NASD

# Notice To Members

SPECIAL

National Association of Securities Dealers, Inc. April 1, 1992

## Number 92-16

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**Subject: NASD Policies and Procedures for Markups/Markdowns in Equity Securities**

## EXECUTIVE SUMMARY

Fairness of markups and markdowns charged by members in principal equity transactions with customers has become an increasingly important issue to members as the NASD, Securities and Exchange Commission (SEC), state, and other federal regulatory and criminal agencies place greater emphasis on these practices in examination and enforcement programs. The NASD and other regulators have initiated a substantial number of disciplinary proceedings during the recent past alleging excessive markups. The Association has also placed great emphasis on member education in the area as well as a variety of other sales- and trading-practice abuses at NASD educational seminars and in *Notices to Members*.

In order to provide more guidance and assistance to our members, and in response to interest expressed by a significant segment of the membership for a comprehensive NASD release concerning markups and markdowns, the NASD is issuing this detailed Notice, which addresses the significant considerations in determining appropriate markups and markdowns in connection with retail transactions in equity securities.

Members must take steps to develop compliance procedures designed to guard against abusive markup/markdown practices, and to ensure that critical issues such as prevailing market price, market-maker status, market environment for a security, and validation of quotations, among others, are routinely and consistently considered.

The NASD is committed to ensuring fair pricing with customers and requires strict adherence to all rules and regulations to accomplish this goal. We will continue to carefully review markup and markdown practices in examinations and investigations, and violations will be vigorously pursued. We are hopeful that this Notice, which embodies existing principles governing markups and markdowns, will aid members in their compliance efforts so customer protection is enhanced and fewer disciplinary actions required.

## I. Introduction

NASD policies and procedures concerning markups and markdowns have been the subject of extensive interest by the membership. This remains a very significant subject, especially as the NASD as well as other securities regulators continue to review for and investigate potential fraud and other abusive sales and trading practices, which often involve excessive and unfair pricing to customers.

In response to numerous requests from the membership, the NASD is publishing this *Notice to Members* (Notice) to assist firms in resolving markup and markdown issues associated with principal transactions in equity securities executed with retail customers.[1] Specifically, this Notice will address how to determine the prevailing market price of an equity security and the appropriate methodology for calculating a markup or markdown under differing market conditions.[2] The discussion will focus on the process to determine the prevailing market price at the time a member executes a transaction with its customer. This process is articulated in the leading markup case of *Alstead Dempsey & Co., Inc.*, 47 S.E.C. 1034 (1984)[3] and reiterated in subsequent SEC and NASD cases, and requires the member to determine: (1) whether it is a market maker or a retail broker/dealer; (2) whether the market for the stock is competitive or instead dominated and controlled; and (3) whether actual transactions or validated quotations may be used as the best evidence of the prevailing market price.

In preparing this Notice, the NASD has not established new rules, interpretations, or policies with respect to markup and markdown issues. Rather, this Notice embodies longstanding policies and principles developed by the NASD, SEC, and the courts. Recognizing that excessive and unfair pricing to customers and other sales-practice abuses continue to be a prime regulatory concern, members are encouraged to consult the full text of decisions, as well as existing interpretations and rules and regulations, which form the basis for these important policies and principles.

## II. NASD Regulatory Concerns

For many years, the NASD and other regulatory authorities have been aggressively fighting against excessive markups and markdowns, especially in the "penny stock" market, which is primarily composed of non-Nasdaq over-the-counter (NNOTC) securities. In recent years, the NASD has also placed a great deal more emphasis and focus on sales practices and fair dealing with customers in general, as well as markups and markdowns, during NASD examinations and investigations. Furthermore, there has been an increase in NASD disciplinary actions, as well as administrative, civil, and criminal proceedings by other regulatory and prosecutorial authorities against securities laws violators for abusive practices in these areas.

For the NASD's part, it is actively enforcing its markup/markdown policy, as well as the case law established in this area through SEC and NASD Board decisions and interpretations. Additionally, the NASD will continue to initiate disciplinary proceedings against firms and associated persons for other types of sales- or trading-practice violations, such as market manipulation, fraud in the offer and sale of securities, and unauthorized trading.

## III. General Markup/Markdown Considerations

For more than 50 years, a broker/dealer's obligation to deal fairly with its customers in pricing securities has rested on the important principle that a broker/dealer holds itself out as a securities professional with special knowledge and ability, implicitly representing that it will deal fairly, honestly, and in accordance with industry standards with its public customers. In this regard, a securities dealer may not take advantage of its customer to extract unreasonable profits resulting from a price that bears no reasonable relation to the prevailing price. Article III, Section 4 of the NASD Rules of Fair Practice requires a NASD member, when trading for its own account, to purchase from or sell to a customer at a "fair" price, taking into consideration all relevant factors. Although the

[1] See, *Notice to Members 91-69*, issued in November 1991, which addresses, among other things, the application of the NASD's Mark-Up Policy to the secondary market in direct participation program securities.

