiated and paid in connection with a transaction that occurs in lieu of the proposed offering as a result of the efforts of the underwriter and related persons and provided, however, that the reimbursement of out-of-pocket accountable expenses actually incurred by the member or person associated with a member shall not be presumed to be unfair or unreasonable under normal circumstances[;].

[(v)] (E) [a]Any "tail fee" arrangement granted to the underwriter and related persons that has a duration of more than two [(2)] years from the date the member's services are terminated, in the event that the offering is not completed in accordance with the agreement between the issuer and the underwriter and the issuer subsequently consummates a similar transaction, except that a member may demonstrate on the basis of information satisfactory to [the Association] NASD that an arrangement of more than two [(2)] years is not unfair or unreasonable under the circumstances.

[(vi)] (F) [a]Any right of first refusal provided to the underwriter or related persons to underwrite or participate in future public offerings, private placements or other financings [which] that:

[a.] (i) has a duration of more than three [(3)] years from the [effective] date of effectiveness or commencement of sales of the public offering; or

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[b.] (ii) has more than one opportunity to waive or terminate the right of first refusal in consideration of any payment or fee[;].

[(vii)] (G) [a] Any payment or fee to waive or terminate a right of first refusal regarding future public offerings, private placements or other financings provided to the underwriter and related persons [which] that:

[a.] (i) has a value in excess of the greater of [one percent (1%)] of the offering proceeds in the public offering where the right of first refusal was granted (or an amount in excess of [one percent] 1% if additional compensation is available under the compensation guideline of the original offering) or [five percent (5%)] of the underwriting discount or commission paid in connection with the future financing (including any overallotment option that may be exercised), regardless of whether the payment or fee is negotiated at the time of or subsequent to the original public offering; or

[b.] (ii) is not paid in cash[;].

[(viii)] (H) The terms or the exercise of the terms of an agreement for the receipt by the underwriter and related persons of underwriting compensation consisting of any option, warrant or convertible security [which] that:

[a.] (i) is exercisable or convertible more than five [(5)] years from the effective date of the offering;

[b.] is exercisable or convertible at a price below either the public offering price of the underlying security or, if a bona fide independent market exists for the security or the underlying security, the market price at the time of receipt;

[c.] (ii) is not in compliance with subparagraph [(5)(A)] (e)(1) above;

[d.] (iii) has more than one demand registration right at the issuer's expense;

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[e.] (iv) has a demand registration right with a duration of more than five [(5)] years from the [effective] date of effectiveness or the commencement of sales of the public offering;

[f.] (v) has a piggyback registration right with a duration of more than seven [(7)] years from the [effective] date of effectiveness or the commencement of sales of the public offering;

[g.] (vi) has anti-dilution terms [designed to provide] that allow the underwriter and related persons [with disproportionate rights, privileges and economic benefits which are not provided to the purchasers of the securities offered to the public (or the public shareholders, if in compliance with subparagraph (5)(A) above)] to receive more shares or to exercise at a lower price than originally agreed upon at the time of the public offering, when the public shareholders have not been proportionally affected by a stock split, stock dividend, or other similar event; or

[h.] (vii) has anti-dilution terms [designed to provide for the receipt or accrual of] that allow the underwriter and related persons to receive or accrue cash dividends prior to the exercise or conversion of the security[; or].

[i. is convertible or exercisable or otherwise is on terms more favorable than the terms of the securities being offered to the public;]

[(ix)] (l) [t]The receipt by the underwriter and related persons of any item of compensation for which a value cannot be determined at the time of the offering[;].

[(x)] (j) [w]When proposed in connection with the distribution of a public offering of securities on a “firm commitment” basis, any over allotment option providing for the over allotment of more than [fifteen (15) percent] 15% of the amount of securities being offered, computed excluding any securities offered pursuant to the over allotment option[;].

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[xi] stock numerical limitation. The receipt by the underwriter and related persons of securities which constitute underwriting compensation in an aggregate amount greater than ten (10) percent of the number or dollar amount of securities being offered to the public, which is calculated to exclude:]

[a. any securities deemed to constitute underwriting compensation;]

[b. any securities issued pursuant to an overallotment option;]

[c. in the case of a "best efforts" offering, any securities not actually sold; and]

[d. any securities underlying warrants, options, or convertible securities which are part of the proposed offering, except where acquired as part of a unit;]

[(xii)] ~~(K)~~ [t]The receipt by a member or person associated with a member, pursuant to an agreement entered into at any time before or after the effective date of a public offering of warrants, options, convertible securities or units containing such securities, of any compensation or expense reimbursement in connection with the exercise or conversion of any such warrant, option, or convertible security in any of the following circumstances:

[a.](i) the market price of the security into which the warrant, option, or convertible security is exercisable or convertible is lower than the exercise or conversion price;

[b.](ii) the warrant, option, or convertible security is held in a discretionary account at the time of exercise or conversion, except where prior specific written approval for exercise or conversion is received from the customer;

[c.](iii) the arrangements whereby compensation is to be paid are not disclosed:

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[1.]a. in the prospectus or offering circular by which the warrants, options, or convertible securities are offered to the public, if such arrangements are contemplated or any agreement exists as to such arrangements at that time, and

[2.]b. in the prospectus or offering circular provided to security holders at the time of exercise or conversion; or

[d.](iv) the exercise or conversion of the warrants, options or convertible securities is not solicited by the underwriter or related person, provided however, that any request for exercise or conversion will be presumed to be unsolicited unless the customer states in writing that the transaction was solicited and designates in writing the broker/dealer to receive compensation for the exercise or conversion[;].

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

(xiv) (M) [f]For a member or person associated with a member to participate in a public offering of real estate investment trust securities, as defined in Rule 2340(c)(4), unless the trustee will disclose in each annual report distributed to investors pursuant Section 13(a) of the Act a per share estimated value of the trust securities, the method by which it was developed, and the date of the data used to develop the estimated value.

(C) In the event that the underwriter and related persons receive securities deemed to be underwriting compensation in an amount constituting unfair and unreasonable compensation pursuant to the stock numerical limitation in subparagraph (B)(ix) above, the recipient shall return any excess securities to the issuer or the source from which received at cost and without recourse, except that in exceptional and unusual circumstances, upon good cause shown, a different arrangement may be permitted.]

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[(7)] (g) Lock-Up Restriction[s] on Securities

[(A) No member or person associated with a member shall participate in any public offering which does not comply with the following requirements:]

[(i) securities deemed to be underwriting compensation shall not be sold, transferred, assigned, pledged or hypothecated by any person, except as provided in subparagraph (B) below, for a period of (a) one year following the effective date of the offering. However, securities deemed to be underwriting compensation may be transferred to any member participating in the offering and the bona fide officers or partners thereof and securities which are convertible into other types of securities or which may be exercised for the purchase of other securities may be so transferred, converted or exercised if all securities so transferred or received remain subject to the restrictions specified herein for the remainder of the initially applicable time period;]

[(ii) certificates or similar instruments representing securities restricted pursuant to subparagraph (i) above shall bear an appropriate legend describing the restriction and stating the time period for which the restriction is operative; and]

[(iii) securities to be received by a member as underwriting compensation shall only be issued to a member participating in the offering and the bona fide officers or partners thereof.]

(1) Lock-Up Restriction

In any public equity offering, other than a public equity offering by an issuer that can meet the requirements in subparagraphs (b)(7)(C)(i) or (ii) any common or preferred stock, options, warrants, and other equity securities of the issuer, including debt securities convertible to or exchangeable for equity securities of the issuer, that are unregistered and acquired by an underwriter and related person during 180 days prior to the required filing date, or acquired after the filing of the registration statement and deemed to be underwriting compensation by the NASD, and securities excluded from



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underwriting compensation pursuant to subparagraph (d)(5) above, shall not be sold during the offering, or sold, transferred, assigned, pledged, or hypothecated, or be the subject of any hedging, short sale, derivative, put, or call transaction that would result in the effective economic disposition of the securities by any person for a period of 180 days immediately following the date of effectiveness or commencement of sales of the public offering, except as provided in subparagraph (g)(2) below.

(2) Exceptions to Lock-Up Restriction

[ (B) The provisions of subparagraph (A) notwithstanding:]

Notwithstanding subparagraph (g)(1) above, the following shall not be prohibited:

(A) the transfer of any security:

(i) by operation of law or by reason of reorganization of the issuer [shall not be prohibited.];

(ii) to any member participating in the offering and the officers or partners thereof, if all securities so transferred remain subject to the lock-up restriction in subparagraph (g)(1) above for the remainder of the time period;

[ (C) Venture capital restrictions. When a member participates in the initial public offering of an issuer's securities, such member or any officer, director, general partner, controlling shareholder or subsidiary of the member or subsidiary of such controlling shareholder or a member of the immediate family of such persons, who beneficially owns any securities of said issuer at the time of filing of the offering, shall not sell such securities during the offering or sell, transfer, assign or hypothecate such securities for ninety (90) days following the effective date of the offering unless:]

(i) the price at which the issue is to be distributed to the public is established at a price no higher than that recommended by a qualified independent underwriter who does not beneficially own 5% or more of the outstanding voting securities of the issuer, who shall also participate in the preparation of the registration statement and

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the prospectus, offering circular, or similar document and who shall exercise the usual standards of "due diligence" in respect thereto; or]

[(ii)] (iii) if the aggregate amount of [such] securities of the issuer held by [such a member and its related persons enumerated above would] the underwriter or related person do not exceed 1% of the securities being offered[.];

(iv) that is beneficially owned on a pro-rata basis by all equity owners of an investment fund, provided that no participating member manages or otherwise directs investments by the fund, and participating members in the aggregate do not own more than 10% of the equity in the fund;

(v) that is not an item of value under subparagraphs (c)(3)(B)(iv) - (vii) above;

(vi) that is eligible for the limited filing requirement in subparagraph (b)(6)(A)(iv)b and has not been deemed to be underwriting compensation under the Rule;

(vii) that was previously but is no longer subject to the lock-up restriction in subparagraph (g)(1) above in connection with a prior public offering (or a lock-up restriction in the predecessor rule), provided that if the prior restricted period has not been completed, the security will continue to be subject to such prior restriction until it is completed; or

(viii) that was acquired subsequent to the issuer's initial public offering in a transaction exempt from registration under SEC Rule 144A; or

(B) the exercise or conversion of any security, if all securities received remain subject to the lock-up restriction in subparagraph (g)(1) above for the remainder of the time period.

[(8)] (h) [Conflicts of Interest] Proceeds Directed to a Member[:]

(1) Compliance With Rule 2720

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No member shall participate in a public offering of an issuer's securities where more than [ten (10) percent] 10% of the net offering proceeds, not including underwriting compensation, are intended to be paid to [members participating in the distribution of the offering or associated or affiliated persons of such members, or members of the immediate family of such persons] participating members, unless the price at which an equity issue or the yield at which a debt issue is to be distributed to the public is established pursuant to Rule 2720(c)(3).

[(A)] (2) Disclosure

All offerings included within the scope of [this] subparagraph [(8)] (h)(1) shall disclose in the underwriting or plan of distribution section of the registration statement, offering circular or other similar document that the offering is being made pursuant to the provisions of this subparagraph and, where applicable, the name of the member acting as qualified independent underwriter, and that such member is assuming the responsibilities of acting as a qualified independent underwriter in pricing the offering and conducting due diligence.

[(B)] (3) Exception From Compliance

The provisions of [this] subparagraphs [(8)] (h)(1) and (2) shall not apply to:

[(i)] (A) an offering otherwise subject to the provisions of Rule 2720;

[(ii)] (B) an offering of securities exempt from registration with the Commission under Section 3(a)(4) of the Securities Act of 1933;

[(iii)] (C) an offering of a real estate investment trust as defined in Section 856 of the Internal Revenue Code; or

[(iv)] (D) an offering of securities subject to Rule 2810, unless the net offering proceeds are intended to be paid to the above persons for the purpose of repaying loans, advances or other types of financing utilized to acquire an interest in a pre-existing company.

[(d)] (i) Non-Cash Compensation

(1) Definitions

The terms "compensation," "non-cash compensation" and "offeror" as used in this Section (d) of this Rule shall have the following meanings:

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(A) "Compensation" shall mean cash compensation and non-cash compensation.

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

(C) "Offeror" shall mean an issuer, an adviser to an issuer, an underwriter and any affiliated person of such entities.

(2) Restrictions on Non-Cash Compensation

In connection with the sale and distribution of a public offering of securities, no member or person associated with a member shall directly or indirectly accept or make payments or offers of payments of any non-cash compensation, except as provided in this provision. Non-cash compensation arrangements are limited to the following:

(A) Gifts that do not exceed an annual amount per person fixed periodically by the Board of Governors<sup>1</sup> 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 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) associated persons obtain the member's prior approval to attend the meeting and attendance by a member's associated persons is not conditioned by the member on the achievement of a sales target or any other incentives pursuant to a non-cash compensation arrangement permitted by subparagraph (d)(2)(D);

<sup>1</sup> The current annual amount fixed by the Board of Governors is \$100.

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(ii) the location is appropriate to the purpose of the meeting, which shall mean an office of the issuer or affiliate thereof, the office of the member, or a facility located in the vicinity of such office, or a regional location with respect to regional meetings;

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

(iv) the payment or reimbursement by the issuer or affiliate of the issuer is not conditioned by the issuer or an affiliate of the issuer on the achievement of a sales target or any other non-cash compensation arrangement permitted by subparagraph (d)(2)(D).

(D) Non-cash compensation arrangements between a member and its associated persons or a company that controls a member company and the member's associated persons, provided that 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

(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 (d)(2)(D).

