

MARCH 2005

Notice to Members

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Disciplinary and Other NASD Actions

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Notice to Members

MARCH 2005

SUGGESTED ROUTING

Executive Representatives
Legal & Compliance
Senior Management
Registered Representatives

KEY TOPICS

NASD Sanction Guidelines
Institutional Sales Material
and Correspondence
Telemarketing
Research Analysts and Research
Reports

GUIDANCE

Sanction Guidelines

NASD Adopts New *Sanction Guidelines*; **Effective Date:
March 15, 2005**

Executive Summary

This *Notice* advises NASD members of modifications to the NASD *Sanction Guidelines* (Guidelines). NASD is adopting four new guidelines to provide recommended sanctions for violations of Rules 2211 (Institutional Sales Material), 2212 (Telemarketing), and 2711 (Research Analysts and Research Reports). Additionally, NASD is amending the guideline for violations related to communications with the public to indicate that the current sanction guideline also applies to violations of the content standards contained in Rule 2211. The new guidelines are effective as of **March 15, 2005**, and apply to all actions as of that date, including pending disciplinary cases.

The new guidelines for violations of Rules 2211 (Institutional Sales Material), 2212 (Telemarketing), and 2711 (Research Analysts and Research Reports), and the revised guidelines for violations related to communications with the public can be read in their entirety in attachment A to this *Notice*. The new and revised guidelines are also available on NASD's Web site (www.nasd.com).

Questions/Further Information

Questions concerning this *Notice* may be directed to Carla Carloni, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-7019.

05-17

Discussion

NASD initially published the Guidelines in 1993 to promote consistency and uniformity in the imposition of sanctions in disciplinary matters. Over the years, NASD has revised and updated the Guidelines and has adopted new individual guidelines in order to reflect changes in and additions to NASD's rules. Adjudicators rely on the Guidelines to determine appropriately remedial sanctions in disciplinary actions. NASD's Departments of Enforcement and Market Regulation and the defense bar also rely on the Guidelines in negotiating settlements in disciplinary matters. NASD therefore endeavors to maintain up-to-date and inclusive Guidelines that are designed to address a wide variety of potential violations of NASD's rules.

2211 – Institutional Sales Material and Correspondence

On May 9, 2003, the Securities and Exchange Commission (SEC) approved amendments to NASD Rule 2210 (Communications with the Public) and the creation of NASD Rule 2211 (Institutional Sales Material and Correspondence) as part of NASD's effort to modernize and clarify NASD's rules regarding member communications with the public. Rule 2211 is a separate rule applicable only to institutional sales material and correspondence. Rule 2211 subjects institutional sales material to supervision and review requirements, establishes standards for recordkeeping related to institutional sales material, and subjects institutional sales material and correspondence to content standards contained in Rule 2210. NASD separated Rule 2211 from the more general rule regarding member communications with the public (Rule 2210) in order to facilitate members' ability to determine how the advertising rules apply specifically to communications regarding institutional sales material and correspondence.

The new sanction guideline for violations of Rule 2211 is divided into two categories of violation: (1) the failure to establish and maintain written procedures in compliance with Rule 2211(b); and (2) the failure to comply with the record-keeping requirements contained in Rule 2211(b). Additionally, NASD amended the guideline for communications with the public (Rule 2210) to indicate that the current sanction guideline for violations related to communications with the public also now applies to violations of the content standards contained in Rule 2211(d).

Rule 2212 – Telemarketing¹

In 2003, the Federal Trade Commission (FTC) and the Federal Communications Commission (FCC) established requirements for sellers and telemarketers to participate in a national do-not-call registry. In January 2004, the SEC approved amendments to NASD's revised Rule 2212, which applies only to telephone solicitations, provides time-of-day restrictions on solicitation calls, requires member firms to maintain firm-specific do-not-call lists, and prohibits member firms from making telephone solicitation calls to any person who registers his or her phone number on the national do-not-call registry.

The new sanction guideline for violations of Rule 2212 is divided into two categories of violation: (1) the failure to comply with time-of-day restrictions or do-not-call lists; and (2) the failure to establish and maintain procedures to comply with the do-not-call and time-of-day requirements in subpart (a) of the rule.

Rule 2711 – Research Analysts and Research Reports

The SEC approved Rule 2711 on May 10, 2002, and approved important amendments to Rule 2711 on July 29, 2003. Rule 2711 provides specific guidance for member firms regarding the regulation of the relationship between the research and investment banking departments. The rule establishes disclosure requirements for research reports and public appearances by research analysts and imposes time restrictions on the publishing of research reports and research analysts' public appearances. Rule 2711 also imposes restrictions on the personal trading of research analysts; research analysts' communications with target companies; research analysts' compensation; and other conduct related to member firms' research activities.

NASD adopted two new guidelines to address violations of Rule 2711. One guideline recommends sanctions for violations regarding the limitations on the relationships between the research departments and investment banking departments, the relationships between research analysts and subject companies, and the manner of compensation for research analysts. The second guideline addresses violations in two categories. In the first category, the guideline provides recommended sanctions for failing to comply with restrictions on personal trading by research analysts. In the second category, the guideline provides recommended sanctions for failing to comply with restrictions on publishing research reports; restrictions on the public appearances of research analysts; and disclosure requirements for research reports and public appearances.

Effective Date

The amendments to the current sanction guideline for violations related to communications with the public and the new guidelines for violations of Rules 2211 (Institutional Sales Material), 2212 (Telemarketing), and 2711 (Research Analysts and Research Reports) are effective as of **March 15, 2005**, and apply to all actions as of that date, including pending disciplinary cases.

Endnote

1 On May 9, 2003, the SEC approved the renumbering of NASD's former telemarketing rule (Rule 2211) to Rule 2212. On January 12, 2004, the SEC approved significant amendments to Rule 2212. NASD's current telemarketing guideline references NASD's former Rule 2211

and was adopted prior to NASD's enactment of Rule 2212. NASD's new telemarketing guideline addresses violations of Rule 2212, as amended, and supersedes NASD's current telemarketing guideline.

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ATTACHMENT A

(Additions are underlined)

Communications with the Public—Late Filing; Failing to File¹; Failing to Comply with Rule Standards or Use of Misleading Communications²

NASD Conduct Rules 2210, 2211(d), and 2220³

Principal Considerations in Determining Sanctions	Monetary Sanction	Suspension, Bar, or Other Sanctions
<p>See <i>Principal Considerations in Introductory Section</i></p> <p><i>Failure to File</i></p> <ol style="list-style-type: none"> Whether failure to file was inadvertent. Whether communications with the public were circulated widely without having been filed with the Advertising Regulation Department. Whether an individual respondent failed to notify a supervisor of a communication with the public. <p><i>Late Filing</i></p> <ol style="list-style-type: none"> Whether late filing was inadvertent. Whether communications with the public were circulated widely before having been filed with the Advertising Regulation Department. Number of days late. 	<p><i>Failure to File</i></p> <p>Fine of \$1,000 to \$15,000.</p> <p><i>Late Filing</i></p> <p>Fine of \$1,000 to \$10,000.</p>	<p><i>Failure to File</i></p> <p>In egregious cases, consider imposing, for a definite period, a "pre-use" filing requirement to obtain an NASD Regulation staff "no objection" letter on proposed communications with the public.</p> <p>Also consider suspending the responsible individual in any or all capacities for up to five business days.</p> <p><i>Late Filing</i></p> <p>In egregious cases, consider imposing, for a definite period, a "pre-use" filing requirement to obtain an NASD Regulation staff "no objection" letter on proposed communications with the public.</p> <p>Also consider suspending the responsible individual in any or all capacities for up to 10 business days.</p>

1 Failing to file includes instances in which a respondent files with NASD Regulation staff a communication with the public in response to a notice from NASD Regulation staff that a necessary filing had not been made.

2 This guideline is appropriate for disciplinary actions that name as respondents member firms that have violated NASD rules or associated persons who have circumvented the firm's procedures or violated the NASD's rules.

3 This guideline also is appropriate for violations of MSRB Rule G-21.

Communications with the Public Continued

Principal Considerations in Determining Sanctions	Monetary Sanction	Suspension, Bar, or Other Sanctions
<p><i>See Principal Considerations in Introductory Section</i></p> <p>Failure to Comply with Rule Standards</p> <p>1. Whether violative communications with the public were circulated widely.</p>	<p>Failure to Comply/Misleading</p> <p>Failure to Comply with Rule Standards</p> <p>Fine of \$1,000 to \$20,000.</p> <p>Use of Misleading Communications with the Public</p> <p>Fine of \$10,000 to \$100,000.</p>	<p>Failure to Comply/Misleading</p> <p>Failure to Comply with Rule Standards</p> <p>In egregious cases, consider suspending the firm with respect to any or all activities or functions for up to one year and thereafter imposing, for a definite period, a "pre-use" filing requirement to obtain an NASD Regulation staff "no objection" letter on proposed communications with the public. Also consider suspending the responsible person in any or all capacities for up to 60 days.</p> <p>Use of Misleading Communications with the Public</p> <p>In cases involving inadvertent use of misleading communications, consider suspending firm with respect to any or all activities or functions for up to six months and thereafter imposing, for a definite period, a "pre-use" filing requirement to obtain an NASD Regulation staff "no objection" letter on proposed communications with the public.</p> <p>In cases involving intentional or reckless use of misleading communications with the public, consider suspending the firm with respect to any or all activities or functions for up to two years.⁴</p> <p>Also consider suspending the responsible person in any or all capacities for up to two years.</p> <p>In cases involving numerous acts of intentional or reckless misconduct over an extended period of time, consider suspending the firm with respect to any or all activities or functions for up to two years, suspending the responsible person in any or all capacities for up to two years, expelling the firm, and/or barring the responsible individual.</p>

New Guideline

Institutional Sales Material—Failing to Establish and Maintain Written Procedures in Compliance with Rule Standards; Failing to Comply with Rule Standards Regarding Recordkeeping

NASD Conduct Rule 2211

Principal Considerations in Determining Sanctions	Monetary Sanction	Suspension, Bar, or Other Sanctions
<p>See <i>Principal Considerations In Introductory Section</i>.</p> <p><i>Failure to Establish and Maintain Written Procedures in Compliance with Rule 2211(b)</i></p> <ol style="list-style-type: none"> Whether deficiencies enabled violations to occur and escape detection. Nature, extent, and character of underlying misconduct, if any. 	<p><i>Failure to Establish and Maintain Written Procedures in Compliance with Rule 2211(b)</i></p> <p>Fine of \$5,000 to \$20,000.</p>	<p><i>Failure to Establish and Maintain Written Procedures in Compliance with Rule 2211(b)</i></p> <p>In egregious cases, consider suspending the responsible individual(s) in any or all capacities for up to one year. In egregious cases, also consider imposing a pre-use filing requirement for institutional sales material and suspending the firm with respect to any or all activities or functions for up to 30 business days or until the firm's written procedures are amended to conform to the requirements of Rule 2211(b).</p>
<p><i>Failure to Comply with Record-Keeping Requirements of Rule 2211(b)</i></p> <ol style="list-style-type: none"> Nature and materiality of inaccurate or missing information. 	<p><i>Failure to Comply with Record-Keeping Requirements of Rule 2211(b)</i></p> <p>Fine of \$1,000 to \$20,000. In egregious cases, consider a higher fine.</p>	<p><i>Failure to Comply with Record-Keeping Requirements of Rule 2211(b)</i></p> <p>In egregious cases, consider suspending the responsible individual for up to two years and consider suspending the firm in any or all activities or functions for up to 30 days.</p>

New Guideline (supersedes current telemarketing guideline)

Telemarketing—Failing to Comply with Time-of-Day Restrictions and Do-Not-Call Lists; Failing to Establish and Maintain Procedures to Comply with Rule 2212(a)

NASD Conduct Rule 2212

Principal Considerations in Determining Sanctions	Monetary Sanction	Suspension, Bar, or Other Sanctions
<p><i>See Principal Considerations In Introductory Section.</i></p> <p><i>Failure to Comply with Time-of-Day Restrictions or Do-Not-Call Lists</i></p> <ol style="list-style-type: none"> 1. Whether violations were widespread within the firm. 2. Number of calls that violated restrictions. 3. Whether there are patterns of abuses relating to when telephone calls are placed or to the repeated contacting of persons who have previously requested to be placed on a do-not-call list. 4. Whether firm made reasonable efforts to establish an effective call-blocking system for any members of the public requesting to be placed on a do-not-call list. 	<p><i>Failure to Comply with Time-of-Day Restrictions or Do-Not-Call Lists</i></p> <p>Fine of \$5,000 to \$25,000.</p>	<p><i>Failure to Comply with Time-of-Day Restrictions or Do-Not-Call Lists</i></p> <p>Consider suspending responsible individual for up to 30 business days. In egregious cases, consider suspending the responsible individual in any or all capacities for up to two years. Also, consider suspending the firm with respect to any or all activities or functions, including telemarketing activities, for up to one year.</p>

Telemarketing continued

NASD Conduct Rule 2212

Principal Considerations in Determining Sanctions	Monetary Sanction	Suspension, Bar, or Other Sanctions
<p data-bbox="164 737 699 800"><i>Failure to Establish and Maintain Procedures to Comply with Rule 2212(a)</i></p> <ol data-bbox="164 825 732 1230" style="list-style-type: none"> <li data-bbox="164 825 732 915">1. Nature and extent of underlying misconduct that resulted from the deficient procedures, if any. <li data-bbox="164 936 732 1058">2. Whether firm made reasonable efforts to establish an effective call-blocking system for any members of the public requesting to be placed on a do-not-call list. <li data-bbox="164 1079 732 1230">3. Whether there are patterns of abuses relating to when telephone calls are placed or to the repeated contacting of persons who have previously requested to be placed on a do-not-call list. 	<p data-bbox="753 737 964 894"><i>Failure to Establish and Maintain Procedures to Comply with Rule 2212(a)</i></p> <p data-bbox="753 915 964 1073">Fine of \$5,000 to \$50,000. In egregious cases, consider a higher fine.</p>	<p data-bbox="997 737 1456 789"><i>Failure to Establish and Maintain Procedures to Comply with Rule 2212(a)</i></p> <p data-bbox="997 810 1456 999">Consider suspending responsible individual in any or all capacities for up to 30 business days. Consider limiting activities of appropriate branch office or department for up to 30 business days.</p> <p data-bbox="997 1020 1456 1314">In egregious cases, consider suspending the responsible individual for up to two years. In egregious cases, also consider limiting activities of appropriate branch office or department for more than 30 days or suspending the firm in any or all activities or functions, including telemarketing activities, for up to one year.</p>

New Guideline

Research Analysts and Research Reports—Failing to Comply with Rule Requirements Regarding (1) Relationships Between Research Department and Investment Banking Department; (2) Compensation for Research Analysts; and (3) Relationships Between Research Analysts and Subject Companies¹

NASD Conduct Rule 2711(b), 2711(c), 2711(d), 2711(e), 2711(j)

Principal Considerations in Determining Sanctions	Monetary Sanction	Suspension, Bar, or Other Sanctions
<p>See <i>Principal Considerations In Introductory Section</i>.</p> <ol style="list-style-type: none"> 1. Whether misconduct resulted from negligence or intentional/reckless behavior. 2. Whether misconduct also resulted in publication of research reports that omitted material information or contained misleading information. 3. Whether evidence suggested systemic problems or widespread abuse at the firm. 	<p><i>Negligent Misconduct</i></p> <p>Fine of \$5,000 to \$100,000.</p> <p><i>Intentional/Reckless Misconduct</i></p> <p>Fine of \$10,000 to \$200,000. In egregious cases, consider a larger fine.</p>	<p><i>Negligent Misconduct</i></p> <p>Consider suspending the responsible individual(s) in any or all capacities for up to 30 business days.</p> <p><i>Intentional/Reckless Misconduct</i></p> <p>Responsible Individual – Suspend responsible individual(s) in any or all capacities for a period of 30 business days to two years. In egregious cases, suspend individual(s) for a longer period or bar individual(s).</p> <p>Firm – Consider suspending firm’s research activities for a period of one month to two years. Consider requiring firm to retain an independent consultant to review and make recommendations regarding the adequacy of the firm’s supervisory procedures regarding research activities. In cases involving violative relationships between a firm’s research department and investment banking department, consider suspending the firm’s investment banking activities for a period of three months to two years.</p> <p>In egregious cases, suspend firm in any or all activities or functions for up to two years or expel the firm.</p>

¹ For violations of Rule 2711(i) Supervisory Procedures, Adjudicators should refer to the guideline for Supervision – Failure to Supervise.

New Guideline

Research Analysts and Research Reports—Failing to Comply with Rule Requirements Regarding (1) Restrictions on Publishing Research Reports and Public Appearances of Research Analysts; (2) Restrictions on Personal Trading of Research Analysts; and (3) Disclosure Requirements for Research Reports and Public Appearances of Research Analysts¹

NASD Conduct Rule 2711(f), 2711(g), 2711(h)

Principal Considerations in Determining Sanctions	Monetary Sanction	Suspension, Bar, or Other Sanctions
<p><i>For all violations</i></p> <p><i>See Principal Considerations In Introductory Section.</i></p> <ol style="list-style-type: none"> Whether misconduct resulted from negligence or intentional/reckless behavior. Whether misconduct also resulted in publication of research reports that omitted material information or contained misleading information. Whether evidence suggested systemic problems or widespread abuse in the firm. 	<p><i>Failure to Comply with Restrictions on Personal Trading of Research Analysts (Rule 2711(g))</i></p> <p>Fine of \$5,000 to \$50,000.² In egregious cases, consider a higher fine.</p>	<p><i>Failure to Comply with Restrictions on Personal Trading of Research Analysts (Rule 2711(g))</i></p> <p>Suspend individual in any or all capacities for a period of 10 business days to one year. In egregious cases, consider a longer suspension or a bar.</p>

¹ For violations of Rule 2711(i) Supervisory Procedures, Adjudicators should refer to the guideline for Supervision – Failure to Supervise.

² As set forth in General Principle No. 6, Adjudicators may increase the fine amount by adding the amount of the respondent's financial benefit.

Research Analysts and Research Reports continued

NASD Conduct Rule 2711(f), 2711(g), 2711(h)

Principal Considerations in Determining Sanctions	Monetary Sanction	Suspension, Bar, or Other Sanctions
	<p><i>Failure to Comply with Restrictions on Publishing Research Reports, Restrictions on Public Appearances of Research Analysts, and Disclosure Requirements for Research Reports and Public Appearances (Rule 2711 (f) and (h))</i></p> <p><i>Negligent Misconduct</i></p> <p>Fine of \$5,000 to \$100,000.</p> <p><i>Intentional/Reckless Misconduct</i></p> <p>Fine of \$10,000 to \$200,000. In egregious cases, consider a larger fine.</p>	<p><i>Failure to Comply with Restrictions on Publishing Research Reports, Restrictions on Public Appearances of Research Analysts, and Disclosure Requirements for Research Reports and Public Appearances (Rule 2711 (f) and (h))</i></p> <p><i>Negligent Misconduct</i></p> <p>Responsible Individual – Consider suspending responsible individual(s) in any or all capacities for up to 60 business days.</p> <p><i>Intentional/Reckless Misconduct</i></p> <p>Responsible Individual – Suspend responsible individual(s) in any or all capacities for a period of 60 business days to two years. In egregious cases, suspend individual(s) for a longer period or bar individual(s).</p> <p>Firm – Consider suspending firm’s research activities for a period of one month to two years. Consider requiring firm to retain an independent consultant to review and make recommendations regarding the adequacy of the firm’s supervisory procedures regarding research activities. Consider requiring firm, for a period of six months to two years, to certify monthly that a general securities principal has conducted a pre-distribution review of all research reports.</p> <p>In egregious cases, suspend firm in any or all activities or functions for up to two years or expel the firm.</p>

Notice to Members

MARCH 2005

SUGGESTED ROUTING

Corporate Finance
Internal Audit
Legal & Compliance
Registered Representatives
Retail
Senior Management

KEY TOPICS

Broker-Dealer Registration
Due Diligence
Non-Conventional Investments
Private Placements
Real Estate
Rule 2420
Suitability

GUIDANCE

Private Placements of Tenants-in-Common Interests

NASD Issues Guidance on Section 1031 Tax-Deferred
Exchanges of Real Property for Certain Tenants-in-
Common Interests in Real Property Offerings

Executive Summary

This Notice addresses Section 1031 tax-deferred exchanges of real property for certain tenants-in-common (“TIC”) interests in real property offerings.¹ In a TIC exchange, interests in real property are exchanged for instruments that generally are securities for purposes of the federal securities laws and NASD rules.² This *Notice* reminds members that when offering TIC interests that are securities to customers, members and their associated persons must comply with all applicable NASD rules, including those addressing:

- ◆ suitability;
- ◆ due diligence;
- ◆ splitting commissions with unregistered individuals or firms;
- ◆ supervision; and
- ◆ recordkeeping.

In addition, members relying on private offering exemptions from the registration requirements of the Securities Act of 1933 must ensure that their manner of offering TIC interests complies with all applicable requirements, including the prohibition on general solicitation.

Questions/Further Information

Questions concerning this *Notice* should be directed to Joseph E. Price, Vice President, Corporate Financing Department, at (240) 386-4623 or Gary L. Goldsholle, Associate Vice President and Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8104.

Characteristics of TIC Exchanges

Tax Status

Typically, the sale of an investment, including an investment in real estate, is a taxable event, with the seller being responsible for capital gains taxes on the appreciation of the investment. Under Section 1031 of the Internal Revenue Code, however, an investor in income-producing or rental real estate may exchange the investment for another investment in income-producing or rental real estate of equal or greater value and defer payment of capital gains. In order to qualify for a deferral under Section 1031, an investor must acquire an interest in real estate in the exchange, not an interest in a partnership.

For example, if an investor purchased rental real property in 1972 for \$50,000, the property today may be worth \$2 million dollars. The sale of the property would cause the seller to incur taxes on the profit. If the owner of the rental property exchanged the rental property for different real property, he could defer paying these taxes. Because of the difficulty of finding equal and offsetting properties for each investor, sponsors have offered interests in larger real estate offerings to pools of investors, in the form of TIC interests. In the example provided, rather than exchanging a rental property valued at \$2 million for a similarly valued property, the owner could pool his interest with other similarly situated property owners to acquire property or properties with a large enough value to provide tax deferral for all the investors. If, however, the pool of investors is treated as a partnership under the principles of federal tax law, the exchange will not qualify under Section 1031, and the taxes on the investors' profits will not be deferred under that section.