[2] Although the narrative portion of this memorandum tends to focus on markups, the same principles are to be applied when considering markdowns in purchases from customers by a member.

[3] In its House Report on the Penny Stock Reform Act of 1990, Congress cited *Alstead* as the leading case articulating the principles for calculating markups in equity securities.

percentage of markup or markdown from the prevailing market price is a significant factor in determining the fairness of the dealer's pricing, that percentage must be viewed in light of: (1) the type of security involved; (2) the availability of the security in the market; (3) the price of the security; (4) the amount of money involved in a transaction; (5) disclosure; (6) the pattern of markups or markdowns; and (7) the nature of the member's business.

In an effort to ensure fair pricing, the NASD has, since 1943, deemed it inconsistent with just and equitable principles of trade under its Rules of Fair Practice for a member to enter into any securities transaction with a customer at a price not reasonably related to the current price of the security.[4] To provide direction in this area, the Board of Governors adopted its "5% Policy." This policy serves as a guideline, not a rule, and states that markups or markdowns should generally not exceed 5 percent of the prevailing market price for equity securities. Thus, markups or markdowns exceeding 5 percent of the prevailing market price are generally viewed as excessive and a violation of Article III, Sections 1 and 4 of the Rules of Fair Practice unless the member can show the markup/markdown charged to be fair under the unique circumstances of the trade. In this regard, if a member seeks to charge its customers more than a 5 percent markup or markdown, it must be fully prepared to justify its reasons for the higher markup or markdown with adequate documentation.

The 5% Policy also points out that a markup/markdown pattern of 5 percent or even less may be considered unfair or unreasonable and that a determination of the fairness of markups or markdowns must be based on a consideration of the above factors.[5] For example, where a broker/dealer is involved, selling to or purchasing from its customers on a principal basis a very liquid and readily available Nasdaq National Market System (Nasdaq/NMS) issue in riskless transactions, a 5 percent markup/markdown may indeed be excessive and unfair. Furthermore, the SEC and the courts have consistently held that undisclosed markups or markdowns in equity securities in excess of 10 percent of the prevailing market price are considered fraudulent under the federal securities laws.[6] As a result, markups or markdowns exceeding 10 percent could also violate Article III, Section 18 of the Rules of Fair Practice, the NASD's anti-fraud provision.[7]

## IV. Determination of Prevailing Market Price

This section focuses primarily on the manner in which a market maker determines prevailing market price for markup/markdown purposes. The SEC and NASD recognize that an integrated market maker simultaneously makes a wholesale market in a Nasdaq, or non-Nasdaq security while selling the same security to customers. In this regard, depending on the marketplace in which a security trades (i.e., Nasdaq/NMS, regular Nasdaq, or non-Nasdaq), an integrated market maker that risks its capital by continuously buying and selling a security in an active, competitive market may look to prices it charges other dealers in actual sale transactions, or validated quotations, as the best evidence of prevailing market price from which to calculate markups and markdowns, as opposed to its contemporaneous cost.

On the other hand, given the general illiquid nature of an inactive competitive market, integrated market makers may or may not be able to identify actual interdealer transactions or be able to validate quotations to arrive at prevailing market prices. These circumstances may require the use of cost with respect to markup/markdown computations. Moreover, market makers that dominate and control the market for a particular security must look to cost as the best evidence of prevailing market price. A full discussion follows regarding the proper methodology for determining prevailing market price for a market maker depending on the type of security and trading environment involved.

### A. Prevailing Market Price in Active, Competitive Markets

An active, competitive market for a security generally exists where more than one market

[4] *NASD Manual* (CCH) ¶2154.

[5] *See, Gerald M. Greenberg*, 40 S.E.C. 133 (1960); *Thill Securities Corp.*, 42 S.E.C. 89 (1964).

[6] *See, Peter J. Kisch*, 47 S.E.C. 802 (1982); *Staten Securities Corp.*, 47 S.E.C. 766 (1982); *Powell & Associates, Inc.*, 47 S.E.C. 746 (1982).

[7] Article III, Section 18 of the Rules of Fair Practice states:

> No member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance. *NASD Manual* (CCH) ¶2168.

maker has daily or frequent interdealer trades at competitive prices and no market maker dominates and controls that trading activity by accounting for a large portion of the wholesale/retail volume.[8] Nasdaq/NMS and some regular Nasdaq securities being sold by a market maker to retail customers trade in an active competitive market such that, as discussed further below, inside quotations (high bid, low ask) are usually sufficiently valid and reliable as evidence of the prevailing market price for markup and markdown purposes.

