

ALERT

NASD Reviews Its Mark-up Policy

The NASD's current policy on markups, which is contained in an Interpretation of the NASD Board of Governors, serves as a guideline to members in determining fair and reasonable charges to customers in principal transactions.

The policy requires that members deal with their customers at prices that are fair and reasonable, taking into consideration all relevant factors.

Because it is a guideline, and not a rule, application of this policy has shown markups that exceed 5 percent are not always considered excessive and those below 5 percent are not always justified, but rather each trade must be evaluated based on all the relevant factors surrounding that particular trade.

In support of this interpretation, the Board of Governors recently upheld a District Business Conduct Committee decision censuring and fining a member for excessive markups when the firm exhibited a pattern of charging markups slightly below the 5 percent level in liquid NASDAQ securities.

The main issue in calculating markups is determining the price to be used as the prevailing market price from which to base the mark-up calculation.

When there is an active competitive market for securities, the prices paid by other dealers to the market maker under review are considered the most accurate reflection of the prevailing market price.

Absent actual interdealer transactions, market makers who also engage in principal retail business are normally entitled to the inside spread, and the best available price (i.e., inside ask) would be used to calculate

the markups. For non-market makers, contemporaneous cost should be used as the primary basis from which to compute a markup.

In those instances where there is no independent market, or where there is a market dominated and controlled by a market maker, the NASD has long held that the contemporaneous prices paid by the market maker are the only reliable evidence of the prevailing market price and, thus, cost must be used as the basis for the markup.

In instances where no independent market exists, the dominant market maker would not be entitled to the spread, as it would be under competitive market conditions.

All members should review their internal mark-up policies to ensure that markups to retail customers are in accordance with the NASD guidelines.

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MSRB Requires Timely Settlement

The NASD recently censured and fined members in New York and Texas for failing to settle municipal syndicate accounts within the time periods prescribed by the Municipal Securities Rulemaking Board's Rule G-12.

The rule requires that final settlement of syndicate accounts be made within 60 days following the date that the securities are delivered by the syndicate manager to the syndicate members. Recent routine examinations of member firms have revealed that the above referenced disciplinary action is not an isolated case of non-compliance with MSRB Rule G-12.

The NASD strongly urges all members managing municipal syndicate accounts to review the requirements of G-12 to ensure future compliance in the settlement of syndicate accounts.

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Proper Supervision of Employees' Securities Transactions Extends to Accounts With Non-NASD Financial Institutions

Article III, Section 28 of the NASD's Rules of Fair Practice is intended to assure that a member is provided with the necessary information to supervise properly the securities transactions of its associated persons.

In this regard, Section 28 requires a member that is executing a transaction or opening an account for a person associated with another member to give written notice to that employer member and provide the employer with duplicate copies of confirmations and statements upon request.

Notification Required

To accomplish its purposes, Section 28 places an affirmation obligation on an associated person to notify the executing member of his or her employment with another NASD member.

However, as banks and other financial institutions have come to offer a broader range of securities-related services, there is a greater likelihood that an associated person would establish a securities account with an institution that is not a member of the NASD and, therefore, not subject to Section 28.

Since a member's ability to en-

force compliance by its associated persons with important NASD rules is significantly hampered unless the member has information concerning their securities accounts, the NASD extended the requirements of Section 28 to accounts with non-NASD institutions.

Section 28 requires an associated person to notify his or her employer in writing before opening any securities account or placing any order to buy or sell securities with a foreign or domestic investment adviser, bank, or other non-NASD financial institution.

The associated person must also arrange for the employer to receive duplicate copies of confirmations and account statements should the employer request it. These notification requirements include transactions and accounts over which an associated person exercises discretion, as well as accounts in which such person has a financial interest.

Relatives' Accounts

For example, an account for a relative of an associated person is subject to these reporting requirements if the associated person places orders for the account. These requirements, however, are not applicable to

transactions in unit investment trusts and variable contracts or redeemable securities registered under the Investment Company Act of 1940, or to accounts limited to transactions in these securities.