TIC exchanges have grown dramatically, from approximately \$150 million in sales in 2001 to approximately \$2 billion in 2004.³ The driving force behind the growth in TIC exchanges is their favorable tax treatment.

In March 2002, the IRS issued Revenue Procedure 2002-22, 1 C.B. 733 ("Rev. Proc. 2002-22"), which addresses the conditions under which the IRS will consider a request for a ruling that a TIC interest in rental real estate is not an interest in a partnership. Rev. Proc. 2002-22 describes the central characteristic of a tenancy in common (each owner is deemed to own individually a physically undivided part of the entire parcel of property) and sets forth 15 specific conditions that must be met before the IRS will consider issuing a ruling.⁴ If the arrangement among the investors is respected as a TIC interest in rental real estate, rather than an interest in a partnership, an exchange may qualify under Section 1031 if the other conditions of that section are satisfied.

Securities Law Status

When TICs are offered and sold together with other arrangements, they generally would constitute investment contracts and thus securities under the federal securities laws.⁵ An investment contract includes any contract, transaction or scheme in which persons invest their money in a common enterprise, with the expectation of profits to be derived predominantly from the efforts of others.⁶ TIC interests are generally investment contracts because the tenants in common invest in an undivided fractional interest in the rental real property by pooling their assets and sharing in the risks and benefits of the enterprise, while obtaining profits derived predominantly from the efforts of others, such as through contracts concerning leasing, management and operation of the acquired property. In addition to managing the property, TIC sponsors typically structure the TIC and negotiate the sale price and the loan. The fact that investors in a particular TIC program might have authority to terminate a management contract, or even to maintain or repair the property, would not demonstrate that the TIC interest is not an investment contract.⁷

Although Section 1031 does not apply to an exchange of investment property for "interests in a partnership," "stocks, bonds, notes," or "other securities," the federal securities law definitions of those terms do not control interpretation of the tax laws. Accordingly, the fact that TIC interests typically are investment contracts under securities laws does not inherently disqualify them as property that may be exchanged under Section 1031.

We have become aware that certain states may exempt particular types of TIC transactions from the definition of "security" under state law. We remind members, however, that a determination that a particular transaction does not involve a security for purposes of state law is not determinative for purposes of federal securities law.

Application of NASD Rules to TIC Exchanges

TIC interests are a type of non-conventional investment ("NCI"). In NTM 03-71, NASD explained that members engaged in the sale of NCIs must ensure that those products are offered and sold in a manner consistent with the member's general sales conduct obligations, as well as address any special circumstances presented by the sale of those products. Among the issues highlighted in NTM 03-71 are members' responsibilities to:

- ◆ conduct appropriate due diligence;
- ◆ perform a reasonable-basis suitability analysis;
- ◆ perform customer specific suitability analysis for recommended transactions;
- ◆ ensure that promotional materials used by the member are fair, accurate, and balanced;
- ◆ implement appropriate internal controls; and
- ◆ provide appropriate training to registered persons involved in the sale of these products.

Suitability and Due Diligence

Before recommending a TIC exchange, members must have a clear understanding of the investment goals and current financial status of the investor. In many cases, a TIC interest will constitute a significant portion of an investor's total assets. Because of the favorable tax treatment, investors often elect to invest the entire proceeds from the sale of an investment property in a TIC exchange. Concentration of an investor's assets in a single asset class, however, is not suitable for many investors.⁸ Members must, with respect to each customer for whom they make a recommendation, consider the risks from over-concentration against the benefits of tax deferral and the investment potential of the underlying real estate asset(s).

TIC interests are illiquid securities. NASD is not aware of any secondary market for TIC interests. Moreover, the tenant-in-common form of ownership may require unanimous consent to sell a TIC interest. The subsequent sale of TIC interests may only be possible at a significant discount to the net asset value of the undivided interest in the real estate. As fees charged in connection with a TIC exchange increase, the money saved as a consequence of tax deferral will be offset. Accordingly, members should consider the effect of fees on each TIC exchange.

TIC exchange sponsors routinely obtain legal opinions regarding whether a particular TIC's offering structure will qualify as a like-kind exchange of real property under Section 1031. Given the importance of that tax treatment, a member should obtain a "clean" legal opinion that a TIC "should" or "will" qualify for exchange under Section 1031. If a sponsor failed to obtain a legal opinion, or only obtained a "more likely than not" opinion, that would be a material fact. In such a case, a member, as part of its due diligence responsibilities would be required to ascertain the specific tax status risks of the TIC exchange and inform the investor of the risks involved.

In making a suitability determination in connection with a recommendation to a customer to purchase a TIC interest, a member must also consider whether the fees and expenses associated with TIC transactions outweigh the potential tax benefits to the customer. TICs structured with high up-front fees and expenses paid to the sponsor and/or salespersons of the selling broker-dealers raise particular concerns about the ability to make a suitable recommendation. In addition, TIC transactions in many cases may not provide complete tax-free exchanges for investors (e.g., in situations where the investor's debt ratio on the replacement property decreases, the difference may result in a taxable event for the investor). Members must take all of these factors into consideration when recommending a particular TIC transaction to a customer.

NTM 03-71 reminds members that the type of due diligence that is appropriate will vary from product to product. NASD staff believes that it is not appropriate for members that recommend a TIC transaction simply to rely on representations made by the sponsor in an offering document. While the nature and extent of verification will vary with the facts and circumstances related to particular sponsors and offerings, members should make a reasonable investigation to ensure that the offering document does not contain false or misleading information. Such an investigation could include background checks of the sponsor's principals, review of the agreements (e.g., property

management, purchase and sale, lease and loan agreements) and property inspection.⁹ In addition, if the offering document contains projections, members should understand the basis for those projections, and the degree of likelihood that they will occur. For example, members should determine whether any projected yields can reasonably be supported by the property operations.

Payment of Referral Fees

Real estate agents sometimes refer their customers to broker-dealers that offer TIC exchanges. Moreover, some states may require that a licensed real estate agent participate in the transfer of a TIC interest to an investor. A broker-dealer that pays a fee to the real estate agent or splits its brokerage commissions with the agent in connection with a TIC exchange may be deemed to have violated NASD Rule 2420. This rule generally prohibits the payment of commissions and fees to entities that operate (or based on the proposed activities, would operate) as unregistered broker-dealers. Under Section 3(a)(4)(A) of the Securities Exchange Act of 1934, a "broker" is defined as a person "engaged in the business of effecting transactions in securities for the account of others." Section 15(a) of the Exchange Act sets forth the general registration requirements for brokers and dealers.¹⁰

The determination of whether an entity should be registered as a broker-dealer rests with the Securities and Exchange Commission. Among the activities the SEC staff has found require registration are:

- ◆ receiving transaction-based compensation;
- ◆ participating in presentations or negotiations;
- ◆ making securities recommendations or discussing or presenting the attributes of a securities investment;
- ◆ structuring securities transactions; and
- ◆ recommending lawyers, underwriters, or broker-dealers for the distribution or marketing of securities in the secondary market.¹¹

It is our understanding that the SEC staff would deem a real estate agent's receipt of a referral fee from a broker-dealer in connection with the sale of a TIC interest to be the type of activity that would render the real estate agent an unregistered broker-dealer. Therefore, under Rule 2420, a member may not pay a real estate agent who is not registered as a broker-dealer for participating in the transfer of a TIC interest that is structured as a security, nor may a member pay such real estate agent for referring TIC business that involves securities.¹² A member also may not evade Rule 2420 through indirect payments; for example, a member may not engage in an arrangement in which it reduces its normal commission for a TIC exchange so that the customer will pay the difference to the real estate agent for participating in the TIC exchange or for referring business to the broker-dealer.

Members that act as TIC sponsors and pay fees to real estate agents should carefully review SEC and NASD precedent and, if necessary, consult an attorney with experience in these matters.

Licensing, Supervision and Recordkeeping

Associated persons selling TIC interests must have passed the appropriate qualification examinations. Because TICs are typically structured as direct participation programs (“DPPs”), associated persons who sell them generally must have passed either the Series 7 or the Series 22 (Limited Representative — Direct Participation Program securities). In addition, most states require the Series 63 State Agent’s license. Also, as with any security, a TIC interest transaction must be reviewed and endorsed by a qualified principal in accordance with the member’s supervisory procedures.¹³ A qualified principal for supervising TIC interests would be either a General Securities Principal (Series 24) or a DPP principal (Series 39).

In accordance with NASD Rule 3010, members should establish an appropriate supervisory system for the offer and sale of TIC interests. The system should include comprehensive written supervisory procedures reasonably designed to ensure compliance with all applicable rules, including suitability and sales practice requirements related to TIC transactions. The supervisory system should address the sales practice issues discussed in this Notice, including ensuring that neither the member nor its registered representatives pay referral fees or otherwise share transaction-based compensation from TIC transactions with persons that would be deemed to be unregistered broker-dealers.

NASD and SEC record keeping and retention requirements also apply to TIC transactions, and firms should establish appropriate procedures to comply with the applicable requirements in SEC Rules 17a-3 and 17a-4, and NASD Rule 3110. Due to the complexity and varying documentation requirements of TIC exchanges, firms should examine the records they maintain and ensure that applicable record keeping requirements are satisfied.

Private Offering Exemption

Many TIC transactions are conducted without registration under the Securities Act of 1933 as private placements, most in reliance on Regulation D under that statute.¹⁴ One of the fundamental requirements of most Regulation D offerings is a prohibition on general solicitation.¹⁵ As a result of this prohibition, neither the issuer nor any person acting on its behalf may offer or sell securities based on general solicitation or general advertising, including communications published in any newspaper or similar media or any seminar or meeting whose attendees have been invited by any general solicitation or advertising.

A critical factor in determining whether a communication is appropriately limited, and thus not a “general solicitation,” is the existence of an adequate pre-existing relationship between a member and the TIC offeree. An adequate pre-existing relationship will enable the member to evaluate the potential TIC investor’s sophistication and financial circumstances.¹⁶

If a communication is made by general solicitation, then an issuer or its agents will have made a prohibited general solicitation if the communication includes an offer of the privately placed securities. If the communication references a security that is currently offered or contemplated to be offered at the time of the communication, the communication will generally be considered an offer of that security. In addition, if the person solicited via the communication is subsequently offered a security that was currently offered or contemplated to be offered at the time of the communication, the communication would generally be considered an offer of that security.

Members have requested guidance with regard to two specific methods of solicitation or advertising. In the first scenario, a registered representative who also holds a real estate license solicits potential investors by advertising a "real estate" seminar. At the seminar, investors are given a presentation on TIC exchanges and are made aware that the member offers TIC investments to its customers. Since the advertisement for the seminar would be a general solicitation, and since the references to the TIC investments currently being offered by members would be deemed an offer of those securities, the members engaged in such offerings would not be able to rely on the exemption from registration for private placements under Regulation D.¹⁷

In the second scenario, members place advertisements in newspapers and magazines that indicate that the member sells TIC interests, but the advertisements do not identify any particular TIC investment for sale by the member. Since the advertisement itself is a general solicitation, the issue for members is whether the advertisement includes an offer of securities. In general, such an advertisement would not be deemed an offer of securities if:

- ◆ the advertisement is generic;
- ◆ the advertisement is not being made in contemplation of an offering; and
- ◆ the member has procedures to ensure that an investor solicited via the advertisement will not be offered TICs that the member is currently offering or contemplating offering at the time of the initial contact.

Advertisements that do not meet each of these conditions are likely to be deemed general solicitations and inconsistent with the conditions for private placements conducted in compliance with Regulation D. Moreover, in addition to meeting these conditions, the other requirements under Regulation D also must be met, including establishing an adequate, substantive and pre-existing relationship with the investor and completing a suitability analysis prior to offering TICs to an investor.¹⁸

Endnotes

- 1 This NTM is focused on investors exchanging real estate for TIC interests. NASD is aware that some investors purchase TIC interests directly, without a corresponding exchange of real estate. Many of the concepts discussed herein are applicable to investors in TIC interests who are not exchanging real property.
- 2 See, e.g., *SEC v. Edwards*, 540 U.S. 389 (2004), 124 S. Ct. 892 (2004). See also Triple Net Leasing, LLC, SEC No-Action Letter, SEC No-Act. LEXIS 824 (Aug. 23, 2000). (The staff of the SEC's Division of Corporation Finance stated that it was unable to assure the requestor that it would not recommend enforcement action to the Commission unless the described TIC exchanges subject to a master lease agreement were registered under the Securities Act of 1933 or exempt from such registration.)
- 3 Terry Fiedler, *Buying a Little Piece of a Big Deal*, Minneapolis Star Tribune, August 16, 2004; Terry Pristin, *Money Flowing New Way to Pool Buyers*, New York Times, September 22, 2004.
- 4 The 15 factors are: Tenancy in Common Ownership; Number of Co-Owners; No Treatment of Co-Ownership as an Entity; Co-Ownership Agreement; Voting; Restrictions on Alienation; Sharing Proceeds and Liabilities upon Sale of Property; Proportionate Sharing of Profits and Losses; Proportionate Sharing of Debt; Options; No Business Activities; Management and Brokerage Agreements; Leasing Agreements; Loan Agreements; and Payments to Sponsor. Detailed information concerning these conditions is provided in Rev. Proc. 2002-22.
- 5 TIC interests in real property standing alone generally are not securities, but are a form of ownership in which each tenant (i.e., owner) holds a fractional undivided interest in real property under state real property law.
- 6 See, e.g., *SEC v. Edwards*, 540 U.S. 389 (2004); *United Housing Foundation, Inc. v. Forman*, 421 U.S. 837 (1975); *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).
- 7 Rev. Proc. 2002-22 limits the activities of TIC interest holders to those "customarily performed in connection with the maintenance and repair of rental property." Rev. Proc. 2002-22, at 18 (2002). IRB LEXIS 122 *8.
- 8 See *Stephen Thorlief Rangen*, 52 S.E.C. 1304, 1308 (1997) (finding that broker's recommendations were unsuitable where they resulted in 80 percent of the equity in customers' accounts being concentrated in one stock – "by concentrating so much of their equity in particular securities, [the broker] increased the risk of loss for these individuals beyond what is consistent with the objective of safe, non-speculative investing"). See also *Stephen Thorlief Rangen*, 53 S.E.C. 290, 292 (1997) (Order Denying Motion for Reconsideration) ("[O]ur findings of undue concentration served to support our conclusion that Rangen's recommendations were unsuitable."); *Department of Enforcement v. Daniel R. Howard*, No. C11970032, 2000 NASD Discip. LEXIS 16, at *19 (Nov. 16, 2000) (holding that the broker's recommendations "also led to an undue concentration of these speculative securities, making the recommendations particularly unsuitable"), *aff'd*, Exchange Act Rel. No. 46269, 2002 SEC LEXIS 1909 (July 26, 2002), *aff'd*, No. 02-1939, 2003 U.S. App. LEXIS 19454 (1st Cir. Sept. 19, 2003); *Dane S. Faber*, Exchange Act Rel. No. 49216, 2004 SEC LEXIS 277, at *26 (Feb. 10, 2004) ("We have repeatedly found that high concentration of investments in one or a limited number of speculative securities is not suitable for investors seeking limited risk.").
- 9 For example, members should make a reasonable investigation to ensure that any agreement associated with the TIC transaction, such as a master lease agreement with a real estate investment trust or its operating partnership, does not mandate a transaction subsequent to the acquisition of the TIC interest that would threaten the tax treatment of the acquisition under Section 1031.

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- 10 Section 15(a) of the Exchange Act excepts from registration "a broker or dealer whose business is exclusively intrastate and who does not make use of any facility of a national securities exchange." The intrastate exception in Section 15(a) traditionally has been narrowly and literally construed. See *Buy Blue Chip Stocks Direct*, SEC No-Action Letter, SEC No-Act. LEXIS 155 (Jan. 24, 1996); *Legacy Motors, Inc.*, SEC No-Act. LEXIS 986 (Jul. 31, 1991); *CMS Financial Group Inc.*, SEC No-Act. LEXIS 673 (Apr. 2, 1990); *Don Chamberlain*, SEC No-Act. LEXIS 3271 (Aug. 10, 1979); *National Educator's Group, Inc.*, SEC No-Act. LEXIS 2884 (Oct. 17, 1977); *American Liberty Financial Corp.*, SEC No-Act. LEXIS 2629 (Nov. 21, 1975).
- 11 See, e.g., *Dominion Resources, Inc.*, SEC No-Action Letter, 2000 SEC No-Act. LEXIS 304 (Mar. 7, 2000) (revoking prior no-action relief granted to a firm that assisted corporate and governmental issuers in structuring securities transactions and recommending broker-dealers); *John Wirthlin*, SEC No-Action Letter, 1999 SEC No-Act. LEXIS 83 (Jan. 19, 1999) (no-action relief denied to a person that would solicit investments in real estate limited partnership interests and would receive a fee if any referred investors purchased those interests); *Davenport Management, Inc.*, SEC No-Action Letter, 1993 SEC No-Act. LEXIS 624 (Apr. 13, 1993) (registration required where business broker receives transaction fees and participates in negotiations); *Woodmoor Corporation*, SEC No-Action Letter, 1972 SEC No-Act. LEXIS 1052 (Feb. 3, 1972) (real estate agent could not discuss or present any of the attributes of the security, nor provide documents connected with the investment).
- 12 A member that pays fees to an unregistered person who acts as a finder would not be deemed to violate Rule 2420 if the member obtained a no-action letter from the SEC staff indicating that the finder is not required to register as a broker-dealer.
- 13 Rule 3010(d).
- 14 17 CFR 230.501-508.
- 15 Rule 504 under Regulation D has certain exceptions from the general solicitation limitations.
- 16 *E.F. Hutton & Co. Inc.*, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2917 (Dec. 3, 1985) (In determining what constitutes general solicitation, the Division of Corporation Finance underscored the importance of substantive, pre-existing relationships with offerees prior to their being solicited); *Bateman Eichler, Hill Richards, Inc.*, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2918 (Dec. 3, 1985) (Division concurs in the view that it would not constitute a general solicitation if proposed solicitation that would be generic in nature, would not make any reference to any specific investment currently offered or contemplated to be offered at the time of the solicitation, and persons solicited are not offered any securities that were offered or contemplated for offering at the time of the solicitation); see also *H.B. Shaine & Co., Inc.*, SEC No-Action Letter, 1987 SEC No-Act. LEXIS 2004 (May 1, 1987); *Woodtrails-Seattle, Ltd.*, SEC No-Action Letter, 1982 SEC No-Act. LEXIS 2662 (Aug. 9, 1982).
- 17 *Cf. Aspen Grove*, SEC No-Action Letter, 1982 SEC No-Act. LEXIS 3136 (Dec. 8, 1982) (no-action relief denied where promotional brochure for limited partnership offering would be distributed at a horse auction).
- 18 See, e.g., *Bateman Eichler, Hill Richards, Inc.*, *supra* note 16.

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Notice to Members

MARCH 2005

SUGGESTED ROUTING

Legal & Compliance
Operations
Registration
Training

KEY TOPICS

Assistant Representative –
Order Processing (Series 11)
Limited Representative –
Equity Trader (Series 55)
Rule 1032(f)
Rule 1041

INFORMATIONAL

Qualification Examinations

Revisions to the Series 11 and 55 Examination
Programs; **Implementation Date: April 29, 2005**

Executive Summary

NASD has revised the examination programs for the Assistant Representative – Order Processing (Series 11) and Limited Representative – Equity Trader (Series 55).¹ The changes are reflected in study outlines that will soon be available on the NASD Web site (www.nasd.com). The changes will appear in examinations administered starting on April 29, 2005.

Questions/Further Information

Questions concerning this *Notice* may be directed to Joe McDonald, Associate Director, NASD Testing and Continuing Education Department (TCE), at (240) 386-5065; or Carole Hartzog, Senior Analyst, TCE, at (240) 386-4678.

Background and Discussion

The NASD staff and committees of industry representatives recently reviewed the Series 11 and 55 examination programs. As a result of these reviews and as discussed in greater detail below, NASD has revised these examinations to reflect changes in relevant laws, rules, and regulations covered by the examinations, and, in some cases, to reflect more accurately the duties and responsibilities of the individuals who are taking these examinations. The examinations also have been modified to reflect the new Securities and Exchange Commission (SEC) short sale requirements.²

Series 11

The Series 11 examination qualifies an individual to function as an assistant representative to accept unsolicited securities orders from existing customers of a member firm. A Series 11 assistant representative may not solicit transactions or new accounts on behalf of the member, render investment advice, make recommendations to customers regarding the appropriateness of securities transactions, or effect transactions in securities markets on behalf of the member. Further, a Series 11 assistant representative may not be registered concurrently in any other capacity.

NASD has revised the examination program to reflect changes to the laws, rules, and regulations covered by the examination, to include new securities products, such as exchange-traded funds, and to focus the examination more on the handling of customer accounts and orders. Based on these revisions, the title of Section 2 was changed from "Processing Customer Orders; Providing Price Information; and Order Processing" to "Customer Accounts and Orders." NASD further revised the study outline to reflect the new SEC short sale requirements. In addition, the number of questions on each section of the study outline were modified as follows: *Types of Securities* decreased from 11 to 10 questions; *Customer Accounts and Orders* increased from 19 to 24 questions; *Securities Markets* decreased from 8 to 5 questions; and *Securities Industry Regulations* decreased from 12 to 11 questions.

NASD made similar changes to the corresponding sections of the Series 11 selection specifications and question bank. The number of questions on the Series 11 examination will remain at 50, and candidates will continue to have one hour to complete the exam. Also, each question will continue to count as one point, and each candidate will still be required to correctly answer 70 percent of the questions to receive a passing grade.