A member shall maintain records of all non-cash compensation received by the member or its associated persons in arrangements permitted by subparagraphs (d)(2)(C)-(E). The records shall include: the names of the offerors, non-members or other members making the non-cash compensation contributions; the names of the associated persons participating in the arrangements; the nature and value of non-cash compensation received; the location of training and education meetings; and any other information that proves compliance by the member and its associated persons with subparagraph (d)(2)(C)-(E).

[e] (j) Exemptions

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Pursuant to the Rule 9600 Series, the [Association may exempt a member or person associated with a member from the provisions of this Rule] appropriate NASD staff, for good cause shown after taking into consideration all relevant factors, may conditionally or unconditionally grant an exemption from any provision of this Rule to the extent that such exemption is consistent with the purposes of the Rule, the protection of investors, and the public interest.

**2720. Distribution of Securities of Members and Affiliates – Conflicts of Interest**

(a) General

No Change

(b) Definitions

(1) - (8) No Change

(9) Immediate family - the parents, mother-in-law, father-in-law, [husband or wife] spouse, brother or sister, brother-in-law or sister-in-law, son-in-law or daughter-in-law, and children of an employee or associated person of a member, except any person other than the spouse and children who does not live in the same household as, have a business relationship with, provide material support to, or receive material support from, the employee or associated person of a member. In addition, the immediate family includes [or] any other person who [is supported, directly or indirectly, to a material extent by] either lives in the same household as, provides material support to, or receives material support from, an employee [of,] or associated person [associated, with] of a member.

# Disciplinary and Other NASD Actions

## REPORTED FOR FEBRUARY

NASD® has taken disciplinary actions against the following firms and individuals for violations of NASD rules; federal securities laws, rules, and regulations; and the rules of the Municipal Securities Rulemaking Board (MSRB). The information relating to matters contained in this *Notice* is current as of the end of January 2004.

### Firms Expelled, Individuals Sanctioned

**First Providence Financial Group, LLC (CRD #39469, Melville, New York), Kenneth Michael Klein (CRD #2080654, Registered Principal, Roslyn, New York), and Paul Gabriel Wasserman (CRD #2172075, Registered Principal, New York, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was expelled from membership with NASD, and Klein and Wasserman were barred from association with any NASD member in any capacity. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Wasserman, engaged in a distribution to the public of approximately 5.5 million shares of a stock, purchased or received from purchasers of convertible preferred shares; and, as a result, the firm received illicit proceeds of approximately \$5.5 million. The findings stated that the firm, acting through Wasserman, while engaging in the distribution of these stocks, bid for, purchased, and induced others to purchase the stock. NASD also found that the firm, acting through Klein and Wasserman, effected transactions in a stock and induced the purchase and sale of the stock by means of a manipulative, deceptive, or other fraudulent device or contrivance. In addition, NASD found that the firm, acting through Klein and Wasserman, sold shares of a stock to the public when no registration statement was filed with the Securities and Exchange Commission (SEC) or NASD's Corporate Financing Department or in effect as to the public sale of these securities. Furthermore, the findings stated that the firm, Klein, and Wasserman failed to respond to NASD requests for information, and Wasserman made material omissions and misrepresentations in connection with the sale of a common stock to retail customers. **(NASD Case #C3A030051)**

**Shelman Securities Corporation (CRD #39795, Dallas, Texas) and Mark Christopher Parman (CRD #2686104, Registered Principal, Dallas, Texas)** submitted an Offer of Settlement in which the firm was expelled from NASD membership and required to pay \$1.7 million in restitution to public customers, jointly and severally with Parman. Parman was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that they offered and sold unregistered securities in the form of limited partnership interests to customers and made misrepresentations and omissions of material facts in connection with the offerings. The findings also stated that the firm, acting through Parman, utilized interstate facilities by using telephone lines and the U.S. Mail in connection with the offer and sale of the limited partnership interests.

The findings further stated that the firm and Parman received excessive underwriting compensation and failed to disclose the underwriting compensation. In addition, NASD found that the firm and Parman failed to file intertrade offering documents with NASD. (NASD Case #C06030013)

**Stephen Investment Securities, Inc. (CRD #24374, Chesterfield, Missouri) and Mary Elizabeth Oliver (CRD #1972547, Registered Principal, Chesterfield, Missouri)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was expelled from NASD membership and Oliver was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, the firm and Oliver consented to the described sanctions and to the entry of findings that the firm, acting through Oliver, permitted her to perform duties as a registered person while her registration status was inactive due to her failure to timely complete the Regulatory Element of NASD's Continuing Education Requirements. The findings also stated that the firm, acting through Oliver, permitted an individual to be associated with the firm while he was subject to a statutory disqualification. (NASD Case #C04030066)

## Firms Fined, Individuals Sanctioned

**First Allied Securities, Inc. (CRD #32444, San Diego, California) and James Edward Zogby (CRD #2549557, Registered Principal, Pevely, Missouri)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$10,000, jointly and severally with Zogby. Zogby was also suspended from association with any NASD member in any principal or supervisory capacity for 10 business days. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that they failed to reasonably supervise a registered representative.

Zogby's suspension will begin February 17, 2004, and will conclude at the close of business March 1, 2004. (NASD Case #C8A030106)

**MONY Securities Corporation (CRD #4386, Dallas, Texas), Joseph Francis Presutti, Jr. (CRD #367520, Registered Principal, Paradise Valley, Arizona), and Irving Mestel (CRD #1172195, Registered Representative, Houston, Texas)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was fined \$35,837, including disgorgement of \$30,837 in commissions; fined \$5,000, jointly and severally with Presutti; and required to undertake to offer a customer the opportunity to exchange the Class B shares she currently holds for Class A shares at the price at which the Class A shares could have been purchased at the time of the customer's purchase of the Class B shares within 30 business days. Presutti was also suspended from association with any NASD member in any principal capacity for

20 business days. Mestel was fined \$36,867, including disgorgement of \$29,367 in commissions, fined \$7,500, and suspended from association with any NASD member in any capacity for 30 days. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that Mestel recommended that a public customer purchase more than \$1.5 million worth of Class B mutual fund shares in 10 different mutual fund families. NASD found that Mestel's recommendations were unsuitable for the customer in light of the dollar amount being invested. The findings also stated that the firm, acting through Presutti, failed to reasonably supervise Mestel in connection with his unsuitable investment recommendations to a public customer.

Mestel's suspension will begin February 17, 2004, and will conclude at the close of business March 17, 2004. Presutti's suspension will begin February 17, 2004, and will conclude at the close of business March 15, 2004. (NASD Case #C06030042)

**Murjen Financial, Inc. (CRD #100340, Westbury, New York), Michael Patrick Murphy (CRD #2596905, Registered Principal, New York, New York), and Thomas James Jennings (CRD #1902638, Registered Principal, Point Lookout, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$15,000, \$9,000 of which was jointly and severally with Murphy, and \$6,000 of which was jointly and severally with Jennings. Murphy was suspended from association with any NASD member in a principal capacity for two months and Jennings was suspended from association with any NASD member in an options principal capacity for two months. The firm, Murphy, and Jennings were also ordered to pay \$209,882.60 in partial restitution to public customers. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Murphy and Jennings, failed to supervise adequately an individual who was making unsuitable recommendations to public customers and excessively trading the customers' accounts. The findings also stated that the firm, acting through Murphy, failed to establish and maintain a supervisory system reasonably designed to achieve compliance with NASD rules against brokers making unsuitable recommendations and engaging in excessive trading.

Murphy's and Jennings' suspensions began January 20, 2004, and will conclude at the close of business March 19, 2004. (NASD Case #CLI030028)

**Share King, L.L.C. (CRD #33150, San Francisco, California) and Michael Anthony Fitzgerald (CRD #1757192, Registered Principal, Danville, California)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$30,000, jointly and severally with Fitzgerald. Fitzgerald was suspended from association with any NASD member in any capacity for 10 business days, suspended from



association with any NASD member as a financial and operations principal for 60 days, and required to requalify as a financial and operations principal by exam prior to acting in that capacity following his suspension in that capacity. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Fitzgerald, utilized the instrumentalities of interstate commerce to engage in securities business while failing to maintain minimum net capital. The findings also stated that the firm, acting through Fitzgerald, failed to accurately prepare and maintain books and records needed to support its net capital computations in that it incorrectly included an asset on its balance sheet, failed to properly reconcile its omnibus account and bank account, and improperly accrued receivables. The findings further stated that the firm, acting through Fitzgerald, failed to have on deposit in its Special Reserve Account for the Exclusive Benefit of Customers the amount required to be deposited.

Fitzgerald's suspensions will begin March 1, 2004; the suspension in any capacity will conclude at the close of business March 12, 2004; and the suspension as a financial and operations principal will conclude at the close of business April 29, 2004. (NASD Case #C01030035)

**Tejas Securities Group, Inc. (CRD #36705, Austin, Texas), Arnold Reed Durant (CRD #716150, Registered Principal, Austin, Texas), and John Franklin Garber, Jr. (CRD #3061992, Registered Principal, Austin, Texas)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was fined \$30,000, \$15,000 of which was jointly and severally with Durant, and \$10,000 of which was jointly and severally with Garber. Durant and Garber were also suspended from association with any NASD member in any principal capacity for 10 business days. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm self-cleared customer securities transactions by processing the transactions directly through the firm instead of through its clearing firm. The findings also stated that the firm, acting through Durant and Garber, failed to obtain promptly physical possession or control of all fully paid for customer securities in connection with the transactions; failed to maintain a securities received and forwarded blotter for the transactions; and failed to transmit promptly customer securities to its clearing firm. The findings further stated that the firm failed to maintain a stock record evidencing the transactions. In addition, NASD found that the respondents failed to prepare or to provide customers with monthly or quarterly account statements containing a description of any securities positions, money balances, or account activity. Furthermore, NASD found that the firm, acting through Durant and Garber, violated the terms of its NASD membership agreement by engaging in business not set forth in the membership agreement, and by failing to notify and obtain NASD's approval for a material

change in business operations when it self-cleared transactions and held customer fully paid for securities.

Durant's and Garber's suspension will begin February 17, 2004, and will conclude at the close of business March 1, 2004. (NASD Case #C06030036)

## Firms and Individuals Fined

**Gelber Securities, LLC (CRD #18367, Chicago, Illinois) and Franklin Allen Gelber (CRD #1613104, Registered Principal, Wilmette, Illinois)** submitted a Letter of Acceptance, Waiver, and Consent in which they were censured and fined \$12,500, jointly and severally. The firm was fined an additional \$1,000. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Gelber, permitted individuals to trade fixed income securities while they were not properly registered with the firm. The findings also stated that the firm, acting through Gelber, permitted individuals to have access to the handling or processing of securities or monies or original books and records relating thereto of the firm, while they were not fingerprinted and the fingerprints were not forwarded to the Central Registration Depository (CRD). In addition, NASD found that the firm, acting through Gelber, permitted a registered person employed by the firm to perform duties as a General Securities Representative while his registration status with NASD was inactive due to his failure to timely complete the Regulatory Element of NASD's Continuing Education Rule. Furthermore, NASD determined that the firm failed to establish, maintain, and enforce written supervisory procedures reasonably designed to achieve compliance with applicable NASD rules with respect to the Regulatory Element of NASD's Continuing Education Rule in that, among other things, the procedures failed to state any measures that would be taken to ensure that registered representatives who are Continuing Education Inactive do not engage in the securities business. (NASD Case #C8A030095)

**I-Bankers Securities, Inc. (CRD #41352, Fort Worth, Texas) and Shelley Kay Gluck (CRD #2401474, Registered Principal, North Richland Hills, Texas)** submitted a Letter of Acceptance, Waiver, and Consent in which they were censured and fined \$12,500, jointly and severally. Without admitting or denying the allegations, the firm and Gluck consented to the described sanctions and to the entry of findings that the firm, acting through Gluck, permitted registered persons of the firm to act in capacities requiring registration when such persons were deemed inactive for failing to complete the Regulatory Element of Continuing Education. The findings also stated that Gluck acted in a capacity requiring registration when her registration was deemed inactive for failure to comply with the Regulatory Element of Continuing Education. NASD also found that the

firm, acting through Gluck, failed to establish and maintain a supervisory system reasonably designed to address the Regulatory Element of Continuing Education, and including, but not limited to, the establishment and maintenance of written procedures reasonably designed to address the need to verify the continuing education status of the firm's registered persons and the steps necessary to ensure that inactive persons would not perform any duties requiring registration. (NASD Case #C06030033)

**Lawson Financial Corporation (CRD #15261, Phoenix, Arizona) and Lona Marie Nanna (CRD #1618128, Registered Representative, Phoenix, Arizona)** submitted a Letter of Acceptance, Waiver, and Consent in which they were censured and fined \$17,500, jointly and severally. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Nanna, failed to promptly amend the individual's Uniform Application for Securities Registration or Transfer (Form U4) for registered representatives after becoming aware of information that triggered an obligation to update the Form U4. The findings also stated that the firm, acting through Nanna, filed required disclosures late, filed reports that contained inaccurate descriptions of the complaint allegations, and filed reports that identified the wrong registered person. (NASD Case #C3A030052)