Member Obligations

Section 28, however, cannot accomplish its objectives unless members inform their associated persons of these obligations and take affirmative steps to see that their employees understand and comply with the requirements of the rule.

In particular, the potential for significant regulatory problems exists when associated persons conduct securities activities, without advising their employer, at institutions that are not under any obligation to notify the employer of such activities.

All members are urged to review their supervisory procedures and practices with regard to informing associated persons of their responsibilities to provide notice of transactions or accounts with other members or non-NASD financial institutions. It is incumbent on members to ensure that they have adequate ongoing supervision over all the securities transactions of their associated persons.

NASD Disciplines San Francisco Firm and Former Employee

The NASD accepted an Offer of Settlement from a former employee of a member for "marking the close of the market" in certain NASDAQ National Market System (NASDAQ/NMS) securities. In connection with that action, the NASD also accepted an Offer of Settlement from the member itself for violations of the NASD's supervisory requirements.

Douglas H. Levine, a registered representative and former employee of Volpe & Covington in San Francisco, consented to a suspension from association with any NASD member in any capacity for 100 business days

(ending November 23) and to pay a \$15,000 fine. He also was censured.

Without admitting or denying the charges, Levine consented to findings that he violated the NASD's antifraud provisions by entering fictitious trade reports, usually at or near the close of the market, with the intention of affecting the closing price for the securities. Levine's alleged activity included five different securities and involved the entry of 20 fictitious trade reports.

Levine's former employer, Volpe & Covington, submitted an Offer of Settlement in which it agreed to a \$20,000 fine, a censure,

and a suspension from market-making activities in four NASDAQ/NMS securities for periods of time ranging from one to four days.

Without admitting or denying the allegations, the firm consented to the following:

- It failed to establish, maintain, and enforce procedures designed to prevent and detect, insofar as practicable, fictitious trade reporting to the NASDAQ system.
- It failed to require the appropriate level of registration of a principal of the firm, who had substantial supervisory and management responsibility.

NASD Clarifies SOES Rules as to Group or Series of Transactions That Result From Single Investment Decision

Under a Small Order Execution System (SOES) interpretation issued by the NASD, orders that are based on a single investment decision and entered by a SOES order-entry firm for accounts under the control of an associated person or public customer will be deemed to constitute a single order. As such, the orders will be aggregated for determining compliance with the SOES order-size limits.

The NASD presumes trades are based on a single investment decision if entered in SOES within any five-minute period in accounts controlled by an associated person or customer. Control of an account includes discretionary authority, power of attorney to execute transactions in the account, or when it is the associated person's account.

Further, an associated person will be deemed to have control over the accounts of "immediate family" members, as that term is defined in the NASD Free Riding Interpretation, which includes parents, mother-in-law, father-in-law, husband, wife, brother, sister, brother-

in-law, sister-in-law, son-in-law, daughter-in-law, and children.

SOES was created solely for the purpose of entering orders in the NASDAQ System of limited size for public customers for immediate execution at the best available price. Accordingly, since the inception of SOES, any attempts to circumvent the SOES order-size limits by breaking up an order too large for SOES into a series of smaller orders executed through the system, have violated SOES rules, and have resulted in numerous disciplinary actions against firms and individuals for such conduct.

The NASD's interpretation of SOES Rules of Practice and Procedures became necessary in order to clarify the application of SOES rules to certain aggregation practices by associated persons and customers whose control over several accounts led to circumvention of SOES order-size limitations.

These orders were being entered in SOES as a group or series of transactions for these controlled accounts which, taken individually,

appear SOES eligible, but are the result of a single investment decision, and therefore must be aggregated for purposes of determining compliance with SOES order-size limits. These practices violate the intent underlying SOES rules.

Finally, in order to assure that SOES is used only for orders of public customers, the NASD clarified what constitutes an order from a public customer. An order for the account of a person associated with a member firm which has physical access to a terminal capable of entering orders into SOES or if it is for an account of his "immediate family" (as defined in the NASD Free-Riding Interpretation) is **not** considered an order from a public customer. Thus, use of SOES for such orders is prohibited.