Series 55

The Series 55 examination is required, with certain limited exceptions, for registered representatives who are engaged in proprietary trading, the execution of transactions on an agency basis, or the direct supervision of such activities, with respect to transactions in equity, preferred, or convertible debt securities effected otherwise than on a securities exchange. There is an exception from the requirement for the Series 55 examination for any person associated with a member whose trading activities are conducted principally on behalf of an investment company that is registered with the SEC pursuant to the Investment Company Act of 1940 and that controls, is controlled by, or is under common control with the member.

NASD revised the section on NASDAQ Automated Execution and Trading Systems in the study outline to reflect the re-naming of the “SuperMontage System” to the “NASDAQ Market Center Execution Service.” NASD also revised the study outline to delete certain portions (such as SEC Rules 11Ac1-7 and 17a-4, Over-allotments (Greenshoe), Tender Offers, and NASD Rule 11810 (Buying-In)) that relate more to a firm’s sales practice or operations department than to the firm’s NASDAQ trading desk. As a result of the revisions, the title of Section 2 was changed from “NASDAQ Automated Execution and Trading Systems” to “NASDAQ Display, Execution, and Trading Systems.” NASD further revised the study outline to reflect the new SEC short sale requirements. In addition, NASD modified the number of questions on each section of the study outline as follows: *NASDAQ and Over-The-Counter Markets* decreased from 45 to 42 questions; *NASDAQ Display, Execution, and Trading Systems* increased from 9 to 15 questions; *Trade Reporting Requirements* decreased from 18 to 16 questions; and *General Industry Standards* decreased from 28 to 27 questions.

NASD made similar changes to the corresponding sections of the Series 55 selection specifications and question bank. The number of questions on the Series 55 examination will remain at 100, and candidates will continue to have 3 hours to complete the exam. Also, each question will continue to count as one point, and each candidate will still be required to answer 70 percent of the questions correctly to receive a passing grade.

Availability Of Study Outlines

The study outlines for the revised examination programs will be available shortly on the NASD Qualifications Web page at www.nasd.com.

Endnotes

- 1 See Securities Exchange Act Release No. 51214 (February 16, 2005) (Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to Revisions to the Series 11 Examination Program; File No. SR-NASD-2005-014); Securities Exchange Act Release No. 51215 (February 16, 2005) (Notice of Filing and Immediate Effectiveness of Proposed Rule Change Relating to Revisions to the Series 55 Examination Program; File No. SR-NASD-2005-015).
- 2 NASD has repealed Rules 3110(b)(1), 3210, 3370(b), and 11830 in light of the requirements of SEC Regulation SHO. See *Notice to Members 04-93* (December 2004) (Issues Relating to the SEC’s Adoption of Regulation SHO). Accordingly, NASD has deleted references to these rules from the Series 11 and 55 examination programs.

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Notice to Members

MARCH 2005

SUGGESTED ROUTING

Continuing Education
Legal and Compliance
Registered Representatives
Senior Management
Registration
Training

KEY TOPICS

Continuing Education
Regulatory Element
Rule 1120

GUIDANCE

Regulatory Element Exemptions

NASD Announces **Effective Date: April 4, 2005**, for Amendments to Rule 1120 to Eliminate Exemptions from the Continuing Education Regulatory Element Requirements

Executive Summary

On September 27, 2004, the Securities and Exchange Commission (SEC) approved amendments to NASD Rule 1120 (Continuing Education Requirements) to eliminate all current exemptions from the continuing education Regulatory Element requirements. In October 2004, NASD stated in *Notice to Members 04-78* that the amendments would become effective on the later of: (1) April 4, 2005; or (2) 30 days following the implementation of the necessary related changes to Web CRD®. Pursuant to this *Notice*, NASD is announcing that the amendments' effective date is April 4, 2005.

Questions/Further Information

Questions concerning this *Notice* may be directed to Ann M. Griffith, Associate Vice President and Director, NASD Testing and Continuing Education Department, at (240) 386-5051; or Joe McDonald, Associate Director, NASD Testing and Continuing Education Department, at (240) 386-5065.

Background

NASD Rule 1120 specifies the continuing education (CE) requirements for registered persons subsequent to their initial qualification and registration with NASD. The requirements consist of a Regulatory Element component outlined in Rule 1120(a) and a Firm Element component outlined in Rule 1120(b).¹ The Regulatory

Element is a computer-based education program administered by NASD to help ensure that registered persons are kept up-to-date on regulatory, compliance, and sales practice matters in the industry.² Unless exempt, each registered person is required to complete the Regulatory Element initially within 120 days after the person's second registration anniversary date and, thereafter, within 120 days after every third registration anniversary date.³ There are three Regulatory Element programs: the S201 Supervisor Program for registered principals and supervisors, the S106 Series 6 Program for Series 6 representatives, and the S101 General Program for Series 7 and all other registrations. Registered persons who fail to complete the Regulatory Element are deemed inactive, must cease all activities as a registered person, and are prohibited from performing any duties and functioning in any capacity requiring registration.⁴

Certain registered persons currently are exempt from the Regulatory Element. These include registered persons who, when the CE Program was adopted in 1995, had been registered for at least 10 years and who did not have a significant disciplinary action⁵ in their CRD record for the previous 10 years ("grandfathered" persons). Also included are those persons who "graduated" from the Regulatory Element by satisfying their 10th anniversary requirement before July 1998, when Rule 1120 was amended and the graduation provision eliminated, and who did not have a significant disciplinary action in their CRD record for the previous 10 years.⁶

In December 2003, the Securities Industry/Regulatory Council on Continuing Education ("Council")⁷ agreed unanimously to recommend that the SROs repeal the exemptions and require all registered persons to participate in the Regulatory Element. In response, NASD proposed changes to Rule 1120 to eliminate all currently effective exemptions from the requirement that registered persons complete the Regulatory Element of the CE Program, which the SEC approved on September 27, 2004.⁸ NASD subsequently informed members and other interested parties in *Notice to Member 04-78* that the approved amendments would become effective on the later of: (1) April 4, 2005; or (2) 30 days following the implementation of the necessary related changes to Web CRD. NASD is now announcing that the necessary related changes to Web CRD will be in place shortly, and that the effective date of the amendments will be April 4, 2005.

To help prepare firms for the changes, NASD sent an e-mail (and a follow-up hard copy letter) to each firm's Regulatory Element contact person in November 2004, listing each currently exempted registered person and the date on which such person would be required to complete his or her Regulatory Element requirement. In March 2005, NASD sent an updated listing to each firm's Regulatory Element contact person via e-mail and hard copy letter.

The Regulatory Element programs are administered at conveniently located test centers operated by Pearson VUE and Prometric. Appointments to take the session can be scheduled through either network:

Pearson Professional Centers: Contact Pearson VUE's National Registration Center at (866) 396-6273 (toll-free) or (952) 681-3873 (toll number), or go to www.pearsonvue.com/nasd for Web-based scheduling.

Prometric Testing Centers: Contact Prometric's National Call Center at (800) 578-6273 (toll-free) or go to www.prometric.com/nasd for Web-based scheduling.

For more information about the Council's Continuing Education Program, and to review frequently asked questions regarding the elimination of grandfather exemptions, see the Council's Web site at www.securitiescep.com.

Endnotes

- 1 The Firm Element of the CE Program applies to any person registered with an NASD member firm who has direct contact with customers in the conduct of the member's securities sales, trading and investment banking activities, any person registered as a research analyst pursuant to Rule 1050, and to the immediate supervisors of such persons (collectively called "covered registered persons"). The requirement stipulates that each member firm must maintain a continuing and current education program for its covered registered persons to enhance their securities knowledge, skill and professionalism. Each firm has the requirement to annually conduct a training needs analysis, develop a written training plan, and implement the plan.
- 2 Rule 1120(a)(6) permits a member firm to deliver the Regulatory Element to registered persons on firm premises ("In-Firm Delivery") as an option to having persons take the training at a designated center provided that firms comply with specific requirements relating to supervision, delivery site(s), technology, administration, and proctoring. In addition, Rule 1043 requires that persons serving as Proctors for the purposes of In-Firm Delivery must be registered.
- 3 See Rule 1120(a)(1). This is the current Regulatory Element schedule, as amended in 1998.
- 4 See Rule 1120(a)(2).
- 5 For purposes of Rule 1120, a significant disciplinary action generally means a statutory disqualification, a suspension or imposition of a fine of \$5,000 or more, or being subject to an order from a securities regulator to re-enter the Regulatory Element. See Rule 1120(a)(3).
- 6 When Rule 1120 was first adopted in 1995, the Regulatory Element schedule required registered persons to satisfy the Regulatory Element on the second, fifth, and 10th anniversary of their initial securities registration. After satisfying the 10th anniversary requirement, a person was "graduated" from the Regulatory Element. A graduated principal re-entered the Regulatory Element if he or she incurred a significant disciplinary action. A graduated person who was not a principal re-entered if he or she acquired a principal registration or incurred a significant disciplinary action.

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- 7 As of the date of this *Notice*, the Council consists of 19 individuals, six representing self-regulatory organizations (“SROs”) (the American Stock Exchange LLC, the Chicago Board Options Exchange, Inc., the Municipal Securities Rulemaking Board, NASD, the New York Stock Exchange, Inc., and the Philadelphia Stock Exchange, Inc.) and 13 representing the industry. The Council was organized in 1995 to facilitate cooperative industry/regulatory coordination of the CE Program in keeping with applicable industry regulations and changing industry needs. Its roles include recommending and helping to develop specific content and questions for the Regulatory Element, defining minimum core curricula for the Firm Element, developing and updating information about the program for industry-wide dissemination, and maintaining the program on a revenue-neutral basis while assuring adequate financial reserves.
- 8 See Exchange Act Release No. 50456 (September 27, 2004); 69 F.R. 59285 (October 4, 2004) (SR-NASD-2004-98). The approved rule changes also replaced references in Rule 1120(a)(3) to “re-entry” into the Regulatory Element with a requirement to “retake” the Regulatory Element to clarify that the significant disciplinary action provisions apply to all registered persons and not only to currently exempt persons.

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Notice to Members

MARCH 2005

SUGGESTED ROUTING

Legal and Compliance
Operations
Registered Representatives
Senior Management
Technology
Training

KEY TOPICS

Confirmations
Debt Securities
Operations
Transaction Reporting

REQUEST FOR COMMENT

Proposed Rule to Enhance Confirmation Disclosure in Corporate Debt Securities Transactions

NASD Requests Comment on Proposed Rule Requiring Members to Provide Additional Disclosures for Transactions in Debt Securities; **Comment Period Expires April 19**

Executive Summary

NASD is requesting comment on whether it should propose a new rule, Rule 2231, that would require members to provide additional disclosures to customers when effecting a transaction in a debt security for or with the account of a customer. Currently, members effecting such transactions are required to provide certain disclosures to their customers pursuant to Rule 10b-10 under the Securities Exchange Act of 1934 (Exchange Act). Under the proposed rule, members would provide additional transaction-specific disclosures to supplement the disclosures made under Rule 10b-10 and, with the transaction-specific disclosures, include a statement referring customers to NASD educational materials about bonds that would be located on NASD's Web site. (See Attachment A, Proposed Rule 2231, and Attachment B, draft educational materials.)

The proposed rule is based upon NASD standing committee input on a broad framework laid out by the Corporate Debt Market Panel (Panel), a group of 12 industry experts convened by NASD to make recommendations to NASD's Board of Governors regarding how to best ensure market integrity and investor protection in the corporate bond market.

05-21

Questions/Further Information

Questions concerning this *Notice* should be directed to James L. Eastman, Assistant General Counsel, Office of General Counsel (OGC), Regulatory Policy and Oversight (RPO), at (202) 728-6961; Sharon K. Zackula, Associate General Counsel, OGC, RPO, at (202) 728-8985; or Elliot Levine, Chief Counsel, Transparency Services, Markets, Services and Information, at (202) 728-8405.

Action Requested

NASD encourages all interested parties to comment on the proposal. Comments must be received by April 19. Members and other interested persons can submit their comments using the following methods:

- ◆ **Mail** comments in hard copy to the address below; or
- ◆ **E-mail** comments to *pubcom@nasd.com*.

To help NASD process and review comments more efficiently, persons commenting on this proposal should use only one method. Comments sent by hard copy should be mailed to:

Barbara Z. Sweeney
Office of the Corporate Secretary
NASD
1735 K Street, NW
Washington, DC 20006-1506

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.¹

Before becoming effective, a proposed rule change regarding additional debt disclosures must be filed with the Securities and Exchange Commission (SEC), and then approved by the SEC, following publication for public comment in the *Federal Register*.²

Background and Discussion

With the implementation of NASD's Trade Reporting and Compliance Engine (TRACE) on July 1, 2002, and the subsequent availability of a consolidated view of pricing in the U.S. corporate bond market, a number of trends have emerged that have implications for the regulatory framework of the corporate debt market. In particular, there appears to be greater investor awareness of the role that corporate bonds can play in a diversified investment portfolio. NASD believes that ensuring that investors understand some of the key risks associated with bond investing is an important element of its efforts to enhance transparency in the corporate debt market. The rulemaking presented in this *Notice to Members* is a result of NASD's increased focus on the corporate debt market. The recommendations result from staff and NASD standing committee interpretations and modifications to a broad-based framework laid out by the Panel.

The objective of the Panel was to review and make recommendations to the NASD's Board of Governors regarding how to best ensure market integrity and investor protection in the corporate bond market.³

The Panel reviewed information showing significant levels of participation by individual investors in the corporate bond market,⁴ as well as NASD surveys showing that individual investors often do not understand certain key structural aspects of specific bonds or the market in which bonds are traded. For example, 34 percent of individuals surveyed did not believe that they were paying a fee for buying or selling a bond, and approximately 60 percent of investors surveyed did not understand that bond prices generally fall as interest rates rise.⁵ The Panel concluded that individual investors would benefit from additional guidance and information disclosure, and recommended, among other things, that investors obtain improved access to information on bonds and receive increased disclosures regarding their bond transactions.

Proposed Rule 2231

Under proposed Rule 2231, members would provide additional, transaction-specific disclosures in debt securities transactions.⁶ The proposals that follow, including the transaction-specific disclosures and the educational materials, are rooted in the Panel's recommendations and NASD surveys of bond customers' understanding of bond pricing, mechanics, and transaction remuneration. NASD staff finalized these proposals after a further series of consultations with its advisory committees.

The additional transaction-specific disclosures include a brief statement about applicable brokerage charges, the credit rating of the security, and whether transaction price information is publicly available for the security. For purchases only, members would disclose information regarding interest, yield, and, if applicable, call provisions. In addition, members would be required to include a statement referring their customers to NASD's Web site for important general information about investing in bonds. The disclosures would be provided in the same manner that a member confirms the terms of a transaction in a debt security under Rule 10b-10.⁷ Importantly, members would not be required to make any disclosure that would be duplicative of a disclosure already required under Rule 10b-10 for a particular type of debt transaction.

In proposed Rule 2231, there are three significant exceptions to the general requirement that members provide supplemental disclosures to customers in connection with every debt securities transaction. First, none of the requirements would apply to transactions with “institutional customers,” which is defined to include all “qualified purchasers” (as defined under the Investment Company Act of 1940).⁸ The second and third exceptions exclude transactions in “exempted securities” as defined in Section 3(a)(12) of the Exchange Act⁹ and “asset-backed securities” as defined in Rule 10b-10.¹⁰

The transaction-specific disclosures in proposed Rule 2231 are as follows:

- ◆ The debt security’s CUSIP and the TRACE symbol of the debt security, if NASD has assigned one. NASD is requiring that the CUSIP be included for proper identification of the security. NASD is also requiring disclosure of the TRACE symbol, if any, because a non-institutional investor may identify a debt security more readily by its TRACE symbol than by its CUSIP.
- ◆ One of three specified statements in a “brokerage charges” field that informs the customer that he or she paid a commission, mark-up, or mark-down, if applicable:
 - If the member acted as agent for the customer and received or will receive remuneration from the customer in connection with the transaction that would be required to be disclosed to the customer under Rule 10b-10 under the Act, “you paid a commission to our firm for its services”;
 - If the member acted as principal, purchased a debt security from the customer, and reduced the proceeds paid to the customer by a payment for its services, “the proceeds you received from the debt security you sold were reduced by a payment to our firm for its services”; or
 - If the member acted as principal, sold a debt security to the customer, and incorporated a payment to the member in the price paid by the customer, “a payment to our firm for its services was incorporated in the price you paid for the debt security you purchased.”

As discussed more fully below, in some cases investors are unclear that there is any remuneration paid in connection with debt securities transactions. NASD is not requiring that the amount of the member’s mark-up or mark-down be disclosed. This disclosure requirement is consistent with NASD guidance provided in *Notice to Members 04-30*.¹¹

- ◆ If the debt security is rated by a Nationally Recognized Statistical Rating Organization (NRSRO) to which the member subscribes, the member must disclose the NRSRO and the credit rating issued by the NRSRO. Both members and investors view credit ratings issued by NRSROs as providing essential information about a corporate debt security. NASD is proposing that such information be provided to the customer, but only if the member is already

a subscriber to one or more NRSROs. If a member subscribes to more than one NRSRO, the member would be required to identify each NRSRO and the related rating in the proposed disclosures. If the provision is adopted as proposed herein, NASD will monitor the percentage of firms that subscribe to and disclose NRSRO ratings. In the event that a uniform practice of disclosure of NRSRO ratings does not arise should the rule be adopted, NASD will consider the advisability of mandating at least one subscription to an NRSRO.

- ◆ The member must disclose whether transaction price information for the bond is available and, if it is, where it is available for no charge (e.g., TRACE information), if that is the case. NASD believes that investors should know *if* transaction price information is available regarding a security, and if it is available, where an investor can access such information at no charge. For example, for TRACE-eligible securities, a member would indicate that such information is available and refer the customer to a source of free bond price information, such as NASD's Web site, or another Web site, if such information is or becomes available at an industry- or association-sponsored Web site.¹²
- ◆ The frequency of principal and interest payments must be disclosed. NASD believes that investors should be aware of and receive written disclosure of the frequency of interest payments, and, if applicable, any payment of principal that may occur before a bond matures.
- ◆ The yield to maturity, and certain call information must be disclosed (whether a bond is callable and, if so, whether it is continuously callable or otherwise callable, the next occurring call date, and the related call price). NASD is aware that yield to maturity and certain call information must be disclosed for certain (but not all) transactions under Rule 10b-10. (As noted above, proposed Rule 2231 does not require the disclosure of information that a member is already required to disclose under Rule 10b-10.)
- ◆ A member must disclose whether a coupon rate is variable. Additionally, under the proposal, members will be required to provide, upon a customer's written request, certain information relating to debt securities carrying a variable coupon rate. NASD believes that investors who purchase debt securities subject to a variable interest rate should be aware of the formula for the recalculation of the interest and other basic information. At this time, NASD is proposing only that the member indicate that the coupon rate may vary and that the member will provide in writing additional information relating to the calculation of the debt security's interest and principal payments upon a written request from the customer. The written request must be sent not later than six months from the date of settlement.
- ◆ For a zero coupon bond (or one similarly structured) with a call feature, the investor must receive disclosure regarding the bond's compound accreted value and the call price as of the next occurring call date.

NASD Educational Materials about Bonds

NASD believes individual investors need more information and guidance regarding the purchase and sale of bonds. This information should allow investors to determine if bonds are appropriate for their investment objectives, what execution quality they receive, and the bond's overall risk/return. To enhance investor understanding in these areas, NASD would make available an educational brochure about investing in corporate bonds. In this brochure, the staff intends to provide basic descriptive information about various types of corporate bonds and their features, such as coupon rate, face value, and maturity. Other topics covered would be bond pricing, the relationship between the price of a debt security and its yield, and the differences between a bond's yield to maturity and its yield to call.

The educational brochure also would cover some of the key risks related to investing in debt securities, such as interest rate risk, call and reinvestment risk, refunding risk (along with sinking fund provisions), and default and credit risk, as well as the differences between subordinated and non-subordinated debt. Certain debt securities with special features, such as floating rate bonds, zero coupon bonds, convertible bonds, and guaranteed and insured bonds also would be discussed, as they carry somewhat unique risks for the bond investor. The importance of credit ratings and the differences between investment grade and non-investment grade debt also would be discussed to enhance investors' ability to understand the impact credit risk may have on the value of their bonds.

NASD is particularly concerned about NASD survey data showing that more than a third of those surveyed didn't understand they were being charged a fee when buying or selling debt securities. In this regard, the educational materials would cover the different types of broker compensation (e.g., commissions and mark-ups/mark-downs), how it can affect a bond's yield, and the potential for broker compensation to influence whether a particular bond is recommended for purchase.

Generally, NASD is very concerned that investors do not understand the differences in the way the debt and equity markets operate, particularly when attempting to assess execution quality of a bond transaction. For example, NASD believes that bond investors may not understand that some debt securities are difficult to sell because of a lack of liquidity, and, as a result, a member may charge a premium in such transactions. The educational materials would highlight this liquidity risk and investors would be advised to consider the possibility that they might not be able to sell easily or without a discount a bond that has not traded in many months as compared to a bond that trades frequently. The impact that illiquidity may have on a debt security's bid/ask spread also would be addressed. Relatedly, investors would be urged to explore with the member that sells them a particular bond the member's ability and willingness to purchase that bond if the investor desires to sell the bond prior to maturity, particularly if the market for that bond is illiquid.

A member that makes the transaction-specific disclosures discussed above also would be required to disclose that the educational materials are available on NASD's Web site. In addition, and subject to the stated exceptions, a member would be required to provide the customer the educational materials in hard copy upon a customer's written request.

Request for Comment

NASD is soliciting comment on proposed Rule 2231 requiring members to provide additional disclosures for transactions in debt securities. NASD seeks comments on NASD's general approach, the specific disclosure provisions, the educational materials that NASD would make available on its Web site, costs, and issues relating to implementation. In commenting on NASD's general approach, NASD urges members also to review and consider the recommendations of the Panel. Members are asked to consider if the exception for "institutional customers" and the two exceptions for transactions in "exempted securities" and "asset-backed securities" are appropriate in scope, and if other types of transactions should be excepted.

NASD seeks comments on all the specific disclosure provisions, and in particular the disclosures regarding NRSRO information and the yield and call provisions. NASD specifically seeks comment on NASD's approach to information provided by NRSROs, and issues related to costs. NASD also seeks comment as to whether any of the other items of disclosure are misleading, are likely to lead to customer confusion, require additional exceptions or would be difficult for firms to implement.