**Leeb Brokerage Services, Inc. (CRD #46195, New York, New York) and Robert Morton Lehr (CRD #1898673, Registered Principal, New York, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which they were censured and fined \$10,000, jointly and severally. The firm was fined an additional \$12,500. Without admitting or denying the allegations, the firm and Lehr consented to the described sanctions and to the entry of findings that the firm reported transactions to the Automated Confirmation Transaction Service<sup>SM</sup> (ACT<sup>SM</sup>) as principal transactions when the firm had executed them as agent; reported a transaction to ACT with the incorrect number of shares; failed to report OTC Bulletin Board transactions to ACT within 90 seconds; failed to include the time of execution for some of the transactions; and reported some of the transactions as late. The findings also stated that the firm reported a short sale transaction to ACT without indicating that the transaction was a short sale; failed to mark order tickets as either "long" or "short"; created order tickets that failed to show the terms and condition of the order; created order tickets that were time-stamped only once and did not include the time the order was received or entered; and reported transactions to ACT prior to the time of execution indicated on the order ticket. In addition, NASD found that the firm permitted associated persons to be employed by the firm prior to submitting their fingerprints to NASD. Furthermore, NASD found that the firm, acting through Lehr, permitted associated persons to act in capacities that required NASD registration while their registration

status was inactive due to their failure to complete the Regulatory Element of NASD's Continuing Education Requirement. (NASD Case #C10030134)

**Scot Financial Group Incorporated (CRD #27918, Bernardsville, New Jersey) and William Duncan Watt (CRD #460230, Registered Principal, New York, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which they were censured and fined \$10,000, jointly and severally. The firm was fined an additional \$5,000. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Watt, permitted individuals to perform duties as registered persons while their registrations with NASD were inactive due to their failure to timely complete the Regulatory Element of NASD's Continuing Education Rule. NASD also found that the firm, acting under the direction and control of Watt, was a participating broker in contingency offerings of securities and investor funds raised in the offerings were not transmitted to a separate bank escrow account. The findings stated that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with applicable securities laws and regulations concerning the Regulatory Element of NASD's Continuing Education Rule and SEC Rule 15c2-4. (NASD Case #C9B030087)

**Share King, L.L.C. (CRD #33150, San Francisco, California) and Michael Anthony Fitzgerald (CRD #1757192, Registered Principal, Danville, California)** submitted an Offer of Settlement in which the firm was censured and fined \$35,000, jointly and severally with Fitzgerald. Without admitting or denying the allegations, the firm and Fitzgerald consented to the described sanctions and to the entry of findings that the firm, acting through Fitzgerald, failed to make and preserve books and records relating to short stock dividends and distributions, short securities differences, suspense accounts, short securities with related credit balances, unclaimed dividends and interest payable, unconfirmed transfer, securities that failed to receive and to deliver, net capital charge for margin calls over five days, reconciliation of inventory positions, registration T extension filings, and accounts subject to a 90-day freeze. The findings also stated that the firm, acting through Fitzgerald, maintained customer securities in an omnibus account in the name of the firm at another brokerage firm. NASD found that the firm, acting through Fitzgerald, failed to instruct the other brokerage firm that customer fully paid for securities and excess margin securities within the omnibus account were to be maintained free of any charge, lien, or claim of any kind in favor of the brokerage firm or any person claiming through the brokerage firm. In addition, NASD found that the firm failed to determine, on a daily basis, the quantity of customer fully paid for and excess margin securities held in the omnibus account at the brokerage firm on a daily basis and to notify the brokerage firm of those determinations. Furthermore, NASD found that

Fitzgerald performed, and the firm, acting through another individual, permitted him to perform duties of a registered person while Fitzgerald was deemed inactive for failure to complete the Regulatory Element of Continuing Education. (NASD Case #C01020022)

## Firms Fined

**Bear, Stearns & Co., Inc. (CRD #79, Whippany, New Jersey)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined \$10,000, and required to revise its written supervisory procedures concerning the requirements of supervising its registered representatives, reviewing customer account activity and taking steps to prevent unsuitable and excessive trading, and the steps to be taken when a customer account repeatedly appears on active account exception reports subsequent to the receipt of the customer's signed activity letter within 60 days. The firm was also required to provide proof of payment of \$310,000 to public customers to resolve an arbitration claim brought by the customers against it and its registered representative within 60 days. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to adequately and properly supervise a general securities representative with respect to the separate accounts of married public customers that appeared on the Customer Statement Exception Report, or otherwise take steps reasonably designed to prevent unsuitable and excessive trading in those accounts. The findings also stated that the firm failed to establish, maintain, and enforce written supervisory procedures, in that its procedures did not require specific steps to take when a customer account repeatedly appears on active account exception reports subsequent to the receipt of the customer's signed activity letter. (NASD Case #C8A030093)

**Credit Suisse First Boston Corporation (CRD #816, New York, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$15,500. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to report to ACT the correct symbol indicating whether the transaction was a buy, sell, sell short, sell short exempt, or cross for transactions in eligible securities. The findings also stated that the firm failed to display immediately customer limit orders in NASDAQ securities in its public quotation, when each such order was at a price that would have improved the firm's bid or offer in each such security; or when the order was priced equal to the firm's bid or offer and the national best bid or offer in such security, and the size of the order represented more than a de minimis change in relation to the size associated with its bid or offer in each such security. (NASD Case #CMS030293)

**E\*Trade Securities, LLC (CRD #29106, Rancho Cordova, California)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined \$11,000, and required to revise its written supervisory procedures concerning timely Order Audit Trail System<sup>SM</sup> (OATS<sup>SM</sup>) reporting within 30 business days. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it submitted to OATS reports with respect to equity securities traded on The Nasdaq Stock Market that were not in the electronic form prescribed by NASD. The reports were rejected by the OATS system and notice of such rejection was made available to the firm on the OATS Web Site. The firm did not correct or replace the reports. The findings also stated that the firm failed to enforce its written supervisory procedures concerning repairing rejected OATS event submissions. In addition, NASD determined that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance concerning timely OATS reporting. (NASD Case #CMS030291)

**Falcon Research, Inc. (CRD #13115, Palo Alto, California)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined \$10,000, and required to revise its written supervisory procedures to achieve compliance with trade-reporting requirements within 90 days. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to report correctly the capacity in which it acted in transactions; failed to report some of the principal transactions as cross transactions; failed to report to ACT that transactions were short sale transactions; failed to evidence that it made an affirmative determination as to the availability of shares to be borrowed to satisfy customer short sales with respect to short sale transactions. Also, the firm's written supervisory procedures and supervisory system were not reasonably designed to achieve compliance with the transaction reporting requirements of the various trade reporting rules. (NASD Case #C01030036)

**Fieldstone Services Corporation (CRD #27851, New York, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$20,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to file its annual audited reports in a timely manner. (NASD Case #C10030128)

**J.P.R. Capital Corp. (CRD #38056, Roslyn, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$11,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it disseminated sales literature to the public concerning a hedge fund that omitted material facts so as to make the sales literature misleading and

contain exaggerated, inaccurate, or misleading statements. The findings also stated that the firm failed to append the ".S" short sale modifier to transactions to identify them as short sale transactions. (NASD Case #CLI030032)

**Murphy & Durieu (CRD #6292, New York, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined \$17,500, and required to revise its written supervisory procedures concerning the Trade Reporting and Compliance Engine (TRACE) within 30 business days. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to report to TRACE transactions in TRACE-eligible securities within 75 minutes after execution. The findings also stated that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with applicable securities laws and regulations concerning TRACE. (NASD Case #CMS030288)

**NT Securities LLC (CRD #45694, Chicago, Illinois)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined \$12,500, and required to revise its written supervisory procedures concerning OATS reporting within 30 business days. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to report timely OATS Reportable Order Event (ROEs). The findings also stated that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with applicable securities laws and regulations concerning OATS reporting. (NASD Case #CMS030292)

**Peregrine Financials & Securities, Inc. (CRD #43992, Chicago, Illinois)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$25,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to state in the verified complaint filed against a public customer that it had an agreement with the customer to arbitrate all controversies arising between the parties concerning any transaction. The findings also stated that the verified complaint did not allege that the customer had refused to submit to arbitration, did not request that the court order the customer to arbitrate the firm's claim, and did not request the court to render an interpretation of arbitrability of the firm's claim. Furthermore, NASD found that the firm filed an emergency motion with the Circuit Court requesting the court to direct that the arbitration be held in Cook County, Illinois, instead of Los Angeles, California. NASD determined that the filing of the emergency motion was contrary to the ruling by the Director of Arbitration and contrary to the member's agreement to abide by the Code of Arbitration and was in violation of NASD Code of Arbitration Procedure Rules and NASD Conduct Rules. (NASD Case #C8A030090)

**Perrin, Holden and Davenport Capital Corporation (CRD #38785, New York, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined \$10,000, and required to revise its written supervisory procedures concerning limit order protection; frontrunning CQS orders; SEC Rule 11Ac1-6; best execution (agency and principal orders and regular and rigorous assessment of competing markets); anti-intimidation/coordination; trade reporting (riskless principal and accepting or matching trades); and books and records. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to submit, for the offsetting "riskless" portion of three "riskless" principal transactions in a Nasdaq National Market® (NNM®) security, either a clearing-only report with a capacity indicator of "riskless principal," or a non-tape, non-clearing report with a capacity indicator of "riskless principal." The findings also stated that the firm incorrectly reported to ACT the second leg of five "riskless" principal transactions in an NNM security, and incorrectly designated the capacity of such transactions as principal. In addition, NASD found that the firm failed to show the terms and conditions on the memorandum of brokerage orders. Furthermore, NASD determined that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with applicable securities laws and regulations, and NASD rules concerning limit order protection; frontrunning CQS orders; SEC Rule 11Ac1-6; best execution (agency and principal orders and regular and rigorous assessment of competing markets); anti-intimidation/coordination; trade reporting (riskless principal and accepting or matching trades); and books and records. (NASD Case #CMS030295)

**SG Cowen Securities Corporation (CRD #7616, New York, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined \$230,000, and required to revise its written supervisory procedures concerning supervisory personnel and registration; order handling and execution; best execution; the Three Quote Rule; trade reporting; SEC Rules 10a-1, 11Ac1-5, and 11Ac1-6; locked and crossed markets; the One Percent Rule; OATS "Chinese Wall" procedures; affirmative determination; bid test; firm quote compliance; books and records; regular and rigorous review; frontrunning; the trading system; the Limit Order Protection Interpretation; and the Limit Order Display Rule. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to display immediately customer limit orders in NASDAQ securities in its public quotation, when each such order was at a price that would have improved the firm's bid or offer for each security; or when the order was priced equal to the firm's bid or offer and the national best bid or offer in such security, and the size of the order represented more than a de minimis change in relation to the size associated with the firm's bid or offer in each security.

The findings also stated that the firm failed to fully or partially execute within the general time parameter of one-minute customer limit orders in NASDAQ securities after it traded each security for its own market-making account at a price that would have satisfied each customer's limit order. The findings further stated that the firm failed, in transactions for or with a customer, to use reasonable diligence to ascertain the best inter-dealer market and failed to buy or sell in such market so that the resultant price to its customer was as favorable as possible under prevailing market conditions. NASD also found that the firm failed to execute orders fully and promptly; executed short sale transactions and failed to report each of these transactions to ACT with a short sale modifier; executed long sale transactions and incorrectly reported these transactions to ACT with a short sale or short sale exempt modifier; and failed to report to ACT the correct symbol indicating whether the firm executed transactions in eligible securities in a principal, riskless principal, or agency capacity.

In addition, NASD found that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with respect to applicable securities laws and regulations concerning supervisory personnel and registration; order handling and execution; best execution; the Three Quote Rule; trade reporting; SEC Rules 10a-1, 11Ac1-5, and 11Ac1-6; locked and crossed markets; the One Percent Rule; OATS; "Chinese Wall" procedures; regular and rigorous review; affirmative determination; bid test; firm quote compliance; and books and records. Furthermore, NASD found that the firm failed to provide documentary evidence that it performed the supervisory reviews set forth in its written supervisory procedures concerning the requirements of frontrunning; best execution; and a new electronic order-processing system. The findings also stated that the firm failed to recognize that it was not properly complying with the Limit Order Protection Interpretation and the Limit Order Display Rule because the trading system's order screen incorrectly depicted held orders as "not held" and gave the firm false assurances that potential limit order violations were not violative. (NASD Case #CMS030301)

**Southwest Securities, Inc. (CRD #6220, Dallas, Texas)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$10,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to report TRACE transactions in TRACE-eligible securities within 75 minutes after execution. The findings also stated that the firm failed to report to TRACE the correct execution time of transactions in TRACE-eligible securities. In addition, NASD found that the firm double-reported to TRACE transactions in TRACE-eligible securities. (NASD Case #CMS030287)

**Sterne, Agee & Leach, Inc. (CRD #791, Birmingham, Alabama)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined \$35,000, and required to revise its written supervisory procedures concerning the appropriate application of the bona fide market maker exemption under NASD Conduct Rules 3350 and 3370. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it effected short sale transactions in NNM securities at or below the current inside bid when the current inside bid was below the preceding inside bid in each of the securities. The findings also stated that the firm effected short sale transactions in securities for the firm's proprietary account and, for each such sale, failed to make and annotate an affirmative determination that the firm could borrow the securities or otherwise provide for delivery of the securities by settlement date. NASD determined that, although the firm had registered as a market maker in each security before effecting the short sales, it was not entitled to the bona fide market maker exemption because the short sale transactions were effected as part of speculative trading strategies on behalf of a hedge fund customer. In addition, NASD found that the firm executed short sale transactions in securities and failed to report each of these transactions to ACT with a short sale modifier. Furthermore, NASD found that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with applicable securities laws and regulations concerning the appropriate application of the bona fide market maker exemption under NASD Conduct Rules 3350 and 3370. (NASD Case #CMS030282)

**Sunstate Equity Trading Inc. (CRD #43571, Tampa, Florida)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$10,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to report timely OATS ROEs. The findings also stated that the firm, acting through its registered principals, failed to enforce its supervisory system that would detect and prevent violations of the OATS Reporting Rules. In addition, NASD found that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with applicable securities laws and regulations concerning OATS reporting. (NASD Case #CMS030294)