Members and individuals that act inconsistently with the provisions of SOES rules as clarified by this interpretation will violate Article III, Section 1 of the NASD Rules of Fair Practice, and will face probable disciplinary action by the NASD's Market Surveillance Committee.

Rule Mandates Non-NASDAQ Price and Volume Reporting

The SEC recently approved new Schedule H to the NASD By-Laws to require the mandatory reporting of price and volume for OTC equity securities that are not part of the NASDAQ System (NNOTC securities). This requirement became effective September 1, 1988. Under Schedule H, members that are NASDAQ subscribers must use their NASDAQ equipment to report price and volume in NNOTC securities.

Members that are not NASDAQ subscribers must report through a dial-up electronic reporting system for NNOTC securities developed by the NASD for this purpose. Schedule H requires that the member report price and volume daily for principal transactions in NNOTC

securities in which the member's aggregate activity for the day equals or exceeds \$10,000 or 50,000 shares on the purchase or sale side of the market.

During Phase I, all members must report price and volume data for all principal transactions in NNOTC securities that are cleared through the National Securities Clearing Corporation (NSCC).

The second phase, anticipated to go into effect early in 1989, will require price and volume reporting for all NNOTC securities regardless of whether the securities are cleared through NSCC.

The Association is collecting this price and volume information to enhance the NASD's ability to regulate the NNOTC securities market.

As such, this price and volume information is being used for regulatory purposes only and will not be publicly disseminated.

The NASD also is continuing to develop the Non-NASDAQ Electronic Bulletin Board Service, which is a completely separate and distinct system from the NNOTC regulatory reporting requirement under Schedule H.

The Bulletin Board will provide market makers with the ability to enter current quotations in NNOTC securities.

This bulletin board display service is not part of the NASDAQ System but rather is a totally independent system that will be available on NASDAQ as a convenience to members.

District Offices Focusing on Member Compliance With MSRB's New Issue Disclosure Rules

The NASD district offices are placing increased emphasis on member compliance with the disclosure requirements of the Municipal Securities Rulemaking Board's (MSRB) Rule G-32.

In addition to covering all aspects of this rule during routine examinations, a number of on-site special investigations are being conducted that specifically address compliance with Rule G-32.

Under this rule, members selling new issue municipal securities are required to provide purchasers with the issuer's final official statement by settlement date.

If the issuer does not prepare a final official statement, members must provide their customers with a

written notification to that effect.

The rule also requires financial advisers and managing underwriters to make the final official statement available in a timely manner and specifies the minimum number of official statements a manager must provide to broker-dealers purchasing new issue securities.

In addition, members have to maintain records under MSRB Rule G-8(a)(xiii) concerning deliveries of the G-32 disclosures.

Examinations have shown that, for the most part, members have in place procedures governing compliance with the rule.

However, in some instances, they do not appear to be enforcing these procedures. With many issues

of municipal securities having complex put, call, and other unique features, investors need all the disclosure documents authorized by an issuer, and broker-dealers have a significant responsibility to ensure that full disclosure is made to the customers purchasing new issues. Failure to do so violates MSRB rules.

NASD urges all members to review and enforce their written supervisory procedures covering this rule and to ensure that the appropriate persons understand and comply with the rule.

In line with standard policy, District Business Conduct Committee will review occurrences of non-compliance with the rule for possible disciplinary action.

Members Asked to Help Improve Institutional Customer Response to DTC Confirmations for Municipal Transactions

The Depository Trust Company (DTC) reports institutional customer response to its confirmations (i.e., affirmation rate) for municipal securities transactions is a disappointing 64 percent. These confirmations are for transactions cleared through the DTC's Institutional Delivery System. In comparison, for transactions in corporate securities the affirmation rate exceeds 90 percent.