Finally, NASD seeks comment on costs and implementation. The proposal provides members flexibility in determining the means for delivering the disclosures. For example, the proposal contemplates that members may provide the disclosures on the same document on which Rule 10b-10 disclosures are printed, or may use supplemental documentation, provided that the information is transmitted in the same manner that the Rule 10b-10 disclosures are made. NASD seeks member input on the appropriate period needed for members to address systems and operational issues to prepare for additional disclosures.

Endnotes

- 1 See *NTM 03-73* (Nov. 2003) (NASD Announces Online Availability of Comments). Personal identifying information, such as names or e-mail addresses, will not be edited from submissions. Persons commenting on this proposal should submit only information that they wish to make publicly available.
- 2 Section 19 of the Exchange Act permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See Exchange Act Section 19 and rules thereunder.
- 3 The Panel's findings and recommendations were released publicly in September 2004 in the *Report of the Corporate Debt Market Panel (Panel Report)*. The complete text of the *Panel Report* is available at www.nasd.com/pdf_text/corp_debt_panel_report.pdf.
- 4 The *Panel Report* notes that information obtained from TRACE shows that approximately "two thirds of corporate bond transactions reported to TRACE are in quantities of \$100,000 or less in value, a size widely viewed as representative of individual investor activity." *Panel Report* at 4.

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- 5 *Panel Report* at 4.
- 6 For purposes of proposed Rule 2231, “debt security” is defined to have the same meaning it has under Rule 10b-10.
- 7 A member would not be required to provide the supplemental disclosures required under proposed Rule 2231 on the same piece of paper or electronic document (if the confirmation is provided electronically) as that containing the Rule 10b-10 confirmation.
- 8 The term “qualified purchaser” is defined in Section 2(a)(51) of the Investment Company Act of 1940, which provides, in pertinent part:
- any natural person (including any person who holds a joint, community property, or other similar shared ownership interest in an issuer that is excepted under section 3(c)(7) [15 USCS § 80a-3(c)(7)] with that person’s qualified purchaser spouse) who owns not less than \$5,000,000 in investments, as defined by the Commission...or any person, acting for its own account or the accounts of other qualified purchasers, who in the aggregate owns and invests on a discretionary basis, not less than \$25,000,000 in investments....
- 9 Exchange Act Section 3(a)(12)’s definition of “exempted security” covers a variety of securities, including government securities, municipal securities, an interest or participation in certain trust funds, pooled income funds and collective investment funds, and securities issued in connection with certain qualified plans and church plans. This definition is complex and, in determining the scope of this term, members may wish to consult with the staff of the Securities and Exchange Commission regarding any interpretive questions that may arise.
- 10 “Asset-backed security” is defined in Rule 10b-10(d)(10) to mean:
- a security that is primarily serviced by the cash flows of a discrete pool of receivables or other financial assets, either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders.
- 11 See *generally NTM 04-30* (NASD Reminds Firms of Sales Practice Obligations in the Sale of Bonds and Bond Funds) (April 2004).
- 12 NASD provides investors access to bond price information free of charge at www.nasdbondinfo.com. Information obtained from NASD’s Web site may not be used for commercial purposes.

©2005. NASD. All rights reserved. *Notices to Members* attempt to present information to readers in a format that is easily understandable. However, please be aware that, in case of any misunderstanding, the rule language prevails.

ATTACHMENT A

Text of proposed Rule 2231.

Rule 2231. Confirmation of Transactions in Debt Securities

(a) Confirmation of Transactions in Debt Securities

(1) Any member that is required to disclose to a customer information pursuant to Rule 10b-10 under the Act in connection with any transaction in a debt security also shall disclose to the customer the information set forth in paragraph (b). Except as otherwise provided herein, this information shall be disclosed in the same manner in which the member discloses to the customer information in connection with the transaction pursuant to Rule 10b-10 under the Act. Transactions by a member's institutional customers are not subject to this Rule. A member need not disclose to customers information required to be disclosed under this Rule if the member will disclose such information pursuant to Rule 10b-10 under the Act.

(2) For purposes of this Rule:

(A) "institutional customer" means a customer that is a "qualified purchaser" as defined in Section 2(a)(51) of the Investment Company Act of 1940;

(B) "debt security" shall have the same meaning it has in Rule 10b-10 under the Act, except that any exempted security or asset-backed security is excluded from this definition;

(C) "exempted security" shall have the same meaning it has in Section 3(a)(12) of the Act;

(D) "asset-backed security" shall have the same meaning it has in Rule 10b-10 under the Act; and

(E) "nationally recognized statistical rating organization" ("NRSRO") shall have the same meaning it does when used in Rule 15(c)(3)-1 under the Act.

(b) Information Required to be Disclosed

(1) *Debt security information.* Disclose the debt security's CUSIP,¹ and, if it is a TRACE-eligible security, the TRACE symbol of the debt security if one has been designated by NASD.

(2) *Brokerage charges.* Disclose in a text field labeled "brokerage charges" one of the following three statements if applicable:

(A) If the member acted as agent for the customer and received or will receive remuneration from the customer in connection with the transaction that would be required to be disclosed to the customer under Rule 10b-10 under the Act, "you paid a commission to our firm for its services";

(B) If the member acted as principal, purchased a debt security from the customer, and reduced the proceeds paid to the customer by a payment for its services, "the proceeds you received from the debt security you sold were reduced by a payment to our firm for its services"; or

(C) If the member acted as principal, sold a debt security to the customer, and incorporated a payment to the member in the price paid by the customer, "a payment to our firm for its services was incorporated in the price you paid for the debt security you purchased."

(3) *Credit rating.* If the debt security is rated by any NRSRO to which the member subscribes, disclose:

(A) the NRSRO; and

(B) the credit rating.

(4) *Indicators of marketability and liquidity.* Disclose whether transaction price information on the debt security is publicly available and if it is, that a customer may, if the debt security is a TRACE-eligible security, obtain such information at the Internet Web site www.nasdbondinfo.com for the customer's non-commercial use at no charge, or at other sources that provide such information.

¹ The acronym, CUSIP, stands for Committee on Uniform Securities Identification Procedures. CUSIP numbers belong to Standard and Poor's, a division of the McGraw-Hill Companies, Inc. (S&P). S&P's CUSIP numbers are proprietary to S&P and are protected by copyright and other intellectual property laws. S&P licenses to NASD the use of the terms Committee on Uniform Securities Identification Procedures and CUSIP, which may not be copied or otherwise reproduced, repackaged, further transmitted, transferred, disseminated, redistributed or resold, or stored for subsequent use for any such purposes, in whole or in part, in any form or manner or by any means whatsoever, by any person without S&P's prior written consent.

(5) *Cash flow information.* For purchases only, disclose on a per debt security basis:

(A) The frequency of interest and principal payments;

(B) Yield to maturity, and, if the debt security is callable, whether the debt security is continuously callable or otherwise callable, and the next occurring call date and associated call price;

(C) For debt securities carrying a variable coupon rate, disclosure indicating that the coupon rate may vary and that the member will provide in writing additional information relating to the calculation of the debt security's interest and principal payments upon a written request from the customer that is sent not later than six months from the date of settlement. Members shall provide such additional information to any customer, except an institutional customer, within three business days of receiving the customer's request. Any such additional information shall contain:

(i) the amount of the next interest payment based on the current coupon rate,

(ii) a statement that this amount will change if the coupon rate changes,

(iii) how often the coupon rate may be recalculated,

(iv) an explanation of the event(s) that may trigger the recalculation, and

(v) the formula for recalculating such coupon rate;

and

(D) For purchases of debt securities that are callable and, at issue, are not structured to include scheduled interest payments (e.g., "zero coupon bonds"), the compound accreted value as of the next occurring call date and whether the call price equals, exceeds, or is less than the compound accreted value as of the call date.

(6) *Notice of availability of NASD disclosure.* The following statement must appear in a clear and conspicuous manner in any disclosure provided pursuant to this paragraph (b), "A disclosure document discussing your rights as a bondholder and some of the risks related to buying and holding bonds, titled 'Important Information You Need to Know About Investing in Corporate Bonds,' has been prepared by NASD and is available online at www.NASD.com. A paper version of this document is available from your broker upon your written request made not later than six months from the date of settlement of your transaction." Members must provide the document, "Important Information You Need to Know About Investing in Corporate Bonds," to any customer, except an institutional customer, within three business days of receiving the customer's request. Members may access the current version of this document at NASD's Web site at www.NASD.com or obtain it from NASD.

ATTACHMENT B

Important Information You Need to Know about Investing in Corporate Bonds

This document is intended to provide you with some basic facts about the most common features of corporate bonds, and to alert you to some of the risks associated with buying, selling, and holding corporate bonds.

As with any investment, before buying a corporate bond, you should analyze the bond on its own merits, weighing its risks, costs, and rewards. Consult with your firm about any questions you may have about investing in a particular bond.

Corporate Bond Basics

What is a corporate bond?

Corporate bonds are, at their simplest, loans that investors make to public and private corporations. Consequently, bonds are referred to as **debt securities**. Corporations generally issue corporate bonds to raise money for capital expenditures, operations, and acquisitions.

Typically, bondholders receive interest payments during the term of a bond (or, for as long as a bondholder owns a bond), at the stated interest rate—also called the **coupon rate**. In addition, if bondholders hold bonds until **maturity**, they also are repaid the principal amount, called **par value** or **face amount**.

Bond Price and Yield

Price

If you sell a bond before it matures, you may not receive the full principal amount of the bond. This is because a bond's **price** is not based on the par value of the bond. Rather, it is set in the secondary market and is established by the current market values of such bonds, which may be more or less than the amount of principal the issuer would be required to pay the bondholder at maturity. Therefore, it is impossible to predict in advance the price that a bondholder will receive if the bondholder purchases a bond and later sells the bond before maturity.

The price of a bond is often above or below its par value because the price is adjusted according to current interest rates in the whole market for the same debt security and comparable debt securities. For example, if the bond you desire to purchase has a fixed interest rate of 8 percent, and similar quality new bonds available for sale have a fixed interest rate of 5 percent, you will have to pay more than the par amount of the bond that you intend to purchase, because you will receive more interest income than the current interest rate (5 percent) being attached to similar bonds.

Yield

Yield is the overall return on the capital you invest in the bond. Yield is similar to, but different from, a bond's interest rate. This distinction is important, because as is explained above, while a bond's face amount or par value is fixed, its market value almost always changes over time. Because bond prices fluctuate continually in the market, the yield your bond investment will provide if it is sold prior to maturity also changes constantly. *A bond's price is inversely related to its yield. As a bond's price increases, its associated yield decreases; as the price of a bond decreases, the associated yield increases.*

For example, a bond that sells today for \$1,000 and has a coupon rate of 8 percent has a current yield of 8 percent. Because the "price" equals the face amount of the bond, the current yield of 8 percent equals the 8 percent fixed interest rate. However, usually after the first sale of a bond, the price of a bond differs from the face amount. For example, if the same bond sells tomorrow for \$990, the current yield would be slightly higher than 8 percent.

Yield to maturity and yield to call: What's the difference?

Yield to maturity is calculated by taking into account the total amount of interest you will receive over time, your purchase price (the amount of capital you invested), the face amount (or other amount you will be paid when the issuer "redeems" the bond), the time between interest payments, and the time remaining until the bond matures.

If you hold a callable bond, another type of yield calculation, **yield to call**, also is important for you to understand. This calculation takes into account the impact on a bond's yield if it is called prior to maturity and is often done using the first date on which the issuer could call the bond. (Other call dates may be used in specified circumstances.) A bond's yield to call may be lower than its yield to maturity.

To get a more accurate picture of what a bond will cost you or what you received for it, you should also ask your broker to calculate the yield adjusting the purchase price up (when you purchase) or down (when you sell) by the amount of the mark-up or commission (when you purchase) or mark-down or commission (when you sell) and other fees or charges that you are charged by your broker for its services. This is called **yield reflecting broker compensation**.

Corporate Bond Risks

Like virtually all investments, corporate bonds carry risk. It is important that you fully understand the risks of investing in corporate bonds. These risks include:

Interest Rate Risk

When interest rates rise, bond prices fall, and when interest rates fall, bond prices rise. Interest rate risk is the risk that changes in interest rates generally in the U.S. or the world economy may reduce (or increase) the market value of a bond you hold. Interest rate risk increases the longer that you hold a bond. For example, if interest rates rise throughout the economy, bond issuers, along with other borrowers, will need to offer potential bondholders higher rates to compete with the higher interest rates available elsewhere.

Any bonds issued in a period of rising interest rates generally will carry higher coupon rates, which will be more attractive to potential bondholders than the coupon rate paid by bonds issued before the rise in interest rates. This decreased appetite for older bonds that pay lower interest depresses their price in the secondary market, which would translate into your receiving a lower price for your bonds if you chose to resell them in a period of rising interest rates. The opposite holds true as well, and the market value of older bonds that pay higher than current interest rates tends to rise in periods where interest rates are generally declining.

Call and Reinvestment Risk

Bonds with a call provision can be redeemed or “called” by the bond issuers, requiring bondholders to redeem their bonds at the call price well before their maturity dates. Bonds often are called when market interest rates are falling, because bond issuers want to refinance their debt at lower interest rates (similar to when a home owner seeks to refinance a mortgage at a lower rate when mortgage interest rates decrease). This is known as **call risk**.

With a callable bond, a bondholder might not receive the bond’s coupon rate for the entire term of the bond, and it might be difficult or impossible to find an equivalent investment paying rates as high as the called bond. This is known as **reinvestment risk**. Additionally, at any given point in time, the stream of a callable bond’s cash flow is uncertain and any appreciation in the market value of the bond may not rise above the call price.

Refunding Risk and Sinking Funds Provisions

A **sinking fund provision**, which often is a term included in bonds issued by industrial and utility companies, requires a bond’s issuer to retire a certain number of bonds periodically. This can be accomplished in a variety of ways, including through purchases in the secondary market or forced purchases directly from bondholders at a pre-determined price.

Holders of bonds subject to sinking fund redemptions should understand that they risk having their bonds called (or redeemed) prior to maturity. Unlike other bonds subject to call, depending on the sinking fund provision, there may be a relatively high likelihood that the issuer will be able to redeem some or many of the bonds prior to maturity, even if market-wide interest rates do not change.

It is important to understand that there is no guarantee that an issuer of these bonds will be able to comply strictly with any redemption requirements. In certain cases, an issuer may need to borrow funds or issue additional debt to refinance an outstanding bond issue subject to a sinking fund provision when it matures. If the issuer is unable to raise adequate funds to refinance the outstanding issue, the bondholder may be faced with an issuer default and potential loss of principal.

Default and Credit Risk

If you ever loaned money to someone, chances are you gave some thought to the likelihood of being repaid. Some loans are riskier than others. The same is true when you invest in bonds. You are taking a risk that the issuer's promise to repay both principal and interest will be upheld. In the case of Treasuries and other government-issued bonds backed by the "full faith and credit of the U.S. government," that risk is almost zero. However, with most corporate bonds there is some risk of default. This means the corporations issuing them may either be late paying bondholders or—in worst-case scenarios—be unable to pay at all.

Bond ratings are a way of measuring default and credit risk. Five ratings agencies have been designated by the staff of the Securities and Exchange Commission to be a Nationally Recognized Statistical Rating Organization. They are A. M. Best, Dominion, Fitch, Moody's, and Standard & Poor's. These organizations review all information known about the issuer, especially all financial information, such as the issuer's financial statements and assign a rating—AAA (or Aaa) to D.

Generally, bonds are categorized in two broad categories—**investment grade** and **non-investment grade**. Bonds that are rated BBB (or Baa) or higher are considered investment grade. Bonds that are rated BB (or Ba) or lower are non-investment grade. Non-investment grade bonds are also referred to as **high-yield** or **junk bonds**, and in some cases, **distressed bonds**. These bonds are considered riskier investments because the issuer's general financial condition is less sound, and the issuer may default—(may not be able to pay the interest and principal to bondholders when they are due).

Many bondholders heavily weigh the rating of a particular corporate bond in determining if the corporate bond is an appropriate and suitable investment for them. Although credit ratings are an important indicator of creditworthiness, you should also consider that the value of the bond might change depending on changes in the company's business and profitability. The credit rating could be revised downward. In the worst scenario, corporate bankruptcy, holders of corporate bonds could suffer significant losses, including the loss of their entire investment. Finally, some bonds are not rated. In such cases, an individual bondholder may find it difficult to assess the overall creditworthiness of the issuer of the bond.

Liquidity Risk

You should determine whether the bond in which you are interested has traded frequently, infrequently, or not at all in recent months, and if your broker regularly buys and sells the bond. While certain bonds are very actively traded and are relatively "liquid," other bonds, including many high-yield bonds, are traded much less frequently or not at all and may not be easy to sell. If you think you might need to sell the bonds you are purchasing prior to their maturity, you should carefully consider the likelihood of your being able to do so, and whether your broker will be able and willing to assist you in liquidating your investment at a fair price reasonably related to then current market prices. It is possible that you may be able to re-sell a bond *only* at a heavy discount to the price you paid (loss of some principal) or not at all. Additionally, bonds that are less frequently traded may be subject to wider "spreads" in the secondary market, which means that you would receive less for your bond if selling, or pay more if buying, than otherwise would be the case.

Corporate Bonds with Special Features

It also is important to understand any special features a bond may have before you buy, since these features may affect risk.

Floating Rate Bonds

Floating-rate bonds have a floating or variable interest rate that is adjusted periodically, or **floats**, using an external value or measure (for example, the prime rate or a stock index). Such bonds offer protection against interest rate risk, but their coupon rate is usually lower than those of **fixed-rate bonds**.

Zero-Coupon Bonds

Zero-coupon bonds, unlike other bonds, don't make regular interest payments. Instead, the bondholder buys the bond at a discount from the face value of the bond, and, when the bond matures, the issuer repays the bondholder the face amount. The difference between the discounted amount the bondholder pays upon purchase and the face amount later received is the **imputed interest**. Because zero-coupon bonds don't pay any interest until maturity, their prices may be more volatile than other bonds with similar maturities that pay interest periodically.

Secured Bonds

Secured bonds are backed by collateral that the bond's issuer has agreed to sell if it otherwise is unable to meet its obligation when the bond matures. For example, a bond might be backed by a specific factory or industrial equipment. However, any such backing is only as good as the value of the asset being used as collateral, the value of which can decrease during the term of the bond.

Bonds that are not backed by any collateral are unsecured and are sometimes called **debentures**. Debentures are backed solely by an issuer's promise to repay you. Most corporate bonds are debentures.

Guaranteed and Insured Bonds

Certain bonds may be referred to as **guaranteed** or **insured**. This means that a third party has agreed to make the bond's interest and principal payments if the issuer is unable to make these payments. You should keep in mind that such guarantees only are as valuable as the creditworthiness of the third party making the guarantee or providing the insurance.

Convertible Bonds

Convertible bonds may be converted into the stock of the bond's issuer. A bondholder should be careful to understand the conditions under which the bonds may be converted, as this right often is contingent upon the issuer's stock reaching a certain price level, among other things. Bond investors also should ask their broker or financial adviser whether there is any charge or fee associated with making a conversion.

Junior or Subordinated Bonds

The more junior bonds issued by a company typically are referred to as **subordinated debt**, because a junior bondholder's claim for repayment of the principal of such bonds is subordinated to the claims of bondholders holding the issuer's more senior debt. Additionally, other types of claims also may have priority on the issuer's remaining assets over the claims of *all* bondholders (e.g., certain supplier or customer claims). Therefore, although bondholders generally are paid prior to stockholders in a bankruptcy proceeding, this may offer little comfort if the issuer's assets are reduced to zero by other creditors that have the right to be paid before bondholders of a particular class of bonds.

Broker Compensation for Selling Bonds

No commission does not mean no charge.

You should understand that your broker is being compensated for performing services for you, even if you are not charged a **commission** when you buy or sell a bond. In most bond transactions, brokers are compensated, even though a commission charge is not disclosed, because the transaction is structured as a principal transaction (*i.e.*, your broker sells you a bond it already owns). This is because when a dealer sells you a bond in a principal capacity, the dealer increases or marks up the price you pay over the price the dealer paid to acquire the bond. The **mark-up** is the dealer's compensation and is similar to a commission. Similarly, if you sell a bond, a dealer will offer you a price that includes a **mark-down** from the price that the dealer believes he can sell the bond to another dealer or another buyer. Although the broker is not required under the federal securities laws or NASD rules to disclose the amount of the broker's mark-up or mark-down, you should understand that the firm has charged you a fee for its services.

Would a similar bond cost less?

Finally, it is important to consider the potential conflict of interest presented by the payments made to your broker. Bonds issued by different issuers often have very similar risk profiles and carry similar coupon rates. You should consider whether there are other bonds available with similar risk/return profiles that might be available at lower cost. You also should strive to understand how your broker is being compensated for any bond transaction, particularly those that are recommended to you where similar bonds may be available.

Notice to Members

MARCH 2005

SUGGESTED ROUTING

Senior Management
Legal & Compliance
Operations
Options
Systems
Trading

KEY TOPICS

Options

GUIDANCE

Large Options Positions Reports

New Electronic Reporting Requirements for Large Options Positions Reports for Filing of Reportable Conventional Options Positions

Executive Summary

As a result of enhancements to the Securities Industry Automation Corporation's (SIAC) Large Options Positions Reporting system, NASD is eliminating the manual reporting of Large Options Positions Reports (LOPRs). SIAC now has the capability to accept LOPRs for both conventional and standardized options' positions on an electronic basis. As a result, all members will be required to file LOPRs through SIAC on an electronic basis. **As of May 9, 2005, NASD will no longer accept manually filed LOPRs.**

All members must successfully test with SIAC to ensure that they have the ability to report large options positions in the required format. Testing is currently available and must be completed by **May 6, 2005.**

Questions/Further Information

Questions concerning these new reporting provisions can be directed to Mark G. Nolan, Team Leader, Market Regulation Department, at (240) 386-6174; or Susan Tibbs, Deputy Director, Market Regulation Department, at (240) 386-5082.