**Track Data Securities Corporation (CRD #103802, Brooklyn, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$10,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that, as an Electronic Communications Network (ECN), it entered a quote that locked or crossed the market without first sending a Trade-or-Move Directed Order to the market maker or ECN whose quote the firm would lock or cross that was at, or superior to, the receiving market maker's or ECN's quoted price. (NASD Case #CMS030289)

**Turner Investment Distributors, Inc. (CRD #40644, Berwyn, Pennsylvania)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined \$100,000, and required to file all sales literature and advertisements concerning hedge funds and funds of hedge funds with NASD's Advertising Regulation Department at least 10 days prior to their first use for six months from the date of acceptance of this AWC. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it distributed sales literature regarding hedge funds to public customers that had inadequate risk disclosures about the specific risks of investing in hedge funds and made unbalanced presentations about the particular hedge fund that failed to provide investors with a sound basis for evaluating the facts associated with investing in the hedge funds. The findings also stated that the firm launched a Web site that allowed all members of the public to download print-disabled versions of a private placement memoranda in violation of SEC requirements of the registration exemption in Regulation D, Rule 506, and the unregistered offerings violated Section 5 of the Securities Act of 1933. (NASD Case #CAF030068)

**U.S. Bancorp Investments, Inc. (CRD #17868, St. Louis, Missouri)** submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$75,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that the firm, acting through registered representatives, made numerous material misrepresentations of fact regarding callable certificates of deposit (CCDs), which induced many investors, who might not otherwise have done so, to invest in these products. The findings also stated that the firm misrepresented the value of the CCDs on monthly customer account statements in that they listed the current market value as the full amount of the principal investment when, in fact, the market value was subject to market forces and could be, and often was, significantly less than the initial investment amount. (NASD Case #C05030062)

## Individuals Barred or Suspended

**Maurice Wayne Abney (CRD #2733649, Registered Principal, Owensboro, Kentucky)** submitted an Offer of Settlement in which he was fined \$8,500, including disgorgement of \$6,000 in commissions, and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the allegations, Abney consented to the described sanctions and to the entry of findings that he recommended and effected securities transactions in the account of a public customer without having reasonable grounds for believing that the recommendation and resultant transactions were suitable for the customer on the basis of the customer's financial situation and needs.

Abney's suspension began January 5, 2004, and concluded at the close of business January 16, 2004. (NASD Case #C05030046)

**Jonathan Bruce Abrams (CRD #2052573, Registered Principal, River Edge, New Jersey)** was fined \$67,000, suspended from association with any NASD member in any capacity for 90 days, suspended from association with any NASD member as a municipal securities principal for one year, and required to requalify by exam before serving again as a municipal securities principal. The sanctions were based on findings that Abrams failed and neglected to ensure that municipal securities transactions executed by his member firm were executed at prices that were fair and reasonable. The findings also stated that Abrams failed to establish, maintain, and enforce his member firm's written supervisory procedures that would ensure that municipal security sales prices were fair and reasonable in accordance with MSRB Rule G-30.

Abrams' suspension began January 20, 2004; the suspension in all capacities will conclude at the close of business April 19, 2004, and the suspension as a municipal securities principal will conclude at the close of business January 19, 2005. (NASD Case #C9B030043)

**Raymond Henry Beliveau (CRD #17256, Registered Representative, Edmonds, Washington)** submitted a Letter of Acceptance, Waiver, and Consent in which he was suspended from association with any NASD member in any capacity for four months. In light of the financial status of Beliveau, no monetary sanction has been imposed. Without admitting or denying the allegations, Beliveau consented to the described sanction and to the entry of findings that he engaged in excessive trading in the securities accounts of public customers while registered with a member firm. The findings also stated that Beliveau engaged in the unsuitable use of margin in a customer's account.

Beliveau's suspension will begin March 1, 2004, and will conclude at the close of business June 30, 2004. (NASD Case #C8A030105)

**Dennis Scott Bonge (CRD #2726663, Registered Representative, Little Rock, Arkansas)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$36,844.13, including disgorgement of \$26,844.13 in commissions earned, and suspended from association with any NASD member in any capacity for one year. The fine must be paid before Bonge reassociates with any NASD member in any capacity or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Bonge consented to the described sanctions and to the entry of findings that he recommended and effected option transactions in the accounts of public customers without having reasonable grounds for believing that the recommendations and resultant transactions were suitable for the customers on the basis of their

financial situations, investment objectives, and needs. The findings also stated that Bonge effected options transactions totaling \$15,696,766.25 in the accounts of public customers without prior written authorization from the customers and prior written acceptance of the accounts as discretionary by his member firm.

Bonge's suspension will begin February 17, 2004, and will conclude at the close of business February 16, 2005. (NASD Case #C05030063)

**Charles Alfonse Borbone (CRD #1320748, Registered Representative, Essex Falls, New Jersey)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$30,000, including disgorgement of \$25,000 in commissions, and suspended from association with any NASD member in any capacity for six months. The fine must be paid before Borbone reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Borbone consented to the described sanctions and to the entry of findings that he exercised effective control over the account of a customer. The findings stated that Borbone recommended and effected securities transactions in the account without having reasonable grounds for believing that such transactions were suitable for the customer in view of the size, frequency, and nature of the recommended transactions, and in light of the customer's investment objectives, circumstances, and needs.

Borbone's suspension began February 2, 2004, and will conclude August 1, 2004. (NASD Case #C9B030090)

**Christopher Borgo (CRD #2377439, Registered Principal, Boca Raton, Florida)** submitted an Offer of Settlement in which he was fined \$22,500, ordered to disgorge commissions of \$29,725 in partial restitution to public customers, and suspended from association with any NASD member in any capacity for six months. The restitution must be paid before Borgo reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Borgo consented to the described sanctions and to the entry of findings that he recommended to public customers the purchase of a common stock and, based on his recommendation, customers agreed to invest in the stock. The findings stated that Borgo conducted no independent investigation into the merits of the stock prior to recommending the stock to his customers and was unaware of the materially adverse information concerning the stock that he either intentionally or recklessly failed to disclose to customers in connection with his recommendation that they purchase the stock. NASD also found that Borgo, by use of the means of instrumentalities of interstate commerce or of the mails, or of any facility of any national securities exchange, employed a device, scheme, or artifice to defraud; omitted to state material facts necessary in order to make the

statements made, in light of the circumstances under which they were made, not misleading; or engaged in acts, practices, or a course of business that operated, or could operate, as a fraud or deceit upon persons in connection with the recommendations he made to customers to purchase a stock.

Borgo's suspension will begin February 17, 2004, and will conclude at the close of business August 16, 2004. (NASD Case #C3A030048)

**Robert Judson Brannon (CRD #810610, Registered Representative, Chandler, Arizona)** submitted an Offer of Settlement in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for one year. The fine must be paid before Brannon reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Brannon consented to the described sanctions and to the entry of findings that he participated in outside business activities without providing prompt written notice to his member firm.

Brannon's suspension began February 2, 2004, and will conclude at the close of business February 1, 2005. (NASD Case #C3A030022)

**John Clark Byrnes, Jr. (CRD #3147134, Registered Representative, Greensboro, North Carolina)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 30 days. The fine must be paid before Byrnes reassociates with any NASD member in any capacity following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Byrnes consented to the described sanctions and to the entry of findings that he failed to respond timely to NASD requests for information.

Byrnes' suspension began February 2, 2004, and will conclude at the close of business March 2, 2004. (NASD Case #C07030088)

**Steven Lewis Camacho (CRD #2309043, Registered Representative, Hanford, California)** submitted a Letter of Acceptance, Waiver, and Consent in which he was suspended from association with any NASD member in any capacity for 30 days. In light of the financial status of Camacho, no monetary sanction has been imposed. Without admitting or denying the allegations, Camacho consented to the described sanction and to the entry of findings that he participated in outside business activities without providing prompt written notice to his member firm.

Camacho's suspension will begin February 17, 2004, and will conclude at the close of business March 17, 2004. (NASD Case #C02030072)

**Michael Ralph Catania (CRD #2725908, Registered Principal, Windsor, California)** was fined \$20,000 and suspended from association with any NASD member in any principal capacity for two years. The fine is due and payable when or if Catania seeks to return to the securities industry. The sanctions were based on findings that Catania failed to supervise the private securities transactions of a former registered representative and to record the representative's private securities transactions on the books and records of his member firm. The findings also stated that Catania failed to establish, maintain, and enforce a supervisory system reasonably designed to achieve compliance with NASD Conduct Rule 3040 regarding private securities transactions.

Catania's suspension began January 5, 2004, and will conclude at the close of business January 4, 2006. (NASD Case #C07030024)

**Stephen Henry Chriest (CRD#1659802, Registered Representative, Alamo, California)** submitted an Offer of Settlement in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Chriest consented to the described sanctions and to the entry of findings that he participated in private securities transactions without prior written notification to, or approval from, his member firm. (NASD Case #C01030032)

**Salvatore Clark (CRD #2580477, Registered Representative, Deer Park, New York)** was fined \$7,500 and suspended from association with any NASD member in any capacity for 10 business days. The sanctions were based on findings that Clark entered an unauthorized trade in the account of a public customer.

Clark's suspension began January 5, 2004, and concluded at the close of business January 16, 2004. (NASD Case #C3A020039)

**Richard Bennett Cohen (CRD #2688040, Registered Representative, Merrick, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Cohen consented to the described sanctions and to the entry of findings that he received \$25,000 from a public customer to purchase shares of a municipal fund but failed to apply the funds as directed and/or intended. Cohen also failed to respond to an NASD request to appear for an on-the-record interview. (NASD Case #C10030130)

**Armando Carl Corbino (CRD #4671949, Registered Representative, Mount Holly, New Jersey)** submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Corbino

consented to the described sanction and to the entry of findings that he failed to respond to NASD requests for information. (NASD Case #C9A030043)

**John D. Crooks (CRD #3071684, Registered Representative, Norwich, Connecticut)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$2,500 and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the allegations, Crooks consented to the described sanctions and to the entry of findings that he attempted to settle a customer complaint without his member firm's knowledge or approval.

Crooks' suspension will begin February 17, 2004, and will conclude at the close of business March 1, 2004. (NASD Case #C11040001)

**Paul Michael Daly (CRD #2970512, Registered Representative, Highland Beach, Florida)** submitted a Letter of Acceptance, Waiver, and Consent in which he was suspended from association with any NASD member in any capacity for 30 days. In light of the financial status of Daly, no monetary sanctions have been imposed. Without admitting or denying the allegations, Daly consented to the described sanction and to the entry of findings that he failed to respond timely to NASD requests for information regarding a customer complaint containing allegations of unauthorized trades.

Daly's suspension began February 2, 2004, and will conclude at the close of business March 2, 2004. (NASD Case #C07030087)

**Julio Enrique DeJesus (CRD #4086955, Registered Representative, Yonkers, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, DeJesus consented to the described sanction and to the entry of findings that he falsified bank withdrawal slips and misused \$15,000 by initiating unauthorized withdrawals from bank client accounts. (NASD Case #C11030043)

**Daniel Louis Denney (CRD #1886850, Registered Representative, Houston, Texas)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$15,000 and suspended from association with any NASD member in any capacity for one year. The fine must be paid before Denney reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Denney consented to the described sanctions and to the entry of findings that, while associated with a member firm, he recommended and effected a high-risk investment in a private equity fund for a public customer without having reasonable



grounds for believing that the recommendation and resulting transaction were suitable because the customer did not meet the minimum income and net worth requirements for the investment.

Denney's suspension will begin February 17, 2004, and will conclude at the close of business March 1, 2004. (NASD Case #C06030043)

**Coleman Joseph Devlin (CRD #2317635, Registered Representative, Baltimore, Maryland)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$10,000, including disgorgement of financial benefits received, suspended from association with any NASD member in any capacity for 15 business days, and required to requalify by exam as a general securities representative. Without admitting or denying the allegations, Devlin consented to the described sanctions and to the entry of findings that he recommended and effected uncovered put option transactions in the account of a public customer without having reasonable grounds for believing that the recommendations and resultant transactions were suitable for the customer based upon the customer's financial situation, investment objectives, and needs. The findings also stated that Devlin exercised discretion in the account of a public customer without having obtained prior written authorization from the customer and prior written acceptance of the account as discretionary by his member firm.

Devlin's suspension began January 5, 2004, and concluded at the close of business January 26, 2004. (NASD Case #C9A030042)

**Michael Vincent Drayton (CRD #2828236, Registered Representative, Villa Rica, Georgia)** submitted an Offer of Settlement in which he was fined \$10,000 and suspended from association with any NASD member in any capacity for 20 business days. The fine must be paid before Drayton reassociates with any NASD member in any capacity following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Drayton consented to the described sanctions and to the entry of findings that he participated in an undisclosed outside business activity, for compensation, without providing his member firm with prompt written notice. The findings also stated that Drayton operated a Web site that did not disclose the name of his NASD member firm and had not been approved by his member firm.

Drayton's suspension began February 2, 2004, and will conclude at the close of business March 1, 2004. (NASD Case #C07030064)

**James Robert Edrington (CRD #4564293, Associated Person, Eagan, Minnesota)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for six months. The fine must be paid before Edrington reassociates with any NASD member in any capacity or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Edrington consented to the described sanctions and to the entry of findings that he incorrectly answered questions on his Form U4 and failed to respond timely to NASD requests for information.