Despite obvious differences between corporate and municipal bond markets, an affirmation rate of 64 percent is unacceptable to the NASD. A low affirmation or response rate not only disrupts settlement of municipal transactions but also indicates that members are not complying with the Municipal Securities Rulemaking Board's (MSRB) Rule G-15(d).

Specifically, the MSRB's Rule G-15(d) requires a municipal broker-dealer that is a member, or whose agent is a member of a registered securities depository, to use the facilities of the depository when effecting eligible municipal securities transac-

tions on a delivery versus payment or receipt versus payment (DVP/RVP) basis for confirmation, affirmation, and book-entry settlement.

Members who continue to effect transactions on a DVP/RVP basis with institutional customers that do not affirm transactions on a timely basis are not complying with the rule and thus may face potential disciplinary action. Therefore, members must inform these institutional customers of the requirements of MSRB Rule G-15(d), and insist on compliance.

Members who do not terminate business with institutional clients that, despite repeated advice and warnings regarding MSRB rule requirements, continue to fail to affirm through DTC or other depositories are clearly violating the rule. The NASD will present repeated instances of apparent non-compliance by members to the District Business Conduct Committees for possible disciplinary action.

To help monitor institutional customer activities, DTC has

developed a monthly Quality Control Report listing institutions that are delinquent in affirming transactions. DTC sends these reports to member firms so they can contact their customers and advise them of the need to affirm transactions by the third business day following trade date.

The NASD is taking aggressive action to ensure members' compliance with MSRB Rule G-15. Those firms whose monthly quality reports indicate low affirmation rates on the part of their customers are being contacted on an individual basis. The NASD is requesting that each firm review its policies regarding delinquent institutional customers and then respond in writing regarding what affirmative steps it has taken to assure compliance with the rule.

To reiterate, firms that continue to effect a DVP/RVP business with institutional customers that do not affirm transactions on a timely basis will be in violation of MSRB Rule G-15(d). Members should bring this fact to the attention of all their institutional customers.

NASD Agrees to Halt Domestic Trading on SEC Request, Restates Its Opposition to "Circuit Breaker" Principle

The NASD recently announced that, on request from the Securities and Exchange Commission (SEC), it will halt domestic trading in the markets that are subject to its supervision. However, the NASD continues to oppose, in principle, the proposed practice of instituting market-wide trading halts in response to extraordinary conditions based on predetermined, arbitrary formulas, referred to as "circuit breakers."

This policy has been filed with the SEC and, if approved, will be effective through December 31, 1989, unless modified or extended by the NASD Board of Governors. It applies to domestic trading in all securities quoted in the NASDAQ System and to domestic trading in equity or equity-related securities in the U.S. over-the-counter market.

"Circuit breakers are likely to increase market volatility rather than curb it," said NASD President Joseph R. Hardiman. "The closer a market

gets to a circuit-breaker level, the more likely it is of reaching it as sellers rush to execute orders under the wire. Academic studies also indicate that markets are the most volatile at the opening or reopening of a security following a trading halt."

In formulating its position, the NASD Board acknowledged that any market that remains open when its counterparts have closed may incur unacceptable risks. As a more permanent solution to any future market breaks, the NASD Board would prefer to see action taken on a series of other initiatives. They include:

- Congress should vest regulatory authority for all equity derivative instruments with the SEC.
- Congress should give the SEC authority to oversee the establishment of prudential or maintenance margin requirements by self-regulatory organizations for all equity instruments. Relative margin levels for all equities and equity derivative instruments should be con-

sistent across all marketplaces.

- The activities of clearing and settlement systems should be coordinated across marketplaces to reduce financial risk for all participants. Clearing and settlement facilities for all equity derivative instruments should be unified or linked as in the options and securities markets.

- An intermarket self-regulatory policy group (with sub-groups) composed of persons at the senior management level of all regulatory organizations should be established to plan, communicate, and coordinate with each other in the surveillance, financial, operations, and technology areas and, acting with federal regulators, to formulate contingency plans for market emergencies.