Background and Discussion

NASD Rule 2860(b)(5) requires member firms to file, or cause to be filed, reports for each account² that has an aggregate position of 200 or more options contracts (whether long or short) on the same side of the market covering the same underlying security or index. These reports are referred to as LOPRs. With respect to listed options (also known as standardized options), a member firm

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currently may comply with this requirement by filing, or ensuring that another firm files on its behalf, reports to SIAC, or by manually filing a LOPR form by faxing it to NASD. With respect to over-the-counter options (also known as conventional options), a member firm currently must manually file a LOPR form because SIAC has not up to this point accepted electronic reports with respect to conventional option positions.

To enable NASD to enhance the efficiency of options surveillance, SIAC has developed the capability to accept reporting of conventional options positions on an electronic basis. The electronic reporting to SIAC of such options positions is now available. Beginning **May 9, 2005**, NASD will require all members to report all large options positions (for both conventional and standardized options) required to be reported under NASD Rule 2860 through SIAC on an electronic basis. NASD will continue to accept manually filed LOPRs only **until May 6, 2005**.

Current Requirements

All NASD Members

NASD Rule 2860 currently requires NASD member firms to file LOPRs in a manner prescribed by NASD. All NASD members currently must transmit LOPRs in conventional options via facsimile to NASD.

NASD/Options Exchange Members

NASD members that are also members of an options exchange on which the option is listed and traded may currently comply with this obligation by transmitting LOPRs in electronic form to SIAC.

Electronic Filing of LOPRs

NASD is enhancing LOPR reporting by requiring the electronic reporting of conventional options positions, which, up to this point, have only been reported to NASD via facsimile. This requirement will become effective on **May 9, 2005**. As a result, commencing on this date, NASD will no longer support or otherwise permit the filing of any LOPRs (whether such reports cover standardized or conventional options) via facsimile. Under the new requirements, position reports in conventional and standardized options must be reported to SIAC on an electronic basis using designated record types. Member firms will be able to add conventional option reports to their existing LOPR transmissions for standardized options or send them to SIAC as a separate file. The record layout of the new options positions report is set forth in Attachment A.

LOPRs should be transmitted to SIAC no later than the close of business on the next business day following the day on which the transaction or transactions requiring the filing of such report occurred.³

NASD has also determined to enhance LOPR reporting to support member firm transmissions to SIAC of hedge instrument positions involving standardized and conventional options.⁴ The record layout of the new report for hedge instrument positions is also set forth in Attachment A.

Testing

Prior to being approved to submit production data to SIAC, each submitting organization must conduct a successful test with SIAC. The test will verify connectivity and check the format and content of a test file.

In order to establish connectivity to SIAC and/or conduct a test, please contact SIAC's Client Activation Group at (212) 383-5401 and identify your request by mentioning Sysid 28044.

All members must successfully test with SIAC in order to be in compliance with these new provisions by the effective date of **May 9, 2005**.

Endnotes

- 1 NASD would like to remind its members that LOPR filings to NASD pursuant to NASD Rule 2860(b)(5) should be made with respect to reportable positions in options only and not in any other derivative security. Members, and those entities filing on behalf of NASD members, must not report positions in other financial instruments in a LOPR filing to NASD, aside from those instruments being reported as hedges against reportable options positions.
- 2 Accounts for which reports are required pursuant to NASD Rule 2860(b)(5)(A)(i)a include accounts in which the member has an interest, each account of a partner, officer, director, or employee of such member, and of each customer, non-member broker, or non-member dealer. As such, if a member enters into a transaction with a customer creating a reportable position for both the member and the customer, then NASD Rules require that a LOPR reporting each position be submitted for both the customer and the member.
- 3 See NASD Conduct Rule 2860(b)(5)(A)(ii).
- 4 NASD previously issued guidance regarding hedge instrument position reporting in *NTM 97-56*.

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ATTACHMENT A

Intermarket Surveillance Group Large Options Positions Reporting System Input File Layout

V1.1

February 16, 2005

File Description

The ISG Large Options Positions Reporting System (LOPR) utilizes the input file described in this document. The file consists of the following structure:

- ◆ Datatrak Header Record – Identifies the file as a LOPR input file. Must be the first record in the file.
- ◆ Account Description and Position Records – For each account/trade date, up to five records may be present that provide the name on the account (Record Types 1-5). Following the Account Name records will be any number of position records for the account. There are six types of Position Records. Any or all types may be reported for a given account.
 - Listed Option Positions (Record Type 6).
 - Hedge Instrument Positions on Listed Options (Record Type 7).
 - Currency and Stock Index Warrant Positions (Record Type 8).
 - OTC Option Positions (Record Types A and B).
 - Hedge Instrument Positions on OTC Options (Record Type C).
- ◆ Datatrak Trailer Record – Must be the last record in the file.

The first 34 characters in all records (except Datatrak Header and Trailer) consist of a key that must be the same in all records for an account for a given trade date. Positions for multiple trade dates may be reported in a single file.

All alphanumeric (X) fields must be left justified and space filled. All numeric (9) fields must be right justified and zero filled.

Establishing Connectivity to SIAC

Organizations that do not already have connectivity to SIAC's Shared Data Center and its Datatrak input subsystem, must contact SIAC's Client Activation Group at (212) 383-5401. Please identify your request by mentioning Datatrak Sysid 28044. Various connectivity options will be presented to you.

If you already maintain connectivity to SIAC, you may use the Datatrak Originator and Sub-Originator you use in other file transmissions.

Testing Requirements

Prior to being approved to submit production data to SIAC, each submitting organization must conduct a successful test with SIAC. The test will verify connectivity and check the format and content of a test file. Please contact SIAC's Client Activation Group at (212) 383-5401 and once again identify your request by mentioning Datatrak Sysid 28044. They will also assign Datatrak Originator and Sub-Originator codes that must be included as part of the Datatrak header and trailer records.

Datatrak Header Record

The Datatrak header record must be the first record in the file.

Position	Field Name	Description	Format	Value
1-16	System ID	Identifies an ISG Large Options Positions File.	X(16)	HDR.S28044.E00.C
17-20	Originator	Identifies organization sending the file.	X(4)	Assigned by SIAC; please call (212) 383-5401.
21-22	Filler		X(2)	.S
23-26	Sub-Originator	Identifies organization sending the file.	X(4)	Assigned by SIAC; please call (212) 383-5401.
27-27	Filler		X(1)	Space.
28-33	Date	Date of file submission.	X(6)	MMDDYY
34-34	Filler		X(1)	Space.
35-59	Description	Textual identification of the file.	X(25)	ISG OPT. LARGE POS.
60-80	Filler		X(21)	Space.

Account Name Records—Record Types 1-5

Up to five records (Record Types 1-5) are used to provide the name and address on the account.

Position	Field Name	Description	Format	Value
1	Firm Type	Identifies the type of firm submitting the report.	X(1)	O = Firm that is only NASD member. L = Member of an option exchange.
2-7	Trade Date	Position effective date.	9(6)	MMDDYY
8-11	Firm ID	Reporting firm ID.	X(4)	OCC clearing number if OCC clearing firm or listed options market assigned number. If only NASD member, alpha identifier.
12-15	Branch	Firm branch code.	X(4)	
16-24	Account Number	Account number.	X(9)	
25-33	Social Security Number or Tax ID	Social Security Number or Tax ID depending on the Indicator field.	X(9)	If Social Security/Tax ID Indicator is "F" or "N," this field could be zero.
34-34	Social Security Number or Tax ID Indicator	Indicates whether the above field is a Social Security Number or a Tax ID.	X(1)	S = Social Security Number. T = Tax ID. F = Foreign. N = Not available.
35-35	Record Type	Identifies account name records.	X(1)	Values = 1-5. Record Type 1 must be present. Record Types 2-5 are optional, but must appear in numerical order.
36-65	Account Name/Address	Name/Address on the account.	X(30)	The last line of the address should include the City, State, and ZIP or Country Code. ¹
66-80	Filler		X(15)	Spaces.

¹ Separate Account Name/Address records should be provided to represent each line of the full account name and address. For example, to report Account information for the following account: James Q Public, c/o Fairfax Investment Group, 1500 Broadway, New York, NY 10036, four Account Name/Address records must be submitted, with Account Name/Address fields populated as follows:
Record Type 1 Account Name/Address = 'James Q Public'
Record Type 2 Account Name/Address = 'c/o Fairfax Investment Group'
Record Type 3 Account Name/Address = '1500 Broadway'
Record Type 4 Account Name/Address = 'New York, NY 10036'

Information reported in all other fields must be the same for each of the four records.

Listed Options Positions Record—Record Type 6

These records must appear after the account name records (Record Types 1-5) for a given account/trade date.

Position	Field Name	Description	Format	Value
1	Firm Type	Identifies the type of firm submitting the report.	X(1)	O = Firm that is only NASD member. L = Member of an option exchange.
2-7	Trade Date	Position effective date.	9(6)	MMDDYY
8-11	Firm ID	Reporting firm ID.	X(4)	OCC clearing number if OCC clearing firm or listed options market assigned number. If only NASD member, alpha identifier.
12-15	Branch	Firm branch code.	X(4)	
16-24	Account Number	Account number.	X(9)	
25-33	Social Security Number or Tax ID	Social Security Number or Tax ID depending on the Indicator field.	X(9)	If Social Security/Tax ID Indicator is "F" or "N," this field could be zero.
34-34	Social Security Number or Tax ID Indicator	Indicates whether the above field is a Social Security Number or a Tax ID.	X(1)	S = Social Security Number. T = Tax ID. F = Foreign. N = Not available.
35-35	Record Type	Identifies a listed option position report.	X(1)	6
36-41	Symbol	Option symbol.	X(6)	Use the 3-6 character option symbol.
42-44	Month	Expiration month.	X(3)	JAN, FEB, MAR, APR, MAY, JUN, JUL, AUG, SEP, OCT, NOV, DEC.
45-46	Year	Expiration year.	9(2)	Last 2 digits of the year.
47-47	Put/Call	Put/Call indicator.	X(1)	P = Put. C = Call.
48-59	Strike Price	Strike price.	9(6) V9(6)	
60-66	Long Quantity	Long position.	9(7)	If no position, set to zero.
67-73	Short Covered	Short covered position.	9(7)	If no position, set to zero.
74-80	Short Uncovered	Short uncovered position.	9(7)	If no position, set to zero.

Hedge Instrument Positions on Listed Options—Record Type 7

These records must appear after account name records (Record Types 1-5) and any listed option position records (Record Type 6) for a given account/trade date.

Position	Field Name	Description	Format	Value
1	Firm Type	Identifies the type of firm submitting the report.	X(1)	O = Firm that is only NASD member. L = Member of an option exchange.
2-7	Trade Date	Closing position effective date.	9(6)	MMDDYY
8-11	Firm ID	Reporting firm ID.	X(4)	OCC clearing number if OCC clearing firm or listed options market assigned number. If only NASD member, alpha identifier.
12-15	Branch	Firm branch code.	X(4)	
16-24	Account Number	Account number.	X(9)	
25-33	Social Security Number or Tax ID	Social Security Number or Tax ID depending on the Indicator field.	X(9)	If Social Security/Tax ID Indicator is "F" or "N," this field could be zero.
34-34	Social Security Number or Tax ID Indicator	Indicates whether the above field is a Social Security Number or a Tax ID.	X(1)	S = Social Security Number. T = Tax ID. F = Foreign. N = Not available.
35-35	Record Type	Identifies a hedge instrument position report on listed options.	X(1)	7
36-45	Option Symbol	Option symbol.	X(10)	Use the 3-6 character symbol of the option that is being hedged.
46-55	Hedge Instrument Symbol	Hedge instrument symbol.	X(10)	
56-59	Filler		X(4)	Spaces.
60-68	Long	Long position.	9(9)	
69-77	Short	Short position.	9(9)	
78-80	Filler		X(3)	Spaces.

Positions on Currency and Stock Index Warrants—Record Type 8

These records must appear after account name records (Record Types 1-5) and any listed option position records (Record Type 6) or hedge instrument position records (Record Type 7) for a given account/trade date.

Position	Field Name	Description	Format	Value
1	Firm Type	Identifies the type of firm submitting the report.	X(1)	O = Firm that is only NASD member. L = Member of an option exchange.
2-7	Trade Date	Closing position effective date.	9(6)	MMDDYY
8-11	Firm ID	Reporting firm ID.	X(4)	OCC clearing number if OCC clearing firm or listed options market assigned number. If only NASD member, alpha identifier.
12-15	Branch	Firm branch code.	X(4)	
16-24	Account Number	Account number.	X(9)	
25-33	Social Security Number or Tax ID	Social Security Number or Tax ID depending on the Indicator field.	X(9)	If Social Security/Tax ID Indicator is "F" or "N," this field could be zero.
34-34	Social Security Number or Tax ID Indicator	Indicates whether the above field is a Social Security Number or a Tax ID.	X(1)	S = Social Security Number. T = Tax ID. F = Foreign. N = Not available.
35-35	Record Type	Identifies a currency and stock index warrant position report.	X(1)	8
36-45	Warrant Symbol	Warrant symbol.	X(10)	
46-59	Filler		X(14)	Spaces.
60-68	Long	Long position.	9(9)	
69-77	Short	Short position.	9(9)	
78-80	Filler		X(3)	Spaces.

OTC Options Positions—Record Type A

OTC options positions reports consist of a set of two records (Record Types A and B). They must appear consecutively after the account identification records (Record Types 1-5) and any other position reports (Record Types 6-8) for a given account/trade date.

Position	Field Name	Description	Format	Value
1	Firm Type	Identifies the type of firm submitting the report.	X(1)	O = Firm that is only NASD member. L = Member of an option exchange.
2-7	Trade Date	Closing position effective date.	9(6)	MMDDYY
8-11	Firm ID	Reporting firm ID.	X(4)	OCC clearing number if OCC clearing firm or listed options market assigned number. If only NASD member, alpha identifier.
12-15	Branch	Firm branch code.	X(4)	
16-24	Account Number	Account number.	X(9)	
25-33	Social Security Number or Tax ID	Social Security Number or Tax ID depending on the Indicator field.	X(9)	If Social Security/Tax ID Indicator is "F" or "N," this field could be zero.
34-34	Social Security Number or Tax ID Indicator	Indicates whether the above field is a Social Security Number or a Tax ID.	X(1)	S = Social Security Number. T = Tax ID. F = Foreign. N = Not available.
35-35	Record Type	Identifies the first of two records of an OTC Options Positions report.	X(1)	A
36-36	Exercise Style	Indicates the exercise style.	X(1)	1 = American; 2 = European.
37-42	Symbol	Option symbol.	X(6)	Same symbol as the underlying equity.
43-45	Filler		X(3)	Spaces.
46-51	Expiration Date	Option expiration date.	9(6)	MMDDYY
52-52	Put/Call	Put/Call indicator.	X(1)	P = Put C = Call
53-64	Strike Price	Strike price.	9(6) V9(6)	
65-71	Multiplier	Shares per contract.	9(7)	
72-80	Filler		X(9)	Spaces.

OTC Options Positions—Record Type B

Position	Field Name	Description	Format	Value
1	Firm Type	Identifies the type of firm submitting the report.	X(1)	O = Firm that is only NASD member. L = Member of an option exchange.
2-7	Trade Date	Closing position effective date.	9(6)	MMDDYY
8-11	Firm ID	Reporting firm ID.	X(4)	OCC clearing # if OCC clearing firm or listed options market assigned number. If only NASD member, alpha identifier.
12-15	Branch	Firm branch code.	X(4)	
16-24	Account Number	Account number.	X(9)	
25-33	Social Security Number or Tax ID	Social Security Number or Tax ID depending on the Indicator field.	X(9)	If Social Security/Tax ID Indicator is "F" or "N," this field could be zero.
34-34	SSN/Tax ID Indicator	Indicates whether the above field is a Social Security Number or a Tax ID.	X(1)	S = Social Security Number; T = Tax ID; F = Foreign; N = Not available.
35-35	Record Type	Identifies the second of two records of an OTC Options Positions report.	X(1)	B
36-36	Foreign/Regional Indicator	Indicates if option is on a foreign security or a domestic security that only trades on a regional.	X(1)	F = Option on a foreign stock. R = Option on a regional stock. Space = Option on a stock listed on the Amex, NASDAQ, or NYSE.
37-37	OTC Index Option	Reserved for future use.	X(1)	Space.
38-44	Final Long Quantity	Final long position.	9(7)	If no position, set to zero.
45-51	Final Short Covered	Final short covered position.	9(7)	If no position, set to zero.
52-58	Final Short Uncovered	Final short uncovered position.	9(7)	If no position, set to zero.
59-65	Intra-day Long	Intra-day long position.	9(7)	If no position, set to zero.
66-72	Intra-day Short Covered	Intra-day short covered position.	9(7)	If no position, set to zero.
73-79	Intra-day Short Uncovered	Intra-day short uncovered position.	9(7)	If no position, set to zero.
80-80	Hedge Indicator	OTC position is hedging a listed option position or vice versa.	X(1)	L = Position is a hedge. Space = Position is not a hedge.

Hedge Instrument Position Report on OTC Options—Record Type C

These records must appear after the account identification records (Record Types 1-5) and any other position reports (Record Types 6-8, A, B) for a given account/trade date.

Position	Field Name	Description	Format	Value
1	Firm Type	Identifies the type of firm submitting the report.	X(1)	O = Firm that is only NASD member. L = Member of an option exchange.
2-7	Trade Date	Closing position effective date.	9(6)	MMDDYY
8-11	Firm ID	Reporting firm ID.	X(4)	OCC clearing number if OCC clearing firm or listed options market assigned number. If only NASD member, alpha identifier.
12-15	Branch	Firm branch code.	X(4)	
16-24	Account Number	Account number.	X(9)	
25-33	Social Security Number or Tax ID	Social Security Number or Tax ID depending on the Indicator field.	X(9)	If Social Security/Tax ID Indicator is "F" or "N," this field could be zero.
34-34	Social Security Number or Tax ID Indicator	Indicates whether the above field is a Social Security Number or a Tax ID.	X(1)	S = Social Security Number. T = Tax ID. F = Foreign. N = Not available.
35-35	Record Type	Identifies a hedge instrument position report on OTC options.	X(1)	C
36-36	Exercise Style	Indicates the exercise style.	X(1)	1 = American style. 2 = European style.
37-42	Symbol	Option symbol.	X(6)	Symbol of the option that is being hedged, should use the same symbol as the underlying entity.
43-45	Filler		X(3)	Spaces.
46-55	Hedge Instrument Symbol	Hedge instrument symbol.	X(10)	
56-59	Filler		X(4)	Spaces.
60-68	Long	Long position.	9(9)	Right justified, zero filled.
69-77	Short	Short position.	9(9)	Right justified, zero filled.

Hedge Instrument Position Report on OTC Options—Record Type C

Continued

Position	Field Name	Description	Format	Value
78-78	Foreign/Regional Indicator	Indicates if option is on a foreign security or a domestic security that only trades on a regional.	X(1)	F = Option on a foreign stock. R = Option on a regional stock. Space = Option on a stock listed on the Amex, NASDAQ, or NYSE.
79-80	Filler		X(2)	Spaces.

Datatrak Trailer Record

This record must be the last one in the file.

Position	Field Name	Description	Format	Value
1-16	Trailer ID	Identifies the Trailer Record.	X(16)	END.S28044.E00.C
17-20	Originator	Identifies organization sending the file.	X(4)	Same as Header Record.
21-22	Filler		X(2)	.S
23-26	Sub-Originator	Identifies organization sending the file.	X(4)	Same as Header Record.
27-80	Filler		X(54)	Spaces.

Notice to Members

MARCH 2005

SUGGESTED ROUTING

Legal and Compliance
Operations Managers
Senior Management

KEY TOPICS

Section 1 of Schedule A to
NASD By-Laws
Trading Activity Fee

GUIDANCE

Trading Activity Fee

NASD Issues Further Guidance on the Trading Activity Fee

Executive Summary

On October 1, 2004, the Securities and Exchange Commission (SEC or Commission) approved an NASD rule filing amending the Trading Activity Fee (TAF) that would reduce the TAF rate for covered equity securities, reduce the maximum per trade charge on covered equity securities, and assess the TAF on corporate debt securities that, under the Trade Reporting and Compliance Engine (TRACE) Rules, are defined as "TRACE-eligible securities" that fall within the definition of a "reportable TRACE transaction" (as defined in Rule 6210(c)) and all municipal securities subject to Municipal Securities Rulemaking Board (MSRB) reporting requirements.¹ As previously announced in *Notice to Members (NTM) 04-84*, the TAF will be assessed on "TRACE-eligible securities" that fall within the definition of a "reportable TRACE transaction" (as defined in Rule 6210(c)) and all municipal securities subject to MSRB reporting requirements effective April 1, 2005. In *NTM 04-84*, NASD also requested that members submit written questions concerning any operational aspects of applying the TAF to debt securities so that member firms could program their systems accordingly. NASD received a limited number of written questions in response to *NTM 04-84*.

In this *Notice*, NASD is providing guidance with respect to applying the TAF to debt securities based on the interpretive questions submitted in writing to NASD. In addition, NASD is also addressing additional interpretive questions that have been raised concerning the application of the TAF on other covered security transactions.

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Questions/Further Information

Questions concerning this *Notice* should be directed to NASD Finance at (240) 386-5397; or the Office of General Counsel, Regulatory Policy and Oversight, at (240) 728-8071.