Edrington's suspension began February 2, 2004, and will conclude August 1, 2004. (NASD Case #C04030071)

**Patrick Troy Fanning (CRD #4051410, Registered Representative, Mechanicsville, Maryland)** was barred from association with any NASD member in any capacity. The sanction was based on findings that Fanning converted funds from the accounts of public customers because he withdrew and kept for his own use money from clients' accounts without their knowledge, consent, or authorization. The findings also stated that Fanning transferred money from the accounts of public customers to the accounts of other customers to cover his unauthorized withdrawals with funds from other customers' accounts. NASD also found that Fanning failed to respond to NASD requests to appear for an on-the-record interview. (NASD Case #C10030045)

**Brian Frederick Ferraioli (CRD #2864240, Registered Representative, Moriches, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the allegations, Ferraioli consented to the described sanctions and to the entry of findings that he executed a short sale transaction in a public customer's account without the customer's prior knowledge, authorization, or consent.

Ferraioli's suspension began February 2, 2004, and concluded at the close of business February 13, 2004. (NASD Case #C11030045)

**Michael Barnes Fishbein (CRD #2182699, Registered Principal, Bronx, New York)** submitted an Offer of Settlement in which he was fined \$7,500 and suspended from association with any NASD member in any capacity for three months. Without admitting or denying the allegations, Fishbein consented to the described sanctions and to the entry of findings that he threatened a former member of his firm with bodily harm and effected an unauthorized transaction in the account of a public customer.

Fishbein's suspension began January 20, 2004, and will conclude at the close of business April 19, 2004. (NASD Case #C10030022)

**Leroy W. Gallman, Jr. (CRD #2669313, Registered Representative, East Orange, New Jersey)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000, suspended from association with any NASD member in any capacity for one year, and ordered to pay \$20,000 in disgorgement of commissions in partial restitution to a public customer. The fine and restitution must be paid before Gallman reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Gallman consented to the sanctions and to the entry of findings that he recommended and effected securities transactions in the account of a public customer without having reasonable grounds for believing that such transactions were suitable for the customer in view of size, frequency, and nature of the recommended transactions, and in light of the customer's investment objections, circumstances, and needs.

Gallman's suspension began January 20, 2004, and will conclude at the close of business January 19, 2005. (NASD Case #C9B030085)

**Anthony Dale George (CRD #805714, Registered Representative, Palm Beach Gardens, Florida) and Robert Barton McAnany (CRD #1152184, Registered Principal, Palm Beach Gardens, Florida)** submitted an Offer of Settlement in which George was fined \$5,000 and suspended from association with any NASD member in any capacity for 13 months. McAnany was fined \$35,283.27, including disgorgement of \$30,283.27 in commissions, and suspended from association with any NASD member in any capacity for 12 months. McAnany's fine must be paid before reassociating with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, George and McAnany consented to the described sanctions and to the entry of findings that they participated in private securities transactions, for compensation, without prior written notice to their member firm.

George's suspension began February 2, 2004, and will conclude at the close of business March 1, 2005. McAnany's suspension began February 2, 2004, and will conclude at the close of business February 1, 2005. (NASD Case #C07030029)

**Raymond Blake Gibson (CRD #3035781, Registered Representative, Carle Place, New York)** was barred from association with any NASD member in any capacity. The sanction was based on findings that Gibson converted more than \$34,000 in premium payments from insurance policyholders. The findings also stated that Gibson failed to respond to NASD requests for information. (NASD Case #C07030049)

**Louis Schweitzer Gray (CRD #4380025, Associated Person, Chatsworth, California)** was barred from association with any NASD member in any capacity. The sanction was based on findings that Gray willfully misrepresented material facts on a Form U4. (NASD Case #C02030015)

**Jeffrey Keith Hall (CRD #1183661, Registered Representative, Dearborn, Michigan)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$7,500 and suspended from association with any NASD member in any capacity for one year. The fine must be paid before Hall reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Hall consented to the described sanctions and to the entry of findings that he failed to provide his member firm with prompt written notice of his outside business activities for compensation. The findings also stated that Hall failed to respond timely and completely to NASD requests for documents and information.

Hall's suspension will begin February 17, 2004, and will conclude at the close of business February 16, 2005. (NASD Case #C8A030102)

**Jay Han (CRD #4269123, Registered Representative, New York, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 15 business days. Without admitting or denying the allegations, Han consented to the described sanctions and to the entry of findings that he engaged in business activities for a non-member company outside the scope of his relationship with his member firm and failed to provide written notice, or any notice, of this business activity to his firm.

Han's suspension began February 2, 2004, and will conclude at the close of business February 23, 2004. (NASD Case #C10030120)

**Donald Ralph Harmer (CRD #2386417, Registered Representative, Stroudsburg, Pennsylvania)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$2,500 and suspended from association with any NASD member in any capacity for three months. The fine must be paid before Harmer reassociates with any NASD member or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Harmer consented to the described sanctions and to the entry of findings that he failed to file promptly a Form U4 amendment with NASD to disclose material information.

Harmer's suspension began February 2, 2004, and will conclude May 1, 2004. (NASD Case #C9A030044)

**Chris Dinh Hartley (CRD #1799834, Registered Representative, San Jose, California)** was fined \$7,500 and suspended from association with any NASD member in any capacity for 90 days. The National Adjudicatory Council (NAC) imposed the sanctions following the appeal of an Office of Hearing Officers (OHO) decision. The sanctions were based on findings that Hartley participated in private securities transactions and failed to give prior written notice to, and receive written approval from, his member firm prior to engaging in such activities.

Hartley has appealed this action to the SEC. The sanctions are not in effect pending the SEC's consideration of the appeal. **(NASD Case #C01010009)**

**Edwin Houston Hayes (CRD #2398669, Registered Representative, Houston, Texas)** was barred from association with any NASD member in any capacity. The sanction was based on findings that Hayes failed to respond to NASD requests for information. In addition, the findings stated that Hayes effected securities transactions in the accounts of public customers without the customers' authorization, knowledge, or consent. NASD also found that Hayes used his discretion to effect transactions in the accounts of public customers without prior written authorization from the customers and without his firm's written acceptance of the accounts as discretionary. **(NASD Case #C06030018)**

**Christopher Head (CRD #3053211, Registered Representative, Annapolis, Maryland)** submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Head consented to the described sanction and to the entry of findings that he made unauthorized withdrawals totaling \$6,500 from the account of a public customer and improperly transferred these funds to the accounts of two other customers. The findings stated that Head transferred the funds to the account of one customer to make up for trading losses in the customer's account and transferred funds to the account of another customer to pay for an exit penalty being imposed upon the customer for the redemption of a mutual fund. NASD found that Head effected the improper withdrawals from the public customer's account by creating fictitious letters of authorization and forging the customer's signature to these letters. **(NASD Case #C9A030040)**

**Maria Dolores Herrera (CRD #4464058, Associated Person, San Jose, California)** was fined \$10,000 and suspended from association with any NASD member in any capacity for one year. The fine must be paid before Herrera reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. The sanctions were based on findings that Herrera willfully failed to disclose a material fact on her Form U4.

Herrera's suspension began January 5, 2004, and will conclude at the close of business January 4, 2005. **(NASD Case #C01030016)**

**James Paul Hood, Jr. (CRD #4467331, Associated Person, Fort Worth, Texas)** was barred from association with any NASD member in any capacity. The sanction was based on findings that Hood assisted a public customer in opening a new bank account at the parent company of his member firm and, without the customer's knowledge or consent, issued ATM cards on the customer's account and began making unauthorized withdrawals on the same day the account was opened. The findings also stated that Hood authorized automatic bank drafts by several of his creditors to pay his personal expenses and bills. Furthermore, NASD found that Hood caused \$19,380.91 to be withdrawn from the customer's account without the customer's authorization, knowledge, or consent. In addition, the findings stated that Hood failed to respond to NASD requests for information. **(NASD Case #C06030017)**

**Richard Peter Hveem (CRD #2622370, Registered Representative, Weehawken, New Jersey)** submitted an Offer of Settlement in which he was fined \$5,000, including disgorgement of \$1,885.27 in commission, suspended from association with any NASD member in any capacity for two months, and ordered to pay \$17,937.12 in restitution to a public customer. The fine and restitution must be paid before Hveem reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Hveem consented to the described sanctions and to the entry of findings that he executed unauthorized trades in the account of a public customer without prior authorization from the customer and no written authority to trade on discretion in the account.

Hveem's suspension began February 2, 2004, and will conclude at the close of business April 1, 2004. **(NASD Case #C9B030037)**

**Sang Jin Kim (CRD #2332712, Registered Principal, Deer Park, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$3,000 and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the allegations, Kim consented to the described sanctions and to the entry of findings that he attempted to settle a customer complaint against him by proposing settlement terms without informing his member firm.

Kim's suspension began January 20, 2004, and concluded at the close of business February 2, 2004. **(NASD Case #C10030114)**

**Anthony Koulouris (CRD #3011289, Registered Representative, Carle Place, New York)** was barred from association with any NASD member in any capacity for failing to respond to NASD requests for information and for testifying falsely at an NASD on-the-record interview. The findings also stated that Koulouris effected an unauthorized transaction in the account of a public customer and willfully failed to disclose materials facts on his Form U4. (NASD Case #C10030042)

**Santhosh Kumar (CRD #2823790, Registered Representative, Elmont, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 15 business days. The fine must be paid before Kumar reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Kumar consented to the described sanctions and to the entry of findings that he provided a \$7,500 check to an attorney-in-fact for a public customer and executed a promissory note for \$12,000 without the prior written authorization from the attorney-in-fact, the customer, or his member firm. The findings also stated that, by doing so, Kumar impermissibly shared in the losses of the customer's account.

Kumar's suspension began February 2, 2004, and will conclude at the close of business February 23, 2004. (NASD Case #C10030133)

**Ronald Lee Lambert (CRD #801165, Registered Principal, W. Worthington, Ohio)** submitted an Offer of Settlement in which he was suspended from association with any NASD member in any capacity for 30 days. In light of the financial status of Lambert, no monetary sanctions have been imposed. Without admitting or denying the allegations, Lambert consented to the described sanction and to the entry of findings that a member firm, acting through Lambert, prepared inaccurate trial balances, net capital computations, and FOCUS Part IIA reports. The findings also stated that Lambert failed to respond fully to NASD requests for documentation.

Lambert's suspension will begin February 17, 2004, and will conclude at the close of business March 17, 2004. (NASD Case #C8B030014)

**David Edmund Larue (CRD #2571293, Registered Principal, West Palm Beach, Florida)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 30 days. The fine must be paid before Larue reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Larue consented

to the described sanctions and to the entry of findings that he failed to respond timely to NASD requests for documents and information.

Larue's suspension began January 20, 2004, and will conclude at the close of business February 18, 2004. (NASD Case #C07030086)

**Vincent Anthony Leone (CRD #1431345, Registered Principal, New York)** submitted an Offer of Settlement in which he was fined \$5,000 and suspended from association with any NASD member in any financial and operations principal (FINOP) capacity for 30 days. Without admitting or denying the allegations, Leone consented to the described sanctions and to the entry of findings that he maintained inaccurate and/or incomplete books and records for his member firm, and, by erroneously including an allowable asset on his firm's FOCUS report, caused his firm's non-compliance with the Net Capital Rule.

Leone's suspension began February 14, 2004, and will conclude March 14, 2004. (NASD Case #C10030047)

**Gregory Lee Lewis (CRD #3177053, Registered Representative, Plano, Texas)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for one year. The fine must be paid before Lewis reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Lewis consented to the described sanctions and to the entry of findings that he submitted a life insurance application to his member firm on behalf of a public customer who cancelled the policy and Lewis' member firm prepared a refund check payable to the customer for all premiums paid. The findings also stated that, before the refund check was mailed to the customer, Lewis changed the customer's address of record to an address he controlled, took the customer's check, signed his and the customer's name on it without the customer's authorization, cashed it, and then delivered the funds to another individual without his firm's knowledge or consent.

Lewis' suspension will begin February 17, 2004, and will conclude at the close of business February 16, 2005. (NASD Case #C06030032)

**Zheng Lu (CRD #2066154, Registered Representative, Rockville, Maryland)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$2,500 and suspended from association with any NASD member in any capacity for two months. The fine must be paid before Lu reassociates with any NASD member in any capacity or before requesting relief from any statutory disqualification. Without admitting or denying the

allegations, Lu consented to the described sanctions and to the entry of findings that he failed to respond timely to NASD requests for information.

Lu's suspension began February 2, 2004, and will conclude at the close of business April 1, 2004. (NASD Case #C04030070)

**David Christopher Lupo (CRD #1246232, Registered Representative, Mechanicsburg, Pennsylvania)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the allegations, Lupo consented to the described sanctions and to the entry of findings that he effected, or caused to be effected, transactions in the securities account of a public customer, and exercised discretionary power in that customer's account without prior written authorization from the customer or acceptance in writing by his member firm of the account as discretionary.

Lupo's suspension will begin February 17, 2004, and will conclude at the close of business March 1, 2004. (NASD Case #C06030038)

**Leticia Lozano (CRD #2698473, Registered Representative, Arlington, Texas)** submitted a Letter of Acceptance, Waiver, and Consent in which she was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Lozano consented to the described sanction and to the entry of findings that she used a Social Security number belonging to a public customer to obtain a credit card and, thereafter, used the credit card to obtain \$4,000 in cash advances and/or personal items without the customer's authorization, knowledge, or consent. (NASD Case #C06030031)

**Bill Maddox, Jr. (CRD #1550930, Registered Principal, Visalia, California)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$23,872 and suspended from association with any NASD member in any capacity for 90 days. The fine must be paid before Maddox reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Maddox consented to the described sanctions and to entry of findings that he participated in private securities transactions without providing prior written notification to, and receiving prior written approval from, his member firm.

Maddox's suspension will begin February 17, 2004, and will conclude May 16, 2004. (NASD Case #C02030074)

**Tyrone Richard Melville (CRD #4587858, Registered Representative, New York, New York)** submitted an Offer of Settlement in which he was fined \$3,000 and suspended from

association with any NASD member in any capacity for 30 days. The fine must be paid before Melville reassociates with any NASD member in any capacity or before requesting relief from any statutory disqualification. Without admitting or denying the allegation, Melville consented to the described sanctions and to the entry of findings that he failed to disclose material facts on his Form U4.

Melville's suspension began February 2, 2004, and will conclude at the close of business March 2, 2004. (NASD Case #C10030096)

**Matityahu Meshizahav (CRD #2834481, Registered Representative, Brooklyn, New York)** was barred from association with any NASD member in any capacity. The sanction was based on findings that Meshizahav forged the name of a public customer on his member firm's check request forms that directed that the funds be sent to the customer at either Meshizahav's place of business or residence, caused the forms to be processed by his firm and its clearing broker, caused his firm to issue checks totaling \$20,500 that were sent to the customer at Meshizahav's place of business or residence, and cashed the checks, thereby converting \$20,500 to his own use and benefit. The findings also stated that Meshizahav failed to respond to NASD requests for information and documents. (NASD Case #C10030063)

**Richard Montgomery Meyerhoff (CRD #2813681, Registered Representative, New Rochelle, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$20,000, suspended from association with any NASD member in any capacity for two years, and ordered to disgorge \$70,295, plus interest, in commissions in partial restitution to public customers. The fine and disgorgement must be paid before Meyerhoff reassociates with any NASD member in any capacity following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Meyerhoff consented to the described sanctions and to the entry of findings that he recommended to public customers that they engage in a trading strategy that primarily involved purchasing securities on margin and writing covered calls on the securities, and effectuated this strategy for the customers without reasonable grounds to believe the transactions and strategy were suitable in light of the financial situation, investment objectives, and needs of the customers.

Meyerhoff's suspension began January 20, 2004, and will conclude at the close of business January 19, 2006. (NASD Case #CLI030029)

**Gregory Alan Newton (CRD #2714180, Registered Representative, San Francisco, California)** submitted an Offer of Settlement in which he was fined \$10,000, suspended from association with any NASD member in any capacity for one year, and ordered to pay \$12,000 in partial restitution to a public

customer. The fine must be paid before Newton reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Newton consented to the described sanctions and to the entry of findings that he made a recommendation to a public customer and did not have a reasonable basis for believing that the recommendation made was suitable for the customer based on the customer's financial situation, needs, and other security holdings.

Newton's suspension began February 2, 2004, and will conclude at the close of business February 1, 2005. (NASD Case #C3A030037)

**Terry Lamar Obee (CRD #2326611, Registered Representative, Vallejo, California)** submitted an Offer of Settlement in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Obee consented to the described sanction and to the entry of findings that he received \$125,000 from a public customer for investments in real estate ventures, transferred the funds to his personal brokerage account at his member firm, and converted the funds to buy and sell stocks and options for his own account without the knowledge or consent of the customer. The findings also stated that Obee's member firm placed a restriction on options trading in his personal brokerage account at the firm to permit covered option writing only, and, despite the restriction, Obee tendered \$40,000 to his supervisor at the firm to be deposited in the supervisor's brokerage account and directed options transactions in the account, circumventing the restrictions placed on his personal brokerage account. In addition, NASD found that Obee failed to respond to NASD requests for information. (NASD Case #C8A020092)

**Stacy Lynn Passey (CRD #2686699, Registered Representative, Carlsbad, California)** submitted a Letter of Acceptance, Waiver, and Consent in which she was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Passey consented to the described sanction and to the entry of findings that she failed to respond to NASD requests for information. (NASD Case #C02030071)

**James Clinton Pearce (CRD #1206325, Registered Principal, Ashburn, Virginia)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$10,000, suspended from association with any NASD member in any capacity for 30 business days, and ordered to requalify as a general securities representative within 90 days following the suspension. Without admitting or denying the allegations, Pearce consented to the described sanctions and to the entry of findings that he recommended and effected, or caused to be effected, purchases

of large positions of mutual funds in the accounts of public customers. The findings stated that Pearce's recommendations were made without a reasonable basis for believing them to be suitable for the customers.

Pearce's suspension will begin February 17, 2004, and will conclude at the close of business March 29, 2004. (NASD Case #C02030073)

**Jose Alberto Pietri (CRD #2951257, Registered Representative, Hopewell, Virginia)** submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Pietri consented to the described sanction and to the entry of findings that he participated in outside business activities, for compensation, without providing prompt written notice to his member firm. The findings also stated that Pietri failed to respond to NASD written requests for information. (NASD Case #C07030089)

**Joiceita T. Polk (CRD #3094319, Registered Principal, Culver City, California)** was fined \$10,000, suspended from association with any NASD member in any principal capacity for 60 days, and required to requalify by exam as a general securities principal. The fine must be paid before Polk reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. The sanctions were based on findings that Polk directed her member firm to utilize the instrumentalities of interstate commerce to engage in the securities business while failing to maintain its minimum net capital requirements in contravention of SEC Rule 15c3-1.

Polk's suspension began January 5, 2004, and will conclude at the close of business March 4, 2004. (NASD Case #C02030044)

**Matthew Carson Purcell (CRD #4554591, Associated Person, Seattle, Washington)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for one year. The fine must be paid before Purcell reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Purcell consented to the described sanctions and to the entry of findings that he willfully misrepresented a material fact on a Form U4 submitted through his member firm.

Purcell's suspension began February 2, 2004, and will conclude at the close of business February 1, 2005. (NASD Case #C3B030021)

**Timothy Paul Quinn (CRD #1934619, Registered Principal, Overland Park, Kansas)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$12,000 and suspended from association with any NASD member in any capacity for six months. The fine must be paid before Quinn reassociates with any NASD member in any capacity or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Quinn consented to the described sanctions and to the entry of findings that, acting on behalf of his member firm, he failed to prepare trial balances and computations of aggregate indebtedness and net capital on a monthly basis. The findings also stated that Quinn failed to maintain copies of the firm's checkbooks, bank statements, cancelled checks, and cash reconciliations.

Quinn's suspension began February 2, 2004, and will conclude August 1, 2004. (NASD Case #C04030068)

**Fida Rahman (CRD #1841337, Registered Representative, North Brunswick, New Jersey)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$10,000, suspended from association with any NASD member in any capacity for 15 business days, and ordered to pay \$3,238, plus interest, in restitution to a public customer. Without admitting or denying the allegations, Rahman consented to the described sanctions and to the entry of findings that he effected transactions in the account of a public customer without the customer's prior knowledge, authorization, or consent.

Rahman's suspension began February 2, 2004, and will conclude at the close of business February 23, 2004. (NASD Case #C10030119)

**Anthony Joseph Raimondi (CRD #370247, Registered Representative, Dix Hills, New Jersey)** submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Raimondi consented to the described sanction and to the entry of findings that he caused purported account statements for the account of a public customer at his member firm to be created on the purported letterhead of his member firm's clearing firm that contained false, misleading, and deceptive information concerning the holdings in the customer's account and the investment performance of the holdings. The findings also stated that Raimondi caused these account statements to be prepared and delivered to the public customer when he knew, or should have known, that the statements were false, misleading, and deceptive. (NASD Case #C10030127)

**Patrick Richard Ruhle (CRD #2353844, Registered Principal, East Meadow, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for nine months. The fine must be paid before Ruhle

reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Ruhle consented to the described sanctions and to the entry of findings that he exercised control over the securities account of a public customer and effected securities transactions, including options transactions, in the customer's account maintained at his member firm. The findings also stated that the extent of trading was excessive in view of the customer's objectives, financial situation, and the nature of the customer's account.

Ruhle's suspension began January 20, 2004, and will conclude at the close of business October 19, 2004. (NASD Case #CLI030031)

**Geoffrey Wray Sandoval (CRD #4299521, Registered Representative, Elk Grove, California)** was barred from association with any NASD member in any capacity. The sanction was based on findings that Sandoval willfully failed to disclose a material fact on his Form U4. The findings also stated that Sandoval submitted a forged document to his member firm. In addition, NASD found that Sandoval failed to respond to NASD requests for information. (NASD Case #C01030011)

**David Joseph Scranton (CRD #1711211, Registered Representative, Old Saybrook, Connecticut)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 10 days. Without admitting or denying the allegations, Scranton consented to the described sanctions and to the entry of findings that he paid one premium on a variable life insurance policy of public customers without their consent.

Scranton's suspension began January 2, 2004, and concluded at the close of business January 12, 2004. (NASD Case #C11030044)

**Gary Van Schwendinger (CRD #2237185, Registered Representative, Fort Myers, Florida)** submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Schwendinger consented to the described sanction and to the entry of findings that he failed to respond to NASD requests for information. (NASD Case #C04030064)

**Frank James Skelly, III (CRD #2160437, Registered Principal, Rockville Centre, New York)** and **Craig Howard Gross (CRD #2104270, Registered Principal, Kings Park, New York)** were barred from association with any NASD member in any capacity. The NAC imposed the sanction following appeal of an OHO decision. The sanction was based on findings that Skelly and Gross failed to respond to NASD requests to appear for on-the-record interviews. (NASD Case #CAF000013)

**Jere Boyd Spurlock (CRD #1039936, Registered Representative, Fort Worth, Texas)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000, including disgorgement of \$2,360 in earned commissions, and suspended from association with any NASD member in any capacity for 30 business days. Without admitting or denying the allegations, Spurlock consented to the described sanctions and to the entry of findings that, while associated with a member firm, he recommended that a public customer switch from an income-producing mutual fund to a high-risk capital appreciation fund without having reasonable grounds for believing that the recommendation and resultant transaction were suitable for the customer. The findings also stated that, to effect the unsuitable recommendation, Spurlock included inaccurate information on the customer profile used to make the investment. NASD found that Spurlock advised the customer to redeem his existing fund, and then he retrieved the proceeds of the redemption from the customer and used them to make the new investment. NASD determined that this, together with indicating that the source of funds for the new investment was from discretionary income, prevented the "switch" letter that was required pursuant to the member firm's procedures from being generated.

Spurlock's suspension will begin February 17, 2004, and will conclude at the close of business March 29, 2004. (NASD Case #C06030044)

**James Peter Staff (CRD #1003088, Registered Principal, Bronxville, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Staff consented to the described sanction and to the entry of findings that he pled guilty to criminal charges. (NASD Case #C10030125)

**Robert Tedeschi (CRD #2616329, Registered Principal, Brooklyn, New York)** submitted an Offer of Settlement in which he was suspended from association with any NASD member in any capacity for four months. In light of the financial status of Tedeschi, no monetary sanction has been imposed. Without admitting or denying the allegations, Tedeschi consented to the described sanction and to the entry of findings that he either intentionally or recklessly failed to disclose materially adverse information to public customers in connection with his recommendation that they purchase a stock and failed to disclose his financial incentive for recommending a stock. NASD also found that Tedeschi acted in contravention of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, promulgated thereunder, in that, by use of the means or instrumentalities of interstate commerce or of the mails, or of any facility of any national securities exchange, he employed a device, scheme, or artifice to defraud; omitted to state material facts necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading;

or engaged in acts, practices, or a course of business that operated or could operate as a fraud or deceit upon persons in connection with the recommendations he made to customers.

Tedeschi's suspension began February 2, 2004, and will conclude at the close of business June 1, 2004. (NASD Case #C3A030038)

**Alphonso Joseph Vruno, Sr. (CRD #2593764, Registered Representative, St. Charles, Illinois)** submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Vruno consented to the described sanction and to the entry of findings that he failed to invest or deposit \$43,000 in a public customer's securities account as directed by the customer. The findings also stated that Vruno converted the customer's funds for his own use and benefit and not for the benefit of the customer. In addition, NASD found that Vruno misused \$58,600 that was borrowed from the customer and executed promissory notes, and failed to repay when the customer requested repayment. (NASD Case #C8A030098)

**Matthew Thomas Wade (CRD #1195175, Registered Representative, Wantagh, New York)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$7,500 and suspended from association with any NASD member in any capacity for nine months. The fine must be paid before Wade reassociates with any NASD member in any capacity or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Wade consented to the described sanctions and to the entry of findings that he falsely altered a copy of a \$15,647.29 check drawn on an outside bank which he made payable to a public customer to purchase a fixed annuity so that it appeared to be a new check for \$1,847.29. The findings also stated that Wade submitted the altered copy by fax to his member firm as proof that the customer had made an additional \$1,847.29 investment so that Wade might obtain an additional bonus in connection with his sales activities.

Wade's suspension began February 2, 2004, and will conclude at the close of business November 1, 2004. (NASD Case #CLI030033)

**Alexander Wehr (CRD #1911038, Registered Principal, Fort Worth, Texas)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for six months. The fine must be paid before Wehr reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Wehr consented to the described sanctions and to the entry of findings that he participated in a private securities transaction and failed to provide prior written notice, written or otherwise, to his member



firm describing the proposed transaction, his role therein, and whether he had received, or might receive, selling compensation in connection with the transaction.

Wehr's suspension will begin February 17, 2004, and will conclude at the close of business August 16, 2004. (NASD Case #C06030041)

**Eugene Wittstock (CRD #2827218, Registered Representative, Sterling Heights, Michigan)** submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$7,500 and suspended from association with any NASD member in any capacity for one year. The fine must be paid before Wittstock reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Wittstock consented to the described sanctions and to the entry of findings that he failed to provide his member firm with prompt written notice of his outside business activities for compensation. The findings also stated that Wittstock failed to respond timely and completely to NASD requests for documents and information.

Wittstock's suspension will begin February 17, 2004, and will conclude at the close of business February 16, 2005. (NASD Case #C8A030101)

## Individual Fined

**George Martin Livingstone, III (CRD #4108991, Registered Principal, Wilton, Connecticut)** submitted a Letter of Acceptance, Waiver, and Consent in which he was censured and fined \$10,000. The fine must be paid before Livingstone reassociates with any NASD member or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Livingstone consented to the described sanctions and to the entry of findings that he failed to ensure that his member firm filed timely its annual audited reports. The findings also stated that Livingstone was responsible for his member firm conducting a securities business while its membership in NASD was suspended. (NASD Case #C10030129)

## Decision Issued

The following decision has been issued by the District Business Conduct Committee (DBCC) or the Office of Hearing Officers and has been appealed to or called for review by the NAC as of January 2, 2004. The findings and sanctions imposed in the decision may be increased, decreased, modified, or reversed by the NAC. Initial decisions whose time for appeal has not yet expired will be reported in the next *Notices to Members*.

**Joseph Abbondante (CRD #1879052, Registered Principal, Freehold, New Jersey)** was fined \$96,500, suspended from association with any NASD member in any capacity for one year, and ordered to requalify by exam as a general securities representative. The sanctions were based on findings that Abbondante engaged in private securities transactions, for compensation, without prior written notice to, and written approval from, his member firm. The findings also stated that Abbondante engaged in outside business activities without appropriate notice to his member firm. NASD also found that Abbondante misrepresented material facts to public customers regarding a security.

This decision has been appealed to the NAC, and the sanctions are not in effect pending consideration of the appeal. (NASD Case #C10020090)

## Complaints Filed

The following complaints were issued by NASD. Issuance of a disciplinary complaint represents the initiation of a formal proceeding by NASD in which findings as to the allegations in the complaint have not been made, and does not represent a decision as to any of the allegations contained in the complaint. Because these complaints are unadjudicated, you may wish to contact the respondents before drawing any conclusions regarding the allegations in the complaint.

**Darren Ray Adams (CRD #3180366, Registered Representative, Chicago, Illinois)** was named as a respondent in an NASD complaint alleging that he falsified letters of authorization to effect the wire transfer of \$42,500 from a public customer's brokerage account held at his member firm. The complaint also alleges that Adams falsified a bank check request for \$6,000 to transfer funds from the customer's account. The complaint further alleges that the funds from the wire transfer and the check were directed and deposited to the account of his friend and then forwarded to his own account for his benefit and not for the benefit of the customer. In addition, the complaint alleges that Adams affixed the signature of the customer to a letter of authorization to effect the transfer of \$42,500 from the customer's account at the firm, without the customer's knowledge or authority. Furthermore, the complaint alleges that Adams affixed the signature of the customer to a withdrawal request of \$35,000 from the customer's annuity and he deposited the funds or caused the funds to be deposited in the customer's account at the firm without the knowledge or authority of the customer. The complaint also alleges that Adams failed to respond to NASD requests for information. (NASD Case #C8A030097)

**Thomas John Chase (CRD #1313012, Registered Representative, Bratenahl, Ohio)** was named as a respondent in an NASD complaint alleging that, without the knowledge or consent of a public customer, he caused checks totaling \$405,600.83 to be withdrawn from the securities account of a customer for which Chase was the broker, endorsed the checks, and used the proceeds for his benefit or for the benefit of someone other than the customer. The complaint also alleges that Chase, without the knowledge or consent of a public customer, faxed forged letters of authorization to his member firm requesting that checks totaling \$301,014.51 be made payable to public customers and disbursed from the customers' securities accounts at his member firm, endorsed the checks, and deposited the checks into his personal bank account for his personal benefit or for some purpose other than the benefit of the customers. In addition, the complaint alleges that Chase took possession of a \$6,800 check that was a refund of an initial life insurance premium paid by a public customer after the insurance application was declined, endorsed the check, and used the proceeds from the check for his own benefit or for the benefit of someone other than the customer. Furthermore, the complaint alleges that Chase failed to respond to NASD requests for documents and information (NASD Case #C8B030031)

**James Michael Coyne, Sr. (CRD #601719, Registered Representative, Media, Pennsylvania)** was named as a respondent in an NASD complaint alleging that he, directly or indirectly, by use of any means or instrumentalities of interstate commerce or of the mails, knowingly or recklessly used or employed, in connection with the purchase or sale of securities, manipulative or deceptive devices or contrivances; and knowingly or recklessly effected transactions in, or induced the purchase or sale of, securities by means of manipulative, deceptive, or other fraudulent devices or contrivances. The complaint also alleges that Coyne engaged in the short-term purchase and sale of securities in the account of public customers without having a reasonable basis for believing that such transactions were suitable for the customers based upon the frequency of the transactions, the nature of their account, and their financial situation and needs. The complaint further alleges that Coyne made unsuitable use of margin in the account of public customers and failed to follow a public customer's instructions to liquidate his joint account. (NASD Case #C9A030041)

**Roger Parker May (CRD #717728, Registered Principal, Golden, Colorado)** was named as a respondent in an NASD complaint alleging that he omitted to disclose material information in connection with securities transactions. The complaint also alleges that May did not have a reasonable basis for believing that recommendations made to public customers were suitable for public customers based upon the information provided as to their financial circumstances and needs and other security holdings. In addition, the complaint alleges that May

executed, or caused the execution of, unauthorized shares of stock in the account of a public customer. (NASD Case #C3A030050)

**William Taro Mukai (CRD #1760223, Registered Representative, Des Plaines, Illinois)** was named as a respondent in an NASD complaint alleging that he recommended and effected excessive securities transactions and generated commissions in public customers' accounts. The complaint also alleges that Mukai made trading recommendations without having a reasonable basis for believing that the recommendations and resultant transactions were suitable for the customers based upon customers' age, financial situation, and investment objectives. The complaint further alleges that Mukai exercised discretion in the accounts of the customers without having obtained prior written authorization from the customers and prior written acceptance of the account as discretionary by his member firm. Furthermore, the complaint alleges that Mukai prepared and delivered to customers misleading communications, consisting of summaries of the trading in the customers' accounts that contained exaggerated, unwarranted, and misleading statements by omitting losses and misrepresenting losses as gains. In addition, the complaint alleges that Mukai provided these misleading communications to the customers without submitting them to the appropriate registered principal of the firm for review and approval prior to their distribution, as required by the firm's procedures. (NASD Case #C8A030093)

**Ronald J. Ponella (CRD #2616823, Registered Representative, Port Jefferson Station, New York)** was named as a respondent in an NASD complaint alleging that he converted \$2,000 of a public customer's funds for his own use and benefit. The complaint also alleges that Ponella failed to respond to NASD requests to appear for an on-the-record interview. (NASD Case #CLI030030)

**Adam R. Rodriguez (CRD #4299928, Registered Representative, San Antonio, Texas)** was named as a respondent in an NASD complaint alleging that he misused a public customer's funds and forged the customer's signature. The complaint alleges that the customer met with Rodriguez, during which time she instructed him to open an estate account and deposit funds into the account, and later instructed him to invest the funds in the estate account in a fixed annuity. However, the complaint alleges that, without the customer's authorization, knowledge, or consent, Rodriguez invested funds in part in the fixed annuity and used the remaining funds to purchase a check in the same amount which he made payable to an account he controlled. The complaint further alleges that Rodriguez never cashed the check and held it for several months before returning it to the estate account. In addition, the complaint alleges that Rodriguez completed an Annuity Service Request Form, forged the customer's signature on the form, and withdrew funds in the

form of a check from an annuity owned by the customer without the customer's authorization, knowledge, or consent. (NASD Case #C06030037)

**Steven Schaefer (CRD #1894353, Registered Principal, Kings Park, New York)** was named as a respondent in an NASD complaint alleging that, while using the means and instrumentalities of interstate commerce to offer securities for sale, Schaefer omitted to state material facts necessary in order to make the statements made in connection with such offers, in light of the circumstances in which they were made, not misleading. The complaint also alleges that Schaefer, while using the means and instrumentalities of interstate commerce to offer securities for sale, made material misrepresentations in the form of price predictions to induce transactions and transactions did occur. (NASD Case #C3A030053)

### **Firms Suspended for Failure to Supply Financial Information**

The following firms were suspended from membership in NASD for failure to comply with formal written requests to submit financial information to NASD. The action was based on the provisions of NASD Rule 8221. The date the suspension commenced is listed after the entry. If the firm has complied with the requests for information, the listing also includes the date the suspension concluded.

**Dick Spencer & Associates**  
San Marino, California  
(December 9, 2003)

**Epsilon Management Services, Inc.**  
Wellesley, Massachusetts  
(December 9, 2003)

**Leo Group, Inc.**  
Newport Beach, California  
(January 9, 2004)

### **Firm Suspended Pursuant to NASD Rule Series 9510 for Failure to Comply With an Arbitration Award or a Settlement Agreement**

**The Camelot Group, Inc. f/k/a First American Equities, Inc.**  
Ft. Lauderdale, Florida  
(December 18, 2003)

### **Firm Suspended Pursuant to NASD Rule 9531 for Failure to Pay Arbitration Fees**

**Shelman Securities Corp.**  
Dallas, Texas  
(December 15, 2003)

### **Individuals Barred Pursuant to NASD Rule 9544 for Failure to Provide Information Requested Under NASD Rule 8210**

(The date the bar became effective is listed after the entry.)

**Coulter, Cornell L.**  
Newport Beach, California  
(December 22, 2003)

**Gentry, Joshua**  
Kyle, Texas  
(December 8, 2003)

**Langley, Robert J.**  
Laguna Beach, California  
(December 3, 2003)

**Reardon, Michael D.**  
Jasper, Georgia  
(December 29, 2003)

**Szilagyi, Melissa**  
Brookfield, Illinois  
(December 10, 2003)

### **Individuals Suspended Pursuant to NASD Rule 9541(b) for Failure to Provide Information Requested Under NASD Rule 8210**

(The date the suspension began is listed after the entry. If the suspension has been lifted, the date follows the suspension date.)

**Bottomly, Van B.**  
Raleigh, North Carolina  
(December 23, 2003)

**Fonesca, Christopher**  
Philadelphia, Pennsylvania  
(December 9, 2003)

**Geniton, Edward J.**  
Staten Island, New York  
(December 29, 2003)

**Zemlyansky, Mikhail**  
Brooklyn, New York  
(December 29, 2003)

## **Individual Suspended Pursuant to NASD Rule Series 9510 for Failure to Comply With an Arbitration Award or a Settlement Agreement**

Casciole, Ernest S.  
Hampton Bays, New York  
(January 12, 2004)

## **NASD Fines CSFB \$170,000; Orders \$600,000 in Restitution for Failure to Give Best Execution to Customer Orders after IPO**

NASD announced that Credit Suisse First Boston LLC (CSFB) has been censured, fined \$150,000, and required to pay more than \$600,000 in restitution for failing to provide six customers with the best available price at the opening on the first day of trading of MP3.com. NASD also found that CSFB failed to honor its published quotations for MP3 in 30 instances on the same day and fined it \$20,000.

On July 21, 1999, CSFB, as the lead underwriter, conducted MP3.com's initial public offering (IPO) and MP3 began trading on The Nasdaq Stock Market. At the opening of trading on that day, CSFB had orders to buy more shares of MP3 than it had to sell. CSFB did not meet its obligation to make every reasonable effort to execute six of its customer sell orders fully and promptly.

NASD's Market Regulation Department found that CSFB initially sold short over 330,000 shares of MP3 to other customers at a price of \$100.50 per share. While CSFB gave prompt partial executions to three of the six customer sell orders for approximately 15 percent of the combined volume of the six sell orders, the balance of the six orders received untimely executions. Instead of satisfying its best execution obligations as to the remaining portion of the six customer orders, CSFB executed them as the market declined. Due to the manner in which CSFB executed the six customer orders, CSFB profited, and its customers were disadvantaged by, \$606,000. CSFB was censured and fined \$150,000 for violating the duty of best execution and has made restitution to the customers.

Additionally, during this period, CSFB received 277 SelectNet orders to sell nearly 150,000 shares of MP3 from other market participants that were priced equal to or below CSFB's bid. Thirty of these orders were presented to CSFB at its published bid in an amount up to its published quotation size. Under NASD and federal securities laws, market makers are required to execute an order to buy or sell a security from another broker or dealer at a price at least as favorable as the market maker's published quotation for at least the number of shares offered in the quotation. CSFB failed to execute these 30 orders when presented and, therefore, failed to honor its published quotation

(commonly known as "backing away") and was fined \$20,000. CSFB neither admitted nor denied NASD's findings.

## **NASD Hearing Panel Finds Former Tech Banker Frank P. Quattrone Failed to Respond in NASD Investigation**

### *One-Year Suspension Becomes Lifetime Bar Unless Testimony Is Provided*

NASD announced that an NASD Hearing Panel found that Frank P. Quattrone, the former head of Credit Suisse First Boston's (CSFB's) technology sector investment banking unit, failed to cooperate in an NASD investigation, violating NASD rules.

On March 6, 2003, NASD charged Quattrone with failing to cooperate in an NASD investigation. The complaint was an outgrowth of NASD investigations into investment banking activities, including IPO pricing and analyst conflicts of interest, that began in May 2000. The Hearing Panel found that Quattrone never provided NASD with testimony requested in February 2003.

The Hearing Panel rejected Quattrone's arguments that he should not testify because of pending criminal charges against him; that NASD Enforcement did not need his testimony; and that compelled testimony would violate his Fifth Amendment right. The Hearing Panel determined that while Quattrone did fail to testify, there were certain mitigating circumstances. NASD has refused to delay Quattrone's testimony and insisted on expediency without a compelling reason.

The Hearing Panel suspended Quattrone for one year and fined him \$30,000. The Hearing Panel further stated that, if Quattrone does not fully and unconditionally provide information within one year, he will be permanently barred from the securities industry.

The presiding Hearing Officer dissented on the sanctions, concluding that Quattrone's conduct warranted an immediate bar from the industry.

NASD's Department of Enforcement appealed this matter to NASD's National Adjudicatory Council (NAC), and Quattrone cross-appealed. On appeal, the sanctions may be increased, decreased, modified, or reversed.

A Hearing Panel consists of an NASD Hearing Officer, along with two members of the securities industry. The NAC is a 14-person committee composed of seven industry and seven non-industry members that decides appeals from disciplinary, membership, and exemption decisions; rules on statutory disqualification applications; and advises on other policy matters.

The decision has been appealed to the NAC, and the sanctions are not in effect pending consideration of the appeal. (NASD Case #CAF030008)

### **NASD Charges Waddell & Reed with Suitability Violations Relating to Thousands of Variable Annuity Exchanges and Seeks Customer Compensation; Two Senior Execs Also Charged**

NASD filed a complaint charging Waddell & Reed, Inc., of Overland Park, Kansas, for recommending 6,700 variable annuity exchanges to its customers without determining the suitability of the transactions. These exchanges, known as "switching," generated \$37 million in commissions and cost Waddell's customers nearly \$10 million in surrender fees. NASD also alleged that, according to its quantitative analysis, at least 1,400 of the firm's customers were likely to lose money by making these switches. Charges were also brought against the firm's former President, Robert Hechler, and its National Sales Manager, Robert Williams. In addition to other sanctions, NASD is seeking an order requiring the firm to disgorge commissions and compensate customers.

"Today's action should make crystal clear that brokers may not recommend that clients replace their variable annuity contracts when the broker has no reasonable basis for believing the replacement is in the client's, not the broker's, best interest," said Mary L. Schapiro, NASD Vice Chairman and President of Regulatory Policy and Oversight. "Engaging in a campaign to make such recommendations without an assessment of the suitability of the exchange, simply because it will advance the firm's own commercial interests, is completely unacceptable."

According to the complaint, between January 2001 and August 2002, Waddell engaged in an aggressive campaign to switch the variable annuity contracts of its customers from those issued by one insurance company, United Investors Life Insurance Co. (UILIC), to very similar annuities provided by another insurance company, Nationwide Insurance Co. In doing so, Waddell & Reed failed to take adequate steps to determine whether there were reasonable grounds for the customers to enter into these exchanges, such as determining whether the customers were likely to benefit or lose money from the exchanges, and failed to establish sufficient guidance for the sales force to use in determining the suitability of the exchanges. In fact, many customers were likely to lose money through these switches, which typically would raise concerns about the suitability of these transactions.

In addition, over 700 customers were switched into one Nationwide annuity, rather than another Nationwide annuity that was less expensive and offered far more benefits and greater flexibility to the clients, but provided a lower payout to Waddell's

sales force. One of the firm's advisors, in comparing the payouts, noted, "I have no problem selling an annuity that may cost .45 (basis points) more on M&E charges because I have to support my family and pay my assistant and other business overhead."

The misconduct began after Waddell failed to obtain an agreement to receive a share of certain fees collected by UILIC, the original issuer of annuities sold by Waddell. Waddell found another issuer, Nationwide, which agreed to share with Waddell, some of the fees it collected from Waddell's customers. From the customer's perspective, the underlying investment options available in Nationwide's annuities were otherwise virtually identical to the UILIC contracts.

Beginning in late January 2001, following the agreement with Nationwide, Hechler and others engaged in an aggressive campaign to encourage Waddell's sales force to replace UILIC annuities previously sold with those offered by Nationwide. Among other things, Hechler issued a series of memoranda to the sales force repeatedly encouraging them to replace existing UILIC variable annuities with Nationwide variable annuities by questioning UILIC's intentions to provide service to Waddell's clients, and compensation to the sales force, along with questioning UILIC's financial strength.

In response to the pressure from senior management, some Waddell regional vice presidents took steps to encourage exchanges. One vice president sent an e-mail to his division managers on March 6, 2001, encouraging a "campaign of every advisor contacting every UILIC client" to explain what was happening with the UILIC relationship, and later set up a "Call-a-Thon" for advisors in his region to call all of their customers with UILIC variable annuities. During this campaign some Waddell advisors expressed concern that these switches were not in the best interests of their clients. One advisor even noted that management's comments were intended to "prod and scare" advisors into making switches.

Although the president of UILIC assured Hechler on March 14, 2001, that UILIC would continue to provide compensation to Waddell's advisors and provide service to both policyholders and advisors, Hechler did not relay this information to Waddell's sales force for almost two months, during which time the switching campaign continued unabated. During that time, Hechler's actions led to a dramatic increase in the number of switches from UILIC to Nationwide variable annuities.

During March 2001, the number of switches from UILIC contracts to Nationwide contracts jumped 540 percent over the previous month, and the number jumped another 490 percent in April 2001. By August 2002, Waddell had replaced 6,772 UILIC variable annuities, moving approximately \$617 million in assets away from UILIC, costing customers more than \$9.8 million in surrender charges, and generating approximately \$37 million in

commissions to Waddell. Additionally, Waddell earned approximately \$700,000 from fee-sharing arrangements with Nationwide in 2001, and Waddell will continue to accrue such fees annually.

These exchanges of variable annuities were costly to customers in a number of ways. Many customers had to pay surrender charges to switch out of their old policies, and all customers who switched incurred a new surrender charge period that limited their ability to surrender their new annuity contracts. In addition, customers who switched into the Nationwide variable annuities paid higher ongoing expense fees than they had been charged under the old policies. Waddell, on the other hand, made money through the commissions charged on each exchange and through the portion of the annual fees paid by customers that Nationwide shared with Waddell.

Despite repeated requests from its the sales force and their supervisors, Waddell failed to provide adequate guidance, analytical tools or criteria for making the critical suitability analysis required under NASD rules for recommending exchanges. As a result, many variable annuity exchanges were recommended by the sales force without having reasonable grounds for believing that the recommendations were suitable for the customers based on their security holdings and their financial situations and needs. In addition, based on NASD's quantitative analysis, in over 1,400 instances, at the recommendation of Waddell, customers entered into exchanges that were likely to result in customers losing money.

Williams, Waddell's National Sales Manager, who actively participated in the switching campaign and had supervisory authority over the sales force and its management, had responsibility for ensuring that transactions are appropriately reviewed for suitability. He was aware, through communication with the sales force, that there were serious shortcomings with Waddell's process for reviewing the suitability of switches from UILIC to Nationwide variable annuities, and that members of the sales force felt pressure to make switches from the firm and Hechler.

NASD has charged the firm with suitability and supervisory violations, Hechler with causing the firm's suitability violations by encouraging the sales force to switch customers, and Williams with supervisory failures in connection with the variable annuity exchanges.

Under NASD rules, the individuals and the firms named in the complaint can file a response and request a hearing before an NASD disciplinary panel. Possible sanctions include a fine, suspension, bar, or expulsion from NASD.

## **NASD Bars Louisiana Broker and Orders Restitution for Unsuitable Sales of Variable Annuities and Mutual Funds**

NASD announced that John Steven Blount of Lake Charles, LA, has been barred from association with any NASD-regulated securities firm and ordered to pay more than \$1.5 million in restitution plus interest to 10 customers for unsuitable sales of variable annuities and mutual funds totaling over \$6 million.

The unsuitable sales by Blount generated almost \$220,000 in commissions. NASD found that Blount schemed to defraud investors and to frustrate attempts by his employer to supervise his activities. The transactions took place between 1998 and 2001 while Blount was a registered representative of NYLife Securities, Inc. This settlement follows an NASD complaint filed last July that charged Blount with these violations.

"This case was brought in connection with an ongoing series of NASD special examinations and investigations that have focused on the sale of variable annuity products, and have resulted in over 75 annuity-related disciplinary actions taken by NASD since the beginning of 2001," said NASD Vice Chairman Mary Schapiro "Given the popularity of this product, we will continue to focus examination and investigative resources on a wide range of variable annuity related sales practices."

Blount's customers were older, conservative investors who were generally seeking current income from their investments. NASD found that Blount's investment recommendations exposed his customers to excessive market risk, lacked sufficient liquidity, and failed to address the customers' needs for current income.

In one instance, the customer was a 62-year-old retiree who wished to keep his principal investment safe, and had told Blount that he anticipated the need within a few months for \$50,000 to buy a car and to make home repairs. Despite the customer's near-term need for liquidity, Blount recommended that the customer invest almost all of his liquid assets in a variable annuity contract that imposed surrender charges for early withdrawals during the first six years of the contract. Furthermore, Blount recommended allocating the investment to high-risk sub-accounts that were not consistent with the customer's desire to keep his principal safe. In order to buy a car and make home repairs, the customer was forced to draw on his home equity and subsequently had to take early withdrawals from his variable annuity to make the resulting loan payments.

NASD also found that Blount misrepresented material features of the variable annuities in order to induce customers to purchase the products. Additionally, in an effort to circumvent his firm's review of annuity and mutual fund transactions, Blount directed his sales assistant to falsify firm records regarding customers' financial situations and investment objectives.

As part of its overall focus on the sales of variable annuity contracts, NASD has issued educational alerts to both investors and firms to help ensure that these products are properly sold which can be found at:

- ▶ [www.nasdr.com/alert\\_exchange\\_lifeinsurance.htm](http://www.nasdr.com/alert_exchange_lifeinsurance.htm),
- ▶ [www.nasdr.com/pdf-text/9935ntm.pdf](http://www.nasdr.com/pdf-text/9935ntm.pdf), and
- ▶ [www.nasdr.com/pdf-text/0044ntm.pdf](http://www.nasdr.com/pdf-text/0044ntm.pdf).

### **NASD Fines Worldco and Four of Its Owners \$1.5 Million for Co-Mingling Operations with a Hedge Fund; CEO Barred, Three Others Suspended**

NASD announced that it has fined Worldco LLC of New York, NY, and four of its owners \$1.5 million for failing to separate Worldco's business operations from the business and operations of PTJP Partners, a hedge fund. John G. Miller, Worldco's CEO, was barred from serving as a principal of a securities firm for three years. Peter Bruan, founder of Worldco, was suspended for one year, and his sons, Walter Scott Bruan and Christopher Bruan, were suspended for four months and 15 days, respectively. Miller was fined \$250,000; Peter Bruan, \$100,000; Walter Scott Bruan, \$50,000; and Christopher Bruan, \$30,000. Each of the four is a part owner in the firm and their fines are part the \$1.5 million.

PTJP is controlled by members of the Bruan family, including, initially, Peter Bruan. Worldco failed to disclose that Peter Bruan had a controlling ownership interest in Worldco when it applied for NASD membership because of Bruan's concern that the hedge fund's ongoing relationships with other broker/dealers would be disrupted if the other firms learned of his ownership of a competitor. Worldco experienced significant growth during the 1990s due to its day-trading business. Worldco had about 200 individuals associated with it in 1997; by 2001 that number had increased to almost 1,150. PTJP used trading systems, computers and technology provided by and, in some instances, owned by Worldco. At times, PTJP shared certain office space, personnel, and other resources with Worldco. NASD found that, in the past, Worldco failed to establish adequate separation between its business and PTJP's operations, leading to many of the violations.

NASD found that 13 of Worldco's traders and 27 individuals not employed by Worldco, mostly PTJP traders, regularly traded in Worldco's proprietary accounts even though they were not registered, as required by NASD rules. Additionally, at least 35 Worldco traders traded in the PTJP account even though they did not obtain prior written authorization to exercise discretion in a customer account as required by NASD rules.

NASD also found that Worldco maintained inaccurate books and records and submitted inaccurate financial reports to the Securities and Exchange Commission (SEC) and NASD. In particular, as a result of the failure to adequately separate its business from PTJP, Worldco's books, records, and reports did not accurately reflect its individual expenses and revenues.

Further, for over 21 months beginning in early 1999, Worldco inaccurately characterized commission rebates owed to PTJP as revenue to Worldco in anticipation of a possible IPO, resulting in inaccurate books, records, and reports. After market conditions changed and an IPO was no longer practicable, Worldco returned over \$5 million to two Bruan family members for the benefit of PTJP and another hedge fund also connected to the Bruan family.

NASD also found that Worldco and Miller did not reasonably supervise many of these activities to deter and prevent the violations.

In settling these charges, Worldco, John Miller, Peter Bruan, Walter Scott Bruan, and Christopher Bruan neither admitted nor denied the charges.

Christopher Robin Bruan's suspension in any capacity began March 1, 2004, and will conclude at the close of business March 15, 2004.

Peter Bruan's suspension in any capacity began March 1, 2004, and will conclude at the close of business February 28, 2005. John Gerard Miller's suspension in any capacity began March 1, 2004, and will conclude at the close of business April 30, 2004. Miller's bar in a principal capacity will become effective May 1, 2004. Walter Scott Bruan's suspension in any capacity began March 1, 2004, and will conclude at the close of business March 31, 2004. Walter Scott Bruan's suspension in any principal capacity will begin April 1, 2004, and will conclude at the close of business June 30, 2004. (NASD Case #CAF040001).

2004 NASD

# Spring Securities Conference



Tuesday, May 11 – Thursday, May 13

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- ◆ Dozen Workshops on Other Timely Topics
- ◆ Three Days of Opportunities to Hear from and Speak with NASD Senior Staff and Other Industry Experts

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