- To the extent that legislation is needed to accomplish any of these objectives, Congress should be urged by all securities industry organizations to act promptly.

SEC Ruling Clarifies Fiduciary Obligations of NASD Members When Handling Limit Orders for Public Customers

A recent SEC decision affirming an earlier NASD finding has clarified the fiduciary obligations of members when they handle limit orders for customers. Unless a previous, clearly understood arrangement exists with the customer, a member, including a market maker, that accepts a customer's limit order for a NASDAQ stock has a fiduciary obligation to give that order priority over its own proprietary trading activities.

The case involved E. F. Hutton & Company, Inc.'s, handling of an open limit order from a public customer to sell 5,000 shares of Genex Corporation in the customer's account at 17 1/8. Recently acquired by Shearson Lehman and now doing business as Shearson Lehman Hutton, Inc., Hutton was a registered

market maker in the security and accepted the order when the inside quotation was 17 - 17 1/8 and Hutton's quote was 17 - 17 1/2.

While Hutton was holding the order, it sold 4,755 shares of Genex from its own inventory at prices of 17 1/4 and 17 1/2, both higher than the 17 1/8 limit order price sought by the customer. Subsequently, the price of Genex declined substantially. Although the customer's order did not call for "all-or-none" execution, Hutton did not execute any part of the order.

Hutton argued that it was not obligated to execute the customer's limit order because the inside bid never reached the customer's limit price. The firm also argued that it was not obligated to give preference to the customer's order over its own

proprietary position in filling incoming buy orders that it received as a market maker. In rejecting Hutton's arguments and affirming the NASD decision in this case, the SEC said Hutton assumed certain fiduciary obligations when it agreed to accept the customer's limit order and to act on the customer's behalf in obtaining execution.

Although Hutton sold Genex stock for its own account at prices above the customer's limit price, it never executed the customer's order and did not tell the customer when accepting the order that it would give priority to its proprietary position, the agency said. For these reasons, the SEC determined that Hutton's actions violated "high standards of commercial honor and just and equitable principles of trade."

NASD Sanctions New York Firm and Registered Person

In a case brought by its Market Surveillance Committee, the NASD has censured and fined North Country Securities, Ltd., of New York, \$20,000. The NASD also censured and fined William Carey, a registered representative with the firm, \$10,000 and suspended him from association with any NASD member in any capacity for five business days.

The Market Surveillance Committee found that Carey had entered 11 trade reports in NASDAQ that did not represent actual transactions. He also failed to report 14 transactions and inaccurately reported four others.

The Committee also found that North Country failed to establish, maintain, and enforce supervisory procedures designed to assure that associated persons complied with applicable securities laws and NASD trade-reporting rules. In its decision, the committee said it "takes a serious view of NASDAQ/NMS trade-

reporting obligations as the trade-reporting rules are critical to the continual flow of current information to the NASDAQ marketplace."

SEC Reduces Prospectus Delivery Time

The SEC has reduced the maximum allowable aftermarket delivery period for prospectuses from 90 days for initial public offerings (40 days for secondary offerings) to 25 days for NASDAQ and listed securities.

This reduced delivery period, in the form of an amendment to Rule 174 of the Securities Act of 1933, does not apply to offerings of non-NASDAQ over-the-counter securities.

The aftermarket delivery requirement applies to all members effecting transactions in the security.

However, members of the underwriting syndicate must continue to respond promptly to written requests for prospectuses received during the period between the effec-

tive date of the registration statement and the later of either the end of the distribution or the expiration of the applicable 40- or 90-day aftermarket delivery period.

The offering date, which triggers the prospectus delivery requirement, is either the effective date of the registration statement or the first date on which the securities are offered to the public on a bona fide basis, whichever date is later.

Markup

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Market makers should also review their spreads, particularly in non-NASDAQ over-the-counter securities, since the NASD has a number of pending cases in which excessive member spreads in certain types of securities and market conditions have resulted in formal disciplinary actions for fraudulent markups charged to customers.