Background and Discussion

On December 29, 2003, NASD filed with the Commission a proposed rule change (SR-NASD-2003-201) that would reduce the TAF rate for covered equity securities, reduce the maximum per trade charge on covered equity securities, and assess the TAF on corporate debt securities that, under the TRACE Rules, are defined as "TRACE-eligible securities" that fall within the definition of a "reportable TRACE transaction" (as defined in Rule 6210(c)) and on municipal securities subject to MSRB reporting requirements. In connection with this proposed rule change, NASD reviewed reported volumes for TRACE-eligible securities and municipal securities in conjunction with NASD's current regulatory costs associated with the oversight of these securities. Based upon this review, NASD determined to assess the TAF on TRACE-eligible securities and municipal securities at a rate of \$0.00075 per bond, with a maximum assessment of \$0.75 per trade (based on 1,000 bonds). The proposed rule change was published for notice and comment in the *Federal Register* on January 28, 2004.² On May 19, 2004, NASD filed with the Commission Amendment No. 1 and, at the same time, responded to comments submitted on the proposal. On September 30, 2004, NASD responded to further comments.³ The SEC approved the proposed rule change on October 1, 2004.⁴

In November 2004, NASD issued *NTM 04-84*, informing member firms that the TAF proposal was approved and of the requisite effective dates. Specifically, NASD implemented the TAF rate reduction and the reduction on the maximum per trade charge on covered securities on November 1, 2004. In addition, NASD announced that it would begin assessing the TAF on "TRACE-eligible securities" that fall within the definition of a "reportable TRACE transaction" (as defined in Rule 6210(c)) and all municipal securities subject to MSRB reporting beginning on April 1, 2005. NASD designated six months after SEC approval as the effective date for covered debt securities to allow members sufficient time to make programming changes to reflect the addition of two new categories of covered securities. Further, in *NTM 04-84*, NASD solicited interpretive questions relating to the operational aspects of assessing the TAF on debt securities. In response to *NTM 04-84*, NASD received a limited number of written questions. In this *Notice*, NASD is providing guidance with respect to applying the TAF to debt securities based on selected interpretive questions submitted in writing to NASD that were pertinent to the operational aspects of assessing the TAF on debt. NASD is also addressing additional interpretive questions that have been raised concerning the application of the TAF on other covered security transactions.

Submission/Payment Information

The TAF for covered equity, options, and security futures transactions is assessed on clearing firms on behalf of members.⁵ Likewise, the TAF for covered debt securities will also be assessed directly to the clearing firms (responsible for clearing the transaction on behalf of the member firm) and self-clearing member firms.

Clearing and self-clearing member firms are required to self-report covered securities transactions to NASD for the preceding month's activity each month. The prescribed form of the monthly report is available at www.nasd.com/trading_activity_fee_0305/. The monthly report and payment is to be submitted to NASD by the tenth business day following the end of the month. However, to allow firms additional time to comply with the impact of the guidance provided below, NASD has extended the submission and payment date for the April 1, 2005 through June 30, 2005 period for covered debt securities to July 14, 2005. Accordingly, firms may self-report and remit payment to NASD for covered debt securities for this period no later than July 14, 2005. Transactions in covered debt securities for July 1, 2005, and thereafter are to be reported on a monthly basis by the tenth business day following the end of the month.

Firms are reminded that NASD verifies the accuracy of members' self-reporting to ensure the fair assessment of the TAF. Firms are expected to establish and maintain appropriate written supervisory, compliance, legal, internal audit, and operating policies, practices, and procedures sufficient to assure compliance with the TAF self-reporting requirements. The self-reporting verification is performed as part of NASD's regular cycle examinations of members.

The self-reporting form and payment may be submitted to NASD by either U.S. mail or overnight express mail as follows:

For U.S. mail delivery:

NASD
P.O. Box 7777-W8555
Philadelphia, PA 19175-8555

Note: This P.O. Box will not accept courier or overnight deliveries.

For courier and overnight deliveries:

NASD
W8555 c/o Mellon Bank, Rm 3490
701 Market Street
Philadelphia, PA 19106
Phone number: (215) 553-0697 (if required for the recipient)

If other payment methods are required, please call NASD Finance at (240) 386-5394.

Questions and Answers

Covered Debt Securities Transactions

NASD is providing additional guidance with respect to applying the TAF to debt securities based on interpretive questions submitted in writing to NASD.

Question 1:

Will billing and payment mechanisms differ from those existing for TRACE and MSRB transactions? If so, how will firms report such transactions to NASD?

Yes. As discussed above, the TAF for TRACE-eligible securities and municipal securities will be self-reported as is done for equities, options, and futures. Firms are required to self-report covered securities transactions to NASD each month for the preceding month's activity. The monthly report and payment is to be submitted to NASD by the tenth business day following the end of the month. However, for covered debt transactions occurring from April 1 through June 30, 2005, NASD has extended the deadline for the timely submission of the monthly report and payment to July 14, 2005, to allow firms additional time to program in conformity with the guidance provided in this *Notice*.

Question 2:

Will the TAF appear as a component of the TRACE invoice that currently includes Browser Access Fees, Cancelled Trade Fees, Correction Fees, Reversal Fees, and Tier 1-3 Trade Reports Fees?

No. The TAF is a separate fee used by NASD solely to fund NASD's member regulatory activities, including the supervision and regulation of members through examinations, processing of membership applications, financial monitoring, policy, rulemaking, interpretive, and enforcement activities. The TAF, which also applies to covered equity, options, and security futures transactions, is separate and apart from TRACE-related fees that are used to fund, among other things, operation of the TRACE system.

Question 3:

Does the TAF apply to government securities?

No. The only debt securities covered by the TAF are corporate debt securities that, under the TRACE Rules, are defined as "TRACE-eligible securities" that fall within the definition of a "reportable TRACE transaction" (as defined in Rule 6210(c)) and all municipal securities subject to MSRB reporting requirements.

Question 4:

Does the TAF apply only to sell trades?

Yes. Section 1 of Schedule A to NASD By-Laws provides that members shall be assessed a TAF for the sale of covered securities. As stated in *NTM 02-75*,⁶ the sale of a covered security includes both transactions where the sale is for the account of a customer and transactions where the sale is for the member itself. For transactions where the sale is for the account of a customer, this means that the TAF will be assessed on transactions in which a member purchases the security as principal from a customer (for purposes of the TAF, customer is defined as not a broker-dealer) or where the member acts as agent in the sale of a covered debt security on behalf of a customer.

Question 5:

With regard to the calculation of the fee, *NTM 04-84* states "NASD is assessing the TAF on TRACE-eligible securities and municipal securities at a rate of \$0.00075 per bond, with a maximum assessment of \$0.75 per trade (based on 1,000 bonds)." Please confirm that in this statement the term "bond" or "one bond" equals a principal amount of debt of \$1,000. Therefore, the maximum fee would be applied to trades of \$1,000,000 principal amount (1,000 bonds) or greater.

Yes. Generally, the term "bond" or "one bond" equals a principal amount of debt of \$1,000. There are some special circumstances, however, where the principal amount of one bond could be something other than \$1,000 (such as so-called "baby bonds"). In these special circumstances, the maximum fee should be calculated using the actual number of bonds and not \$1,000,000.

Question 6:

Will the current guidance for riskless principal equity transactions apply to TRACE and MSRB transactions?

No. MSRB and TRACE trade reporting rules do not provide for reporting or identifying a transaction as a riskless principal transaction.⁷ Accordingly, the guidance provided for riskless principal equity transactions does not apply to TRACE and MSRB transactions. This means that in instances where a member, after having received an order to sell a covered debt security from a customer, sells the security as principal to satisfy the customer's order and then buys the security as principal from its customer, the TAF will be assessed on both the member's purchase of the debt security from the customer as a principal and the member's sale of the debt security as a principal.

In the same scenario above, if the original sell order is received from another broker-dealer rather than a customer, the firm acting as the intermediary will only be assessed the TAF once. Under this scenario, the TAF for the offsetting purchase will instead be assessed on the broker-dealer that placed the order to sell with the intermediary.

Question 7:

TRACE transaction reporting rules require that two transaction reports be submitted to TRACE when a member acts as agent on behalf of a customer.⁸

For example, broker #1 receives an order from a customer to buy 100 bonds. Acting as the customer's agent, broker #1 buys the bonds from broker #2. The TRACE reports required of broker #1 would be as follows:

Report #1: broker #1 SELL 100 bonds to customer as agent

Report #2: broker #1 BUY 100 bonds from broker #2 as agent

Although broker #1 BOUGHT the bonds for its customer, it actually reported a SELL to the customer, followed by a BUY from broker #2.

How many TAF fees are assessed for this trade and which broker(s) is/are assessed?

For purposes of applying the TAF to covered debt transactions, NASD defines an agency trade as a trade in which a broker-dealer, authorized to act as an intermediary for the account of its customer or another broker-dealer, buys (sells) a covered debt security from (to) a third party (e.g., another customer or broker-dealer). Such a trade is not executed in, or does not otherwise pass through, the broker-dealer's proprietary account, and is appropriately identified on firm transaction records as an agency transaction.

In the above example, this means that only broker #2 would be assessed a TAF since broker #1 has not effected a sale either as principal or on behalf of a customer. If broker #1, however, records the transaction in a firm account prior to satisfying the customer's order to buy, the TAF would also be assessed on broker #1 since this recording of the transaction in a proprietary account may call into question the agency relationship, and it will have a sale of a covered debt security on its books and records.

As stated in Question 4 above, any member acting as agent in the sale of a covered debt security on behalf of a customer will be assessed a TAF for the customer sale. If however, a member is acting as agent on behalf of another member firm, the TAF will be assessed on the member that is the proprietary seller of the security, not the member acting as agent, provided that the member acting as agent does not record the transaction in any type of firm account which would result in a sale being recorded or reported on that member's books and records.

Question 8:

How will the TAF be applied to transactions with investment advisors that ultimately allocate the order among multiple customers?

As provided in *NTM 02-63*,⁹ the TAF is assessed only on the initial execution of a transaction. Any related back office or clearing transactions that serve only to facilitate the clearance and settlement of a previously executed transaction are not assessed a TAF. For investment advisors that initially execute a large transaction that is later allocated among multiple customers, this means that only the initial execution that is reported to TRACE or the MSRB is subject to the TAF. Subsequent account allocations that do not represent reportable TRACE or MSRB transactions are not subject to the TAF.

Question 9:

How will the TAF apply to different types of short-term money market instruments (*i.e.*, corporate debt that at issuance has a maturity of one year or less is not TRACE eligible and not subject to the TAF, but there is no such exemption for short-term municipal securities)?

A member must determine whether a transaction in a short-term money market instrument is required to be reported under either TRACE or MSRB Rules. Based on the member's determination, the TAF will apply if the transaction is required to be trade reported to either TRACE or the MSRB.

Question 10:

Should rounding occur once at the end of each month on an aggregate basis, similar to how rounding occurs on the TAF calculation on equities?

Yes. Solely for purposes of submitting payment to NASD each month, each member's total aggregate payment due should be rounded to the nearest whole cent as is done for TAF calculations for equities, options, and futures.

Question 11:

For equities, there is a rule that says if the total proceeds of the trade are less than the TAF amount (calculated at rate x shares), then the TAF for the trade is zero. Does this rule also apply to fixed income?

Yes. If the execution price for a covered debt security is less than the TAF rate (\$0.00075 for bonds) on a per bond transaction basis, then no fee will be assessed.

Covered Equity Securities Transactions

NASD is providing the following additional guidance with respect to covered equity security transactions based on questions received from member firms.

Question 12:

As a clearing firm, I receive transactions from my correspondents bundled together for clearing purposes, often referred to as "compressed" trades. I do not receive the individual components of these compressed clearing entries. Is it permissible to apply the TAF to the single compressed entry rather than the individual transactions that make up the compressed clearing entry?

No. As previously stated in *NTM 02-63*, Question 15, the TAF is applied to the initial execution of a transaction and not to any related clearing entries. The TAF must therefore be calculated based on the individual components of compressed clearing transactions. It is not permissible to apply the maximum transaction limit based on a compressed clearing entry. Clearing firms must have a mechanism in place that will allow them to identify the individual components of compressed clearing entries so that the TAF may be properly calculated based on the individual executions.

All Covered Securities Transactions

The following question applies to both covered debt and equity transactions.

Question 13:

Does the TAF apply to trades that are cancelled and subsequently corrected?

Yes. For a trade that is cancelled and later corrected, the TAF would apply to the corrected trade. If a cancelled trade, however, is not later corrected and re-billed, the TAF would not be assessed. Accordingly, corrected trades should be included in the firm's monthly aggregate transactions required to be reported on the monthly TAF Self-Reporting Form but cancelled trades that were not corrected should not be reported. Debt and equity trade corrections should be treated the same for the purposes of the TAF.

Endnotes

- 1 Securities Exchange Act Rel. No. 50485 (Oct. 1, 2004), 69 FR 60445 (Oct. 8, 2004) (File No. SR-NASD-2003-201) (Order of Approval).
- 2 Securities Exchange Act Rel. No. 49114 (Jan. 22, 2004), 69 FR 4194 (Jan. 28, 2004) (Notice of Filing of Proposed Rule Change).
- 3 See Letter to Katherine A. England, Assistant Director, Division of Market Regulation, SEC, from Kathleen O'Mara, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, NASD, dated September 30, 2004.
- 4 Securities Exchange Act Rel. No. 50485 (Oct. 1, 2004), 69 FR 60445 (Oct. 8, 2004) (File No. SR-NASD-2003-201).
- 5 Although reporting obligations are ultimately the responsibility of the member, the TAF, along with certain other NASD fees, has historically been assessed directly to the clearing firms (responsible for clearing the transaction on behalf of the member firm) and self-clearing member firms for operational reasons.
- 6 See *NTM 02-75*, Question 1.
- 7 See *Rule 6230(c)(7)*.
- 8 See TRACE User Guide specifying how agency transactions are to be reported to TRACE.
- 9 See *NTM 02-63*, Question 15.

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Trading Activity Fee Self-Reporting Form



Firm Name: _____

Mailing Address: _____

Check If New Address

B/D#: _____

Clearing#: _____

For the Month of: _____

Each member shall report sales of covered securities pursuant to the provisions of Section 1(b) [Trading Activity Fee] of Schedule A, Section 1 [Member Regulation Fees] to NASD's By-Laws. Covered securities include: 1) all exchange registered securities wherever executed (other than bonds, debentures, and other evidence of indebtedness); 2) all other equity securities traded otherwise than on an exchange; 3) all security futures wherever executed; 4) all "TRACE-eligible securities" wherever executed, provided that the transaction also is a "reportable TRACE transaction," as these terms are defined in Rule 6210; and (5) all municipal securities subject to MSRB reporting requirements.

Transaction Type	Aggregate Volume	Rate	Assessment Amount
1. Covered Equity Securities (under maximum) ¹ - # of Shares	_____	\$ 0.000075	_____
2. Covered Equity Securities (at maximum) ¹ - # of Trades	_____	\$ 3.75	_____
3. Covered Option Contracts	_____	\$ 0.002	_____
4. Covered Future Securities (# of Contracts Traded on a Round Turn Basis)	_____	\$ 0.04	_____
5. Covered Debt Securities (under maximum) ² - # of Bonds	_____	\$ 0.00075	_____
6. Covered Debt Securities (at maximum) ² - # of Trades	_____	\$ 0.75	_____
Total Assessment			_____

Signature of Authorized Representative _____ Title _____

Print Name _____ Date/Telephone Number _____

E-Mail Address _____

Payment must be submitted with this form. The monthly form and payment are to be filed no later than 10 business days following the end of the month. The monthly form and payment may be submitted to NASD by either U.S. mail or overnight Express mail as follows:

For U.S. mail delivery:
 NASD, P.O. Box 7777-W8555, Philadelphia, PA 19175-8555
 Note: This P.O. Box will not accept courier or overnight deliveries.

If other payment methods are required, please call NASD Finance, at (240) 386-5394. Questions regarding the Trading Activity Fee or the report should be directed to NASD Finance, at (240) 386-5397.

For courier & overnight deliveries:
 NASD, W8555 c/o Mellon Bank, Rm 3490, Philadelphia, PA 19106
 Phone number: 215-553-0697 (if required for the recipient)

- 1 There is a \$3.75 maximum on covered equity securities. All volumes under the maximum of 50,000 shares must be reported as the aggregate number of shares on Line 1. Share volume for any transactions of 50,000 shares or more should be excluded from Line 1 and would be reported as the aggregate number of trades on Line 2.
- 2 There is a \$0.75 maximum on covered debt securities. All volumes under the maximum of 1,000 bonds must be reported as the aggregate number of bonds on Line 5. Bond volume for any transactions of 1,000 bonds or more should be excluded from Line 5 and would be reported as the aggregate number of bonds on Line 6.

Disciplinary and Other NASD Actions

REPORTED FOR MARCH

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 February 2005.

Firms Expelled, Individuals Sanctioned

Back Bay Capital, Inc. (CRD #22824, San Diego, California) and Albert Tommie Carazolez (CRD #2204105, Registered Principal, San Jose, California) submitted offers of settlement in which the firm was expelled from NASD membership. Carazolez 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 the firm, acting through Carazolez, encouraged and directed a registered representative acting under the firm's direction and control as its employee and agent to employ fraudulent sales practices and to make baseless price predictions and unsuitable recommendations of a security to public customers. In addition, the NASD found that Carazolez provided misleading documents and made false and misleading statements under oath in response to NASD's requests for information. The findings also stated that the firm and Carazolez egregiously failed to: supervise properly, establish and implement a supervisory compliance structure, and provide the firm's registered representatives with written supervisory procedures reasonably designed to prevent fraudulent sales practices. Furthermore, NASD found that the firm, acting through Carazolez, failed to: (1) register a person associated with the firm who was engaging in the firm's securities business and acting as a principal of the firm; and (2) name this associated person in Schedule A of the firm's Form BD, even though this person held an ownership interest of more than 5 percent of the firm. (NASD Case #CMS040049)

Clark Street Capital, Inc. (CRD #38304, Levittown, New York) and Marco Alfonsi (CRD #2770342, Registered Principal, Hicksville, New York) submitted a Letter of Acceptance, Waiver, and Consent in which they were censured and fined \$15,000, jointly and severally. In addition, Alfonsi was suspended from association with any NASD member in all principal capacities for six months. Without admitting or denying the allegations, the firm and Alfonsi consented to the described sanctions and to the entry of findings that the firm failed to obtain signed and dated receipts from public customers evidencing the receipt of penny stock risk disclosure documents for purchase transactions. The findings also stated that the firm failed to document a review of a company's financial statements, and other material business information, to ensure that its representatives had a reasonable basis to recommend stock to clients.

NASD also found that the firm, acting through Alfonsi, failed to establish, maintain, and enforce an adequate supervisory system that was reasonably designed to achieve compliance with the penny stock rules. In addition, the findings stated that Alfonsi failed to supervise reasonably the representatives in his branch office to ensure compliance with the penny stock rules.

Alfonsi's suspension began February 22, 2005, and will conclude at the close of business August 21, 2005. (NASD Case #C07050005)

Firm Fined, Individuals Sanctioned

Pryor, Counts & Co., Inc. (CRD #11002, Philadelphia, Pennsylvania) and Malcolm Dermott Pryor, Sr. (CRD #368534, Registered Principal, Villanova, Pennsylvania) submitted a Letter of Acceptance, Waiver, and Consent in which they were censured and fined \$15,000, jointly and severally. In addition, Pryor was suspended from association with any NASD member in any principal or supervisory capacity for 10 business days. Without admitting or denying the allegations, the firm and Pryor consented to the described sanctions and to the entry of findings that the firm participated in the underwriting of "hot issues" in which it sold shares in the public offerings to investment partnerships or corporations, and did not obtain sufficient information required for compliance. In addition, the NASD determined that the firm, acting through Pryor, failed to implement its written supervisory procedures in a manner sufficient to achieve compliance with informational requirements.

Pryor's suspension began February 22, 2005, and concluded at the close of business March 7, 2005. (NASD Case #C9A050001)

Firm and Individual Fined

GunnAllen Financial, Inc. (CRD #17609, Tampa, Florida) and Stephen Irvin Saunders, IV (CRD #2873747, Registered Principal, Tampa Florida) submitted a Letter of Acceptance, Waiver, and Consent in which they were censured and fined \$11,250 jointly and severally, and the firm was also fined \$18,750, of which \$8,750 was assessed jointly and severally with another individual. Without admitting or denying the allegations, the firm and Saunders consented to the described sanctions and to the entry of findings that the firm failed to implement its anti-money laundering ("AML") program in a manner that was reasonably designed to achieve and monitor compliance with the requirements of the Bank Secrecy Act and the implementing regulations promulgated thereunder by the Department of Treasury. The findings also

stated that the firm, acting through Saunders and another, permitted registered representatives to act in a capacity requiring registration when such persons were deemed inactive for failing to complete the Regulatory Element of Continuing Education. NASD also found that the firm, acting through Saunders, failed to report in a timely manner information regarding customer complaints to NASD, failed to file all information regarding customer complaints, and failed to report, within 10 business days, information regarding settlements of claims for damages against the firm and Registered Representatives and the receipt of a customer complaint alleging forgery. In addition, the findings stated that the firm, acting through an individual, failed to update in a timely manner the Forms U4 and U5 of registered representatives to disclose customer complaints, settlements, and/or arbitrations, as well as the Form U4 of Registered Representatives. The finding also stated that the firm, acting through Saunders, failed to ensure that all new account forms contained the signature of a partner, officer, or manager accepting the account on behalf of the firm. (NASD Case #C07050004)

Firms Fined

Crown Financial Group, Inc. (CRD #540, Jersey City, New Jersey) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$59,500. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to make/annotate an affirmative determination that the firm could borrow the securities or otherwise provide for delivery of the securities by settlement date. The findings also stated that the firm incorrectly designated as late through ACT last sale reports of transactions in NASDAQ National Market, OTC Equity, and SmallCap securities reported to ACT within 90 seconds of execution. NASD found that the firm incorrectly reported to ACT the second leg of "riskless" principal transactions in NASDAQ National Market and OTC equity securities and incorrectly designated the capacity of such transactions as principal and media report. NASD also found that the firm failed to report to ACT the correct symbol indicating whether it executed transactions in eligible securities in principal or agency capacity, and failed to report the correct execution time in transactions involving OTC equity securities. The findings also indicated that the firm executed short sale transactions and failed to report each of these transactions to ACT with a short sale modifier. In addition, NASD determined that the firm made available a report on the covered orders in national market system securities that it received for execution. However, the report did not include all covered orders, and as a result, it contained inaccurate data with regard to near quote limit orders of shares in NASDAQ security

Antigenics, Inc. The findings also stated that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with respect to the applicable securities laws and regulations concerning the 1% rule, Limit Order Display Rule, Order Handling Rule, order routing reports, order execution reports, short sales in CQS securities, educating of personnel concerning anti-competitive practices, trade reporting, best execution, ACT reporting, affirmative determination, bid test rule, record keeping, and OATS. 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 for each 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 such security. NASD determined that the firm failed to: preserve for a period of not less than three years, the first two in an accessible place, the memorandum of brokerage orders; report to OATS the correct replace time for orders that were cancelled or modified; and report to OATS the correct Limit Order Display indicator for orders. (NASD Case #CMS040222)

GRE Securities, LLC (CRD #123762, New York, 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 it did not have in place a system for the retention of electronic mail as required by SEC Rule 17a-4. The findings also stated that the firm started to utilize electronic storage media as defined in SEC Rule 17a-4(f); however, it failed to notify NASD 90 days prior to employing such electronic storage media. (NASD Case #C10050002)

National Clearing Corp. (CRD #14343, Sherman Oaks, California) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured; fined \$80,000; ordered to pay \$5,384.21, plus interest, in restitution to public customers; and required to revise its written supervisory procedures with respect to maintaining a two-sided quotation. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it did not 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. In addition, NASD found that the firm failed to maintain a continuous two-sided quotation in the absence of an excused withdrawal or a functional excused withdrawal. 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, and the Rules

of NASD, concerning maintaining a two-sided quotation. (NASD Case #CLG050009)

Nexus Financial, Inc. (CRD #38528, Colorado Springs, Colorado) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$15,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it permitted individuals to function in a principal capacity while their registrations were inactive for failing to sit for the Regulatory Element of the Continuing Education requirement by the specified date. NASD also found that the firm failed to establish and maintain supervisory procedures, written or otherwise, reasonably designed to achieve compliance with rules pertaining to Regulatory Element Continuing Education. (NASD Case #C3A050007)

Stifel, Nicolaus & Co., Inc. (CRD #793, Saint Louis, Missouri) 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 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 and the national best 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 for each 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 such security. The findings also stated that the firm transmitted to OATS reports that contained inaccurate, incomplete, or improperly formatted data and failed to submit the correct order receipt time to OATS. NASD also found that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with respect to the applicable securities laws and regulations concerning the Limit Order Display Rule. (NASD Case #CLG050006)

White Pacific Securities, Inc. (CRD #42505, San Francisco, California) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined \$25,000, and required to revise its written supervisory procedures with respect to OATS and SEC Rule 11Ac1-6. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to make publicly available a report on its routing of non-directed orders in covered securities. NASD found that the firm 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, and that the firm failed to report to OATS Reportable Order Events (ROEs) in a timely manner. In addition, 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, and the Rules of NASD, concerning OATS and SEC Rule 11Ac1-6. (NASD Case #CLG050001)

Individuals Barred or Suspended

John David Amick (CRD #4485089, Registered Representative, Pendleton, Indiana) 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 Amick reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Amick consented to the described sanction and to the entry of findings that he engaged in outside business activities by receiving compensation for providing financial planning services to public customers, and failed to give prompt written notice of his outside business activities to his member firm.