The integrity of Nasdaq/NMS quotations is a function of the real-time trade reporting system for these securities. Specifically, Nasdaq tests the validity of Nasdaq/NMS securities' quotations against actual transactions reported on a real-time basis throughout the trading day. Similarly, an active, competitive market in a regular Nasdaq security allows market makers executing frequent interdealer trades to use actual trades to validate the inside quotation displayed on Nasdaq.

The ability to use quotations from which to calculate markups and markdowns in Nasdaq/NMS and regular Nasdaq securities is founded on the ability to validate the quotations in an active, competitive market. Members should always be cognizant, therefore, that any quotations used to arrive at a prevailing market price must be validated and that SEC case law favors executed interdealer trades between market professionals as the best evidence of the prevailing market price at the time of contemporaneous retail transactions. Focusing on prices of executed transactions, rather than quotations, for determining prevailing market price should be particularly emphasized where the security is an NNOTC issue.

Members must also be aware that there is no "bright line" test for domination and control and that the facts and circumstances of each case must be carefully weighed. In this regard, a member should carefully consider its potential for domination and control of a market where it accounts for a sizeable portion of the wholesale/retail volume in a particular security.[9] Importantly, the Commission in *Alstead* determined that the market for a security may be dominated by an integrated dealer "to such a degree that it control[s] wholesale prices" for the security. Factors such as the volume of interdealer activity, whether other dealers are purchasing stock, and whether the "demand" is essentially in-house are readily identifiable and should be critically considered in light of potential domination and control.

1. Nasdaq/NMS Securities

The Nasdaq/NMS market consists of active, liquid securities trading in a highly competitive market with real-time transaction reporting where actual interdealer trades are consistently executed at the inside quotations.[10] Computerized surveillance systems at the NASD continuously monitor the validity of each quote by comparing these real-time trade reports to the inside quotations that existed in Nasdaq at the time of the transaction. As a result, members may use as the prevailing market price the lowest (inside) ask quotation for Nasdaq/NMS securities at the time of the sale to the customer unless they are aware of facts and circumstances that suggest otherwise. For example, in the event sales to customers (exclusive of markups) occur at prices that differ from the inside ask, a member should inquire into the basis for the execution price. Similarly, if the market maker executes trades immediately surrounding its retail sales, such as comparable sales to a non-market maker at a price lower than the inside ask, the use of these actual sale prices may be required to arrive at the prevailing market price.

2. Regular Nasdaq Securities

When regular Nasdaq securities trade in an active, competitive market, market makers would be frequently executing transactions in these securities with other dealers at or around the inside market displayed on Nasdaq. Recognizing that actual transactions are the best evidence of prevailing

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[8] In *Hampton Securities, Inc.*, NASD, ATL-992 (June 1, 1989), the NASD Board said that a competitive market is characterized by three features: (i) the regular publication of quotations with relatively narrow spreads, (ii) frequent interdealer transactions consistently effected at or near the quoted prices so as to validate the reliability of quotations, and (iii) the absence of domination by a single firm.

[9] Members should be aware that factors other than volume may indicate domination and control. For example, in the SEC case of *Universal Heritage Investment Corp.*, SEC Exchange Act Release No. 19308 (Dec. 8, 1982), a market maker was the only firm to submit quotations on 109 of 189 days under review, and on 52 of those days it was the exclusive or shared high bid for the security, leading the Commission to conclude that the firm controlled the market for the security to such a degree that it could not use quotes for computing its markups.

[10] Considerations for determining the best evidence of the prevailing market price in various situations are summarized in a matrix attached as Appendix A, which contains a separate matrix for arriving at the prevailing market price in both markup and markdown situations.

market price, routine monitoring by a market maker of its interdealer trades and comparison of those trades to the inside quotations would provide a mechanism for the market maker to validate regular Nasdaq quotations. This validation process, in turn, may permit the use of inside bid or ask quotations as accurate indicators of a security's prevailing market price for markup and markdown purposes.

As with Nasdaq/NMS securities, where the market maker has sales to other broker/dealers that are in immediate proximity to retail sales, the actual sale prices should be used as the prevailing market price for markup purposes unless there are unusual circumstances supported by documentary evidence that establishes a better measure of prevailing market price. In addition, if a member engages in sales to other market makers at prices that are consistently lower than the inside ask, the quotation may not be indicative of market price, and an internal inquiry into the circumstances of the trades would be warranted.

3. NNOTC Securities

The market maker's interdealer sales of NNOTC securities that occur contemporaneously with its retail sales are the best indication of the prevailing market price for an NNOTC security in an active, competitive market. In the absence of contemporaneous sales to other broker/dealers by a market maker, the lowest ask quotation may be used in limited circumstances as evidence of the prevailing market price if the quotations have been validated by comparing them with the member's actual interdealer transactions. Nevertheless, the Commission has required strong evidence that quotations accurately reflect prevailing