Amick's suspension began March 7, 2005, and will conclude at the close of business April 5, 2005. (NASD Case #C8A050009)

Andre Anderson, Sr. (CRD #2872133, Registered Representative, Barrington, Illinois) was barred from association with any NASD member in any capacity. The sanction was based on findings that Anderson willfully failed to disclose material information on his Form U4. (NASD Case #C8A040055)

Penny Rechelle Boston (CRD #4707359, Registered Representative, Nampa, Idaho) submitted an Offer of Settlement in which she was fined \$10,000 and suspended from association with any NASD member in any capacity for two years. The fine must be paid before Boston reassociates with any NASD member or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Boston consented to the described sanctions and to the entry of findings that she willfully misrepresented material facts on her Form U4.

Boston's suspension began March 7, 2005, and will conclude at the close of business March 6, 2007. (NASD Case #C3B040026)

Raymond Lee Bowdich, Jr. (CRD #2051235, Registered Representative, Albuquerque, New Mexico) 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, Bowdich consented to the described sanction and to the entry of findings that he caused the withdrawal of \$52,000 from the securities account of a public customer, obtained

possession of the withdrawn funds, and used them for his own benefit. The findings also stated that Bowdich failed to respond to NASD requests for information. (NASD Case #C3A050010)

Vincent James Cappetta (CRD #2471511, Registered Representative, North Babylon, New York) was barred from association with any NASD member in any capacity and ordered to pay \$24,552.24, plus interest, in restitution to public customers. The sanctions were based on findings that Cappetta made omissions of material fact in the course of his sales presentations of treasury bonds to public customers. The findings also stated that Cappetta effected qualitatively unsuitable transactions to public customers without having reasonable grounds for believing that his recommendations and transactions were suitable based on the customers' financial situations, investment objectives, and needs. NASD also found that Cappetta exercised discretionary trading authority in a public customer's account without obtaining the customer's prior written authorization and his member firm's prior written acceptance of the account as discretionary (NASD Case #C10040085)

Carmen Rosario Caro, (CRD #1949991, Registered Representative, San Juan, Puerto Rico) was barred from association with any NASD member in any capacity, and required to pay \$25,000, plus interest, in restitution to public customers. The sanctions were based on findings that, based on a signed withdrawal form and cover letter, Caro caused \$25,000 to be withdrawn from the annuity of public customers without their knowledge and mailed to another individual. The findings also stated that Caro failed to respond to NASD request for information. (NASD Case #C07040066)

Michael John Catanzaro (CRD #4800801, Registered Representative, Hauppauge, New York) 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 30 business days. The fine must be paid before Catanzaro reassociates with any NASD member or before requesting relief from statutory disqualification. Without admitting or denying the allegations, Catanzaro consented to the described sanctions and to the entry of findings that he failed to disclose material facts on his Form U4.

Catanzaro's suspension began on March 7, 2005, and conclude at the close of business April 15, 2005. (NASD Case #CLI040037)

Robert James Christ (CRD #1100392, Registered Representative, Niagara Falls, 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 three months. The fine must be paid before Christ reassociates with any NASD member

following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Christ consented to the described sanctions, and to the entry of findings that he engaged in business activity (for compensation) outside the scope of his business relationship with his member firm, and without providing the firm prompt written notice of this activity.

Christ's suspension began March 7, 2005, and will conclude at the close of business June 6, 2005. **(NASD Case #C9B050006)**

Benjamin Lee Coyner (CRD #4253091, Registered Representative, Placentia, California) 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 Coyner reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Coyner consented to the described sanctions and to the entry of findings that he forged a college administrator's signature on student Intern Agreement forms in an effort to facilitate the interns' participation in his member firm's summer program.

Coyner's suspension began February 22, 2005, and will conclude at the close of business February 21, 2006. **(NASD Case #C02050005)**

Arthur Marc Davidson (CRD #2876412, Registered Representative, Cherry Hill, 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, Davidson consented to the described sanctions and to the entry of findings that he signed a public customer's name on Financial Advisory Service agreements and Mutual Fund Redemption forms without the customer's permission or knowledge. **(NASD Case #C9B050009)**

Derrick Ross Edward Doba (CRD #2283550, Registered Principal, Marina Del Rey, California) 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 Doba, no monetary sanctions have been imposed. Without admitting or denying the allegations, Doba consented to the described sanction and to the entry of findings that he engaged in private securities transaction without prior notice to and approval from his member firm.

Doba's suspension began February 22, 2005, and will conclude at the close of business June 21, 2005. **(NASD Case # C02040056)**

Patrick W. Donohue (CRD #4168054, Registered Representative, Moreno Valley, California) was barred from association with any NASD member in any capacity. The sanction was based on findings that Donohue forged a public customer's signature to effect wire transfers and transferred \$6,000 from the customer's account at his member firm to his personal bank account, thereby converting the funds to his own use and benefit. The findings also stated that Donohue failed to respond to NASD requests for information. **(NASD Case #C02030030)**

Timothy Robert Evans (CRD #2112351, Registered Representative, Lake Hopatcong, 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 six months, and required to pay \$6,000 in restitution to a public customer. The fine and restitution must be paid before Evans reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Evans consented to the described sanctions and to the entry of findings that he made a recommendation to a public customer without having a reasonable basis for believing that the recommendation was suitable for the customer in light of the customer's investment objectives, financial situation, and needs.

Evans' suspension began February 22, 2005, and will conclude on August 21, 2005. **(NASD Case #C9B050002)**

David Gerald Gillard (CRD #4461228, Registered Representative, Fort Collins, Colorado) 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 days. The fine must be paid before Gillard reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Gillard consented to the described sanctions and to the entry of findings that he exercised discretion in a public customer's account without obtaining the customer's prior written authorization or the written acceptance of the account as discretionary by his member firm.

Gillard's suspension began March 7, 2005, and will conclude at the close of business March 21, 2005. **(NASD Case #C3A050009)**

William Robert Goodhue (CRD #225161, Registered Representative, Wellington, Florida) submitted an Offer of Settlement in which he was fined \$9,800 and suspended from association with any NASD member in any capacity for 10 business days. The fine must be paid before Goodhue reassociates with any NASD member or before requesting relief from any statutory disqualification. Without admitting or

denying the allegations, Goodhue consented to the described sanctions and to the entry of findings that he recommended the purchase of mutual funds to a public customer although, based on the amounts being invested by the customer, Goodhue's recommendations were unsuitable, in that they were not the lowest cost available. NASD found that the customer could have invested in Class D shares in the respective mutual funds by paying lower ongoing expenses than the class B shares which he purchased, and without paying any up-front sales charges.

Goodhue's suspension began December 10, 2004, and concluded at the close of business December 23, 2004. (NASD Case #C07040054)

Albert Joseph Gornatti, Jr., (CRD #4175310, Registered Principal, Little Rock, Arkansas) 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, Gornatti consented to the described sanctions and to the entry of findings that he issued 13 checks totaling \$14,001.78, made payable to himself from the operating account of the member firm. NASD found that Gornatti converted the funds to his own use and benefit by endorsing and negotiating the checks without the knowledge or consent of his member firm, and concealed his activities by falsifying the general ledger and altering bank statements. (NASD Case #C05050002)

Myrle C. Grose Jr. (CRD #2265918, Registered Representative, Ridgeley, West 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, Grose consented to the described sanctions and to the entry of findings that he misappropriated approximately \$1.2 million from public customers intended for investment in securities. The findings stated that instead, Grose converted the funds to his own use and benefit. NASD also found that Grose failed to respond to NASD requests for information. (NASD Case #C9B050005)

Alicia Ann Hiller (CRD #4265601, Registered Representative, Marina Del Rey, California) submitted a Letter of Acceptance, Waiver, and Consent in which she was suspended from association with any NASD member in any capacity for three months. In light of financial status of Hiller, no monetary sanctions have been imposed. Without admitting or denying the allegations, Hiller consented to the described sanction and to the entry of findings that she engaged in private securities transactions without prior notice and approval from her member firm.

Hiller's suspension began February 22, 2005, and will conclude at the close of business May 21, 2005. (NASD Case #C02040057)

Lori A. Huck (CRD #4190301, Registered Representative, Greenfield, Wisconsin) was barred from association with any NASD member in any capacity. The sanction was based on findings that Huck endorsed and deposited into her personal securities and bank account checks totaling \$59,079.69, meant for her member firm, without the firm's knowledge or consent, and used the proceeds for her own benefit or for the benefit of someone other than the firm. NASD also found that Huck received a \$10,000 check, made payable to her member firm, with instructions to deposit the check into the account of a public customer. Huck deposited the funds into her own personal securities account and used the funds for some purpose other than for the benefit of the customer. She later had the deposit reversed and credited to the customer's securities account. In addition, the findings stated that Huck endorsed and deposited into her personal securities account checks totaling \$2,800, made payable to her member firm, and used the proceeds of the checks for her own benefit or for the benefit of someone other than the customer. NASD also found that Huck failed to respond to NASD requests for documents and information. (NASD Case #C8A040069)

Jeffrey Michael Hug (CRD #2287115, Registered Representative, Aurora, Colorado) 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, Hug consented to the described sanction and to the entry of findings that he failed to respond to NASD requests for documents and information. (NASD Case #C3A050004)

Barry Alan Kaufman (CRD #2774898, Registered Representative, Boca Raton, Florida) was barred from association with any NASD member in any capacity and ordered to pay \$34,832.98, plus interest, in restitution to public customers. The sanctions were based on findings that Kaufman effected unauthorized securities transactions in the accounts of public customers. The findings also stated that Kaufman failed to execute customer orders. (NASD Case #CAF030061)

Ki-Moon Kim (CRD #4765910, Registered Representative, Salt Lake City) 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, Kim consented to the described sanction and to the entry of findings that he withdrew or transferred \$26,988 from the bank accounts of public customers without their authorization. The findings also stated that Kim changed the mailing address on a public customer's account form to his branch office address without the consent or knowledge of the customer. (NASD Case #C3A050006)

David J. Lanzatella (CRD #1747171, Registered Representative, Rochester, 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, Lanzatella consented to the described sanctions and to the entry of findings that he willfully failed to amend his Form U4 to disclose a material fact. The findings also stated that Lanzatella failed to respond to NASD requests for information regarding the non-disclosure. **(NASD Case #C9B050010)**

Alex Livak (CRD #4421506, Registered Representative, Astoria, New York) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$25,000 and suspended from association with any NASD member in any capacity for two years. The fine must be paid before Livak reassociates with any NASD member or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Livak consented to the described sanctions and to the entry of findings that he prepared and submitted, or caused to be prepared and submitted, a letter to his landlord that contained a fabricated story as to why he could not pay his rent. NASD found that the letter was written on his member firm's letterhead and was purportedly signed by the "Director of Security, NASD." The findings also stated that the individual who signed the letter was Livak's friend and had never been an employee of NASD or his member firm. In addition, NASD determined that Livak prepared and submitted a variable life insurance policy application to his member firm that contained false and inaccurate information.

Livak's suspension began January 18, 2005, and will conclude at the close of business January 17, 2007. **(NASD Case #C10040114)**

Herman Forrest Lombard (CRD #1664771, Registered Representative, Papillion, Nebraska) 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 Lombard reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Lombard consented to the described sanctions and to the entry of findings that he engaged in private securities transactions totaling \$256,000 without notifying his member firm of these transactions and his proposed role therein, and without receiving prior written approval from his member firm.

Lombard's suspension began March 7, 2005, and will conclude at the close of business September 6, 2005. **(NASD Case #C04050006)**

Stephen Michael Magee (CRD #2469731, Registered Principal, Portland, Oregon), Phillip Bradley Blackwell (CRD #4318779, Registered Representative, New York, New York), and Gary John Ferrara (CRD #2496815,

Registered Representative, Verona, New Jersey) submitted an Offer of Settlement in which Magee was fined \$10,000 and suspended from association with any NASD member in any capacity for two years, and Blackwell and Ferrara were barred from association with any NASD member in any capacity. The fine must be paid before Magee reassociates with any NASD member or before requesting relief from statutory disqualification. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that while acting individually and as a members of a group of salespersons, they employed classic boiler-room techniques to induce customers to purchase shares of a company. NASD found that the members of the group engaged in fraudulent misrepresentations and omissions to induce purchases or to discourage sales of shares in a company and routinely predicted the stock would shortly increase in price. The findings also stated that they engaged in unauthorized trading, as well as other deceptive practices, including buying more than the customer authorized or insisting that the customer pay for an unauthorized trade before selling the stock. In addition, NASD determined that each member of the group knowingly or recklessly provided substantial assistance to other members of the group engaged in the same or similar misconduct, in furtherance of the scheme. The findings also included that the respondents and members of the group failed to furnish customers, prior to effecting such transactions, a risk disclosure document containing the information required by penny stock rules and failed to obtain from customers, prior to effecting customer transactions in a stock, a manually signed and dated written statement acknowledgement receipt of such risk disclosure documents. The findings also stated that they failed to: (1) disclose to customers, either orally or in writing, prior to effecting customer transactions in a stock, the inside bid and offer quotations for the stock; (2) provide the same in writing prior to the time of any written confirmation sent to the customer pursuant to SEC Rule 10b-10; and (3) keep and preserve records of such disclosures as required by the penny stock rules.

Magee's suspension will begin at the opening of business October 19, 2005, and conclude on the close of business October 18, 2007. **(NASD Case #CMS040165)**

Paul Brian Meyers (CRD #3062786, Registered Representative, Lexington, Kentucky) 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 90 days. The fine must be paid before Meyers reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Meyer consented to the described sanctions and to the entry

of findings that he affixed the signature of a public customer on a Letter of Intent Form without the customer's knowledge or consent, and submitted the form to his member firm. In addition, NASD found that Meyer affixed the signature of a public customer on a transfer form and check and submitted these to his member firm to transfer funds from the customer's account to a bank account held in the customer's name.

Meyer's suspension began March 7, 2005, and will conclude at the close of business June 4, 2005. (NASD Case #C8A050005)

Eric David Mistal (CRD # 4762304, Registered Representative, Westchester, Illinois) 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 four months. The fine must be paid before Mistal reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Mistal consented to the described sanction and to the entry of findings that he failed to disclose material information on his Form U4.

Mistal's suspension began March 7, 2005, and will conclude at the close of business July 6, 2005. (NASD Case #C8A050006)

Mark Francis Mizenko (CRD #1812411, Registered Representative, Kent, Ohio) was barred from association with any NASD member in any capacity. The NAC imposed the sanction following review of an OHO decision. The sanction was based on findings that Mizenko forged the signature of a corporate officer of his member firm to a corporate resolution that was used to guarantee payments to an automobile dealership in association with a program to attract clients. Mizenko has appealed the action to the SEC and the sanctions, with the exception of the bar, are not in effect pending consideration of the appeal. (NASD Case #C8B030012)

Terry Alexander Moore (CRD #4115171, Registered Representative, Adel, Georgia) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$10,000 and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the allegations, Moore consented to the described sanctions and to the entry of findings that he made an unsuitable sub-account allocation recommendation to a public customer in connection with a variable annuity purchase.

Moore's suspension began February 22, 2005, and will conclude at the close of business March 7, 2005. (NASD Case #C07050002)

Marcus Kalman Nagel (CRD#2170816, Registered Representative, New York, New York) was barred from association with any NASD member in any capacity. The sanctions were based on finding that Nagel improperly used customer funds when he commingled customer funds, intended for the customer's securities account, with his own funds. NASD also found Nagel failed to respond to NASD requests for information. (NASD Case #C10040082)

Phillip Mauro Nuciola III (CRD #2558471, Registered Representative, Mesa, Arizona) 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 20 days. Without admitting or denying the allegations, Nuciola consented to the described sanctions and to the entry of findings that he failed to provide prompt written notice of his outside business activities to his member firm.

Nuciola's suspension began March 7, 2005, and will conclude at the close of business March 26, 2005. (NASD Case #C3A050008)

Ryan Nicholas Ourth (CRD #4659110, Registered Representative, Itasca, Illinois) submitted an Offer of Settlement in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 45 days. The fine must be paid before Ourth reassociates with any NASD member or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Ourth consented to the described sanctions and to the entry of findings that he willfully failed to disclose a material fact on his Form U4.

Ourth's suspension began March 7, 2005, and will conclude at the close of business April 20, 2005. (NASD Case #C8A040090)

Nicholas Harrel Patton, Jr., (CRD #1545508, Registered Supervisor, Little Rock, Arkansas) was barred from association with any NASD member in any capacity and ordered to pay \$27,214.25, plus interest, in restitution to his member firm. The sanctions were based on findings that Patton received checks totaling \$27,214.25 from public customers for investment purposes and deposited the checks into his personal account without the customers' knowledge or consent. The findings also stated that Patton failed to respond to NASD requests for information. (NASD Case #C05040063)

Anthony George Peterson (CRD #1902189, Registered Representative, Champaign, 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, Peterson

consented to the described sanction and to the entry of findings that he engaged in outside business activities by receiving compensation for selling viaticals, and failed to give prompt written notice of his activities to his member firm. (NASD Case #C8A050007)

Scott Steven Powell (CRD #1987773, Registered Representative, Bellevue, Washington) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$20,000 and suspended from association with any NASD member in any capacity for three months. Without admitting or denying the allegations, Powell consented to the described sanctions and to the entry of findings that he affixed his wife's signature to a letter addressed to the member firm where her securities account was maintained without her knowledge or consent. The findings stated the letter requested the registration and taxpayer I.D. number of the account be changed, effectively transferring control of the account from his wife to himself.

Powell's suspension began December 16, 2004, and will conclude at the close of business March 15, 2005. (NASD Case #C3B040029)

Memory Ursula Pritchard (CRD #1139894, Registered Representative, Templeton, California) submitted a Letter of Acceptance, Waiver, and Consent in which she was fined \$12,073, which includes disgorgement of commissions of \$2,073, and suspended from association with any NASD member in any capacity for 12 months. The fine must be paid before Pritchard reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Pritchard consented to the described sanctions and to the entry of findings that she participated in private securities transactions, received \$53,073 in commission, and failed to provide prior written or oral notification to, and receive prior written approval from, her member firm.

Pritchard's suspension began February 22, 2005, and will conclude at the close of business February 21, 2006. (NASD Case #C02050004)

Robert James Quinn (CRD #4252849, Registered Representative, Freeland, Pennsylvania) 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, Quinn consented to the described sanctions and to the entry of findings that he forged a public customer's signature on a form requesting a partial withdrawal of funds from the customer's variable annuity without the customer's knowledge or consent. (NASD Case #C9A050003)

Bhola Ramsundar (CRD #1132717, Registered Representative, Floral Park, 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 one year. The fine must be paid before Ramsundar reassociates with any NASD member or before requesting relief from statutory disqualification. Without admitting or denying the allegations, Ramsundar consented to the described sanctions and to the entry of findings that he falsified an Electronic Funds Transfer ("EFT") form for the variable life insurance account of public customers.

Ramsundar's suspension began March 7, 2005, and will conclude at the close of business March 6, 2006. (NASD Case # CLI040028)

Paul Victor Roddy, Jr. (CRD #4665217, Registered Representative, Glen Burnie, Maryland) was fined \$10,000 and suspended from association with any NASD member in any capacity for one year. The fine must be paid before Roddy reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. The sanctions were based on findings that Roddy willfully misrepresented material facts on his record on a Form U4.

Roddy's suspension began on January 17, 2005, and will conclude at the close of business January 16, 2006. (NASD Case #C9A040020)

Victor Rene Rogers, II (CRD #4637131, Registered Representative, Denver, Colorado) was barred from association with any NASD member in any capacity. The sanction was based on findings that Rogers willfully failed to disclose material information on his Form U4. The NASD also found that Rogers failed to respond to written requests for information. (NASD Case #C3A040038)

Luke Herbert Scheibner (CRD #4721020, Registered Representative, Milford, 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 30 business days. The fine must be paid upon Scheibner's reassociation with any NASD firm or prior to requesting relief from any statutory disqualification. Without admitting or denying the allegations, Scheibner consented to the described sanctions and to the entry of findings that he willfully failed to disclose material facts on his Form U4.

The suspension began on February 22, 2005, and will conclude at the close of business on April 4, 2005. (NASD Case #C9B050003)

Susanne Olivia Sites (CRD #4758594, Registered Representative, Las Vegas, Nevada) submitted a Letter of Acceptance, Waiver, and Consent in which she was fined \$5,000 and suspended from association with any NASD member in any capacity for six months. The fine must be paid before Sites reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Sites consented to the described sanctions and to the entry of findings that she failed to disclose a material fact on her Form U4.

Sites' suspension began March 7, 2005, and will conclude at the close of business September 6, 2005. **(NASD Case #C02050007)**

Reuel Clarion Swanson (CRD #1208652, Registered Principal, Spokane, Washington) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and barred from association with any NASD member in any principal capacity. Without admitting or denying the allegations, Swanson consented to the described sanctions and to the entry of findings that he, acting on behalf of his member firm, had a supervisory system and written supervisory procedures that were inadequate and did not appropriately deter and detect violations of NASD rules, which included misrepresentations and omissions in the sale of its proprietary products, unsuitable recommendations, and inadequate review and approval of sales of proprietary products. In addition, NASD determined that Swanson failed to take effective supervisory action in the face of red flags indicating improper sales practices by registered representatives. **(NASD Case #C3B040024)**

Robert Jerome Toohey (CRD #854174, Registered Principal, Parkville, Maryland) submitted an Offer of Settlement in which he was fined \$5,000, suspended from association with any NASD member in any capacity for five business days, and barred from associating with any NASD member in a supervisory capacity as a General Securities Principal. Without admitting or denying the allegations, Toohey consented to the described sanctions and to the entry of findings that he failed to supervise adequately the activities of a registered representative in connection with the publication of a press release and a summary buy recommendation that contained certain misleading, exaggerated, and unwarranted claims and omissions of material fact.

Toohey's suspension began November 5, 2004, and concluded at the close of business November 11, 2004. **(NASD Case #CMS040016)**

Patrick Clark Toole (CRD #1092734, Registered Principal, New Orleans, Louisiana) submitted an Offer of Settlement in

which he was fined \$10,000 and suspended from association with any NASD member in any principal capacity for six months. Without admitting or denying the allegations, Toole consented to the described sanctions and to the entry of findings that he failed to: (1) establish, maintain, and enforce an adequate system reasonably designed to comply with NASD rules regarding exception reports; and (2) supervise activities in connection with the sale of variable annuity and variable life products. The findings also stated that Toole failed to supervise an agent adequately, in that he neither conditioned the agent's employment upon heightened supervision nor put a plan of heightened supervision into effect. NASD also found that Toole failed to maintain and enforce written supervisory procedures requiring annual compliance conferences with registered representatives, and to respond reasonably to red flags raised by a customer complaint.

Toole's suspension began March 7, 2005, and will conclude at the close of business September 6, 2005. **(NASD Case #C05040082)**

Ronald Dean Udy (CRD #1981077, Registered Representative, Brigham City, Utah) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$12,500, suspended from association with any NASD member in all capacities for 25 days, and then suspended from association with any NASD member in a principal or supervisory capacity for 25 days. Without admitting or denying the allegations, Udy consented to the described sanctions and to the entry of findings that he engaged in private securities transactions without providing prior written notice to his member firm. NASD also found that Udy acted in a supervisory capacity at his member firm without registration as a general securities principal or investment company and variable contract products principal.

Udy's suspension, in any capacity, will begin on March 7, 2005, and conclude at the close of business March 31, 2005. Udy's suspension, in any principal or supervisory capacity, will begin on April 1, 2005, and conclude at the close of business April 25, 2005. **(NASD Case #C3A050005)**

Nancy A. Wilson (CRD #4673980, Associated Person, Dallas, 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, Wilson consented to the described sanction and to the entry of findings that she failed to respond to NASD requests for information. **(NASD Case #C06040030)**

April Langt Wright (CRD #2557254, Registered Principal, Brooklyn, New York) submitted a Letter of Acceptance, Waiver, and Consent in which she was fined \$10,000 and suspended from association with any NASD member in any

capacity for one year. The fine must be paid before Wright reassociates with any NASD member or before requesting relief from statutory disqualification. Without admitting or denying the allegations, Wright consented to the described sanctions and to the entry of findings that she altered the dates in the signature pages of public customers' Securities Purchase Agreements submitted in connection with a private placement offered by her member firm.

Wright's suspension will begin on March 7, 2005, and conclude at the close of business March 6, 2006. (NASD Case #C10040117)

Decisions Issued

The following decisions have been issued by the DBCC or the Office of Hearing Officers and have been appealed to or called for review by the NAC as of February 25, 2005. 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 *Notice to Members*.

Philippe Noel Keyes (CRD #1172528, Registered Representative, Valencia, California) was barred from association with any NASD member in any capacity. The sanction was based on findings that he engaged in private securities transactions without providing prior written notice to, and prior written approval from, his member firm. The finding also stated that Keyes used unbalanced and misleading sales literature in connection with the recommendation and sale of securities.

This decision has been appealed to the NAC, and the sanction is not in effect, pending consideration of the appeal. (NASD Case #C02040016)

Complaints Filed

NASD issued the following complaints. 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.

Robert Payne Crider (CRD #3237093, Registered Representative, San Antonio, Texas) was named as a respondent in an NASD complaint alleging that he made recommendations to a public customer that were unsuitable, in that the recommendations were inconsistent with the

customer's age, net worth, investment experience, investment objectives, risk tolerance, and time horizon. (NASD Case #C06050003)

Lawrence Nallie (CRD #2364153, General Securities Representative, New Albany, Ohio) was named as a respondent in an NASD complaint alleging that he misused customer funds totaling \$6,500. The complaint also alleges that Nallie engaged in outside business activities without providing prompt written notice of his activities to the member firm and failed to respond to NASD requests for information. (NASD Case #C8A050004)

Andrew James Patton (CRD #2428998, Registered Representative, Fort Collins, Colorado) was named as a respondent in an NASD complaint alleging that he made material misrepresentations of fact in selling long-term callable CDs to public customers in order to induce the customers, purchases. The complaint also alleges that Patton inappropriately exercised the death-put feature of a CD and caused the issuer to bear the loss, in that the death-put feature was invalid under the terms of the certificate of deposit because the account did not hold the CD at the time of the account owner's death. (NASD Case #C05050003)

Elangovan Surendran (CRD #2658729, Registered Representative, Mineola, New York) was named in an NASD complaint alleging that he directly or indirectly, by the use of the 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 alleged that Surendran recommended securities transactions to a public customer without having reasonable grounds for believing that such transactions were suitable for the customer in view of the size and frequency of the transactions, the nature of the account, and the customer's financial situation, investment objectives, and needs. (NASD Case #C9B050008)

Andrew Barrett Vaughley (CRD #2453108, Registered Representative, Seattle, Washington) was named as a respondent in an NASD complaint alleging that he, by the use of instrumentalities of interstate commerce or the mails, intentionally or recklessly employed devices to defraud public customers and their registered representative, by making untrue statements of material facts and/or failing to state material facts necessary, in light of the circumstances, to make the statements not misleading in connection with purchase of securities. The complaint further alleges that Vaughley harassed NASD staff and a witness in an NASD investigation. (NASD Case #C3B050004)

Firms Expelled for Failing to Pay Fines and/or Costs in Accordance with NASD Rule 8320

Chicago Capital, Inc.
Chicago, Illinois
(January 31, 2005)

Program Trading Corp.
Boca Raton, Florida
(January 31, 2005)

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 9552. 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.

Blue Marble Financial, LLC
Irving, Texas
(February 1, 2005)

Individuals Barred Pursuant to NASD Rule 9552 for Failure to Provide Information Requested Under NASD Rule 8210

Richard Samuel Hollander
Boca Raton, Florida
(February 3, 2005)

Michael McFerron Pope
Pittsburgh, Pennsylvania
(February 3, 2005)

Individuals Suspended Pursuant to NASD Rule 9552 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.)

Michael John Assenza
Boca Raton, Florida
(February 7, 2005)

Damon J. Dombroski
Higganum, Connecticut
(February 7, 2005)

James Anthony Dvorznak
Dix Hills, New York
(January 31, 2005)

Roger Mezhibovsky
Holmdel, New Jersey
(January 28, 2005)

Richard Springer Jones
West Melbourne, Florida
(February 9, 2005)

Sean P. Ryan
Boca Raton, Florida
(January 29, 2005)

Individuals Suspended Pursuant to NASD Rule Series 9510 for Failure to Comply with an Arbitration Award or a Settlement Agreement

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

Thomas Andrew Bower, Jr.
Ford City, Pennsylvania
(February 8, 2005)

Lawrence Joseph Ferrari
Uppersaddle River, New Jersey
(February 7, 2005)

Keith Martel Russell
Fort Lauderdale, Florida
(February 17, 2005)

NASD Issues Summary Suspension of Brokerage LH Ross

NASD issued a summary suspension of Boca Raton, FL-based brokerage LH Ross & Company, Inc., based on its determination that the firm is in such financial or operational difficulty that it cannot be permitted to continue to do business as a member with safety to investors, creditors, other members or NASD. The suspension prevents LH Ross from doing business and was effective immediately. The firm has requested a hearing to set aside the summary suspension.

NASD Charges California Broker with Fraud in Municipal Securities Transactions

Broker's Superior Fined, Suspended for Failure to Supervise

NASD charged California-based broker Marshall J. Field, formerly of American National Municipal Corp., with fraud in the offering and sale of municipal securities in violation of federal securities laws and Municipal Securities Rulemaking Board (MSRB) rules.

In its complaint, NASD charged Field with making material misrepresentations and omissions in connection with the purchase and sale of municipal securities and executing unauthorized municipal securities transactions in his clients' accounts. NASD also charged Field with violating the prohibition on guaranteeing an investor against a loss.

According to the complaint, Field, the majority owner of now-defunct American National Municipal Corp., recommended and sold municipal securities to seven investors, most of whom were elderly, without disclosing the accompanying risks. Specifically, Field recommended securities that were special, limited obligations and failed to disclose that the securities were not backed by the full faith and credit of the subject municipalities. In fact, the securities were revenue bonds and certificates of participation payable solely from anticipated sources of revenues. The complaint charged that Field did not disclose that the municipal securities involved a high degree of risk and that investors could lose their entire investments. The complaint also alleged that Field misrepresented that investments in these securities were safe and that the investors' initial investments were secure. The municipal securities have all since defaulted and the investors lost significant portions of their initial investments.

In addition to making material misrepresentations and omissions, the Complaint alleged that Field executed a total of 25 unauthorized transactions involving high-risk municipal

securities in multiple investors' accounts. In all, nine investors suffered losses of approximately \$325,000 because of Field's misconduct.

Finally, NASD charged Field with guaranteeing a customer against a loss in connection with her purchases of a municipal security.

Field's firm, American National Municipal Corp. of Woodland Hills, CA, withdrew its registration with NASD in September 2004.

In a related action, John T. Ford, Field's former supervisor, was fined and suspended for one year from working in any supervisory capacity for any NASD-registered firm for failing to supervise Field's municipal securities sales practices. Ford neither admitted nor denied NASD's charges, but consented to the entry of NASD's findings.

NASD Fines Former Jesup & Lamont Research Analyst for Trading Contrary to His Own Recommendations

Gary Davis Suspended from Industry for Six Months, from Research for 18 Months; Jesup & Lamont, Chief Compliance Officer Charged with Supervisory Failures

NASD fined and suspended former Jesup & Lamont Securities Corporation research analyst Gary Davis for trading contrary to the recommendations in his research reports and for other violations relating to his activities as a research analyst. Davis was suspended from the industry for six months, fined \$130,000 and prohibited from acting as a research analyst for 18 months. Nearly \$117,000 of his fine represents profits Davis made through his unlawful trading.

NASD also charged Jesup & Lamont, a New York City broker-dealer, and its chief compliance officer, Robert Strong, with failing to adequately supervise Davis.

NASD found that from January 2002 to September 2003, Davis authored 12 research reports with "buy" or "strong buy" recommendations. On 41 separate occasions after these research reports were published, Davis executed sales of shares of companies he covered that were inconsistent with the "buy" or "strong buy" recommendations in his reports. Davis sold a total of 215,657 shares in seven different securities and netted profits of more than \$116,500. Those trades were executed in his personal investment accounts at Jesup & Lamont.

"The rules are clear. Analysts may not profit from the recommendations in their research reports," said NASD Vice Chairman Mary L. Schapiro. "Analysts must, at all cost, avoid conflicts of interest when they own and trade securities they cover. In this case, the analyst not only traded in violation of NASD rules—his firm and the analyst's supervisor failed to detect and prevent his illegal trading."

Davis also executed four trades in securities he covered during what is known as the "quiet period" surrounding the publication of research reports. NASD rules prohibit research analysts from buying or selling a security that the analyst is covering for a period beginning 30 days before the research report is issued and continuing for five additional days after the report is published. In addition, Davis also failed to include numerous required disclosures in his research reports—including a disclosure that he had a financial interest in securities covered by his reports.

In settling this matter, Davis neither admitted nor denied the charges, but consented to the entry of NASD's findings.

In a related action, NASD has charged Jesup & Lamont and its chief compliance officer, Robert Strong, for failing to detect and prevent the illegal trading activity by Davis and for other violations relating to research reports published by the firm. Strong was responsible for supervising Jesup & Lamont's research analysts, which included reviewing research reports and the trading activity of research analysts. Despite the fact that Davis's illegal trading activity occurred in his personal accounts at Jesup & Lamont, Strong failed to prevent Davis from trading contrary to the recommendations in his research reports, and failed to prevent him from trading during the "quiet period" surrounding the publication of his research reports. Strong also failed to ensure that the research reports published by Jesup & Lamont included all disclosures required by NASD rules.

Jesup & Lamont and Robert Strong have requested a hearing before an NASD disciplinary panel.

NASD Fines Quick & Reilly, Piper Jaffray \$845,000 for Directed Brokerage Violations

NASD fined Quick & Reilly, Inc. (now part of Banc of America Investment Services, Inc.) \$570,000 and Piper Jaffray & Co. \$275,000 for directed brokerage violations. In imposing sanctions against Piper Jaffray, NASD took into account the fact that the firm self-reported its violative conduct after conducting its own internal review. The two cases are the latest enforcement actions in NASD's ongoing effort to crack down on directed brokerage abuses.

NASD found that both firms operated "preferred partner" or "shelf space" programs, giving favorable treatment to funds offered by certain mutual fund companies in return for brokerage commissions and other payments. That special treatment included higher visibility on the firms' internal websites, increased access to the firms' sales forces, participation in "top producer" or training meetings, and promotion of their funds on a broader basis than was available for other funds. That conduct violated NASD's "Anti-Reciprocal Rule" which prohibits firms from favoring the sale of shares of particular mutual funds on the basis of brokerage commissions.

"The purpose of the rule is to help eliminate conflicts of interest in the sale of mutual funds," said Mary L. Schapiro, NASD Vice Chairman. "These sorts of arrangements encourage the inappropriate use of mutual fund commission dollars and have the potential to improperly influence a firm's judgment when making recommendations to their clients."

Both firms offered a preferred partner program to a relatively small number of mutual fund families. Piper Jaffray, which operated its preferred partner program from 1998 to 2003, included only 12 to 15 fund complexes in the program, but sold funds offered by more than 100 fund complexes. Quick & Reilly maintained its program from 2001 to 2003 and included only 16 to 20 fund complexes, while it sold funds offered by about 300 fund complexes.

The participating mutual fund companies paid the firms extra fees in addition to regular sales fees. Piper Jaffray negotiated those extra payments with mutual fund companies each year, asking for minimum payments of \$100,000 to \$125,000. Some fund complexes paid a flat fee; others paid amounts based on a percentage of gross fund sales and the average daily assets under management for the fund complex. Quick & Reilly charged participating fund complexes 10 basis points on the gross amount of sales and five basis points on the average daily assets under management, subject to a minimum annual payment of \$75,000.

Several of the funds participating in the preferred partner programs paid part or all of the extra fees by directing the funds' brokerage business to the firms. The commissions were generated by the funds through portfolio transactions which the funds executed either through the firm, in the case of Piper Jaffray, or through an affiliate or third party, in the case of Quick and Reilly.

Piper Jaffray, on its own initiative, conducted an internal review of the general subject matter involved in the case and self-reported its findings to NASD staff. "This type of self-examination and self-reporting by a registered firm benefits NASD's enforcement program and investors by allowing for cost-effective enforcement and timely remedial action, and

was taken into account in assessing sanctions against Piper Jaffray," Schapiro said.

In settling these matters, the two firms neither admitted nor denied the charges, but consented to the entry of NASD's findings.

NASD has brought three previous actions for similar violations. In February 2005, NASD charged American Funds Distributors with violating NASD's Anti-Reciprocal Rule by directing approximately \$100 million in brokerage commissions over a three-year period to about 50 brokerage firms that were the top sellers of American Funds. In November 2003, NASD sanctioned Morgan Stanley DW Inc. for giving preferential treatment to certain mutual fund companies in return for approximately \$15 million in brokerage commissions. That case was brought in conjunction with an action filed by the Securities and Exchange Commission in which Morgan Stanley agreed to pay \$50 million in civil penalties and surrendered profits. In December 2004, Edward D. Jones & Co., L.P., agreed to pay \$75 million in resolution of charges that it failed to adequately disclose revenue sharing payments that it received from a select group of mutual fund families that it recommended to its customers, that it received directed brokerage payments in violation of the Anti-Reciprocal rule, and for other violations in settlements with NASD, the Securities and Exchange Commission, and the New York Stock Exchange.

NASD Charges American Funds Distributors, Inc. with Arranging \$100 Million in Directed Brokerage Commissions for Top Sellers of American Funds

NASD charged American Funds Distributors, Inc. (AFD) with violating NASD's Anti-Reciprocal Rule by directing approximately \$100 million in brokerage commissions over a three-year period to about 50 brokerage firms that were the top sellers of American Funds. The payments were made to reward the firms for past sales and to encourage future sales of American Funds' 29 mutual funds.

AFD is the principal underwriter and distributor of American Funds, the third largest mutual fund family in the U.S. with more than \$450 billion in assets and approximately 25 million shareholder accounts. The commissions were payments for executing trades for the American Funds' portfolio that were directed to the brokerage firms as additional compensation for past sales of American Funds, and to ensure that American Funds would continue to receive preferential treatment at those firms.

NASD's "Anti-Reciprocal Rule," which first became effective in July 1973, is designed to prevent quid pro quo arrangements in which brokerage commissions, which are assets of the shareholders of the mutual funds, are used to compensate brokerage firms for selling the funds' shares. The rule also is designed to ensure that the execution of portfolio transactions by brokerage firms is guided by the principle of "best execution" and not by other considerations. In addition, the rule is meant to eliminate the danger that a brokerage firm, when recommending mutual funds to customers, will base its recommendations on the additional rewards the firm may receive in portfolio commissions from the funds rather than on the investment needs of the customer.

"Prior cases in this area have focused on retail firms that received directed brokerage payments from mutual fund companies in exchange for giving preferential treatment to their funds," said NASD Vice Chairman Mary L. Schapiro. "Today's action makes clear that it is just as impermissible to offer and make such payments as it is to receive them."

NASD's complaint alleges that, between 2001 and 2003, AFD calculated "target commissions" that it intended to direct to each of the top-selling retailers of American Funds according to a formula that was based upon each of the firms' prior year's sales of American Funds. AFD communicated to each of these retail firms the specific amount of that firm's "target commissions" for the upcoming year and the fact that the amount was a function of the firm's prior year's sales of American Funds, typically 10 or 15 basis points of those sales. At the same time, AFD also discussed with the top-selling retail firms the benefits that AFD expected to receive pursuant to the sponsorship arrangements, such as the inclusion of American Funds on the firms' "preferred fund" or "recommended fund" lists, and enhanced access to the firms' sales forces.

According to NASD's complaint, at the beginning of each year between 2001 and 2003, AFD provided a chart to the trading desk at AFD's parent company, Capital Research and Management Company (CRMC). CRMC is the investment advisor to American Funds. The chart listed each of the top-selling retailers with which AFD had a sponsorship arrangement and the amount of "target commissions" for each firm. The Fund's trading desk directed brokerage commissions on American Funds portfolio transactions to the top-selling retailers on the chart based on the "target commissions" set by AFD for each firm. Throughout the year, the trading desk provided monthly updates to AFD about the amount of brokerage commissions directed to each of the top-selling retail firms. In turn, AFD occasionally provided updates to the top-selling retailers about how much of the target commissions had been directed to them throughout the year.

The trading desk not only directed brokerage commissions to firms that executed American Funds portfolio transactions, but also to retail firms that did not have the capacity to execute securities transactions. Those firms (approximately 30 of the 50 or so) entered into "step out" arrangements with clearing firms in order to receive the directed brokerage commissions.

NASD's investigation found that the clearing firms, which executed the trades, shared the brokerage commission with the retailers even though the retail firms provided no services in connection with the trade. The amount of commission that the retail firms received-typically seventy to ninety percent of the commission-depended upon the agreement between their firm and the clearing firm executing the trades. Twenty-nine million of the \$100 million in directed brokerage was paid in this fashion and ranged from a high of approximately \$5.4 million to one retailer to a low of approximately \$112,855 to another retailer.

AFD has requested a hearing before an NASD disciplinary panel.

NASD wishes to acknowledge the substantial assistance of the Pacific Regional Office of the Securities and Exchange Commission in this matter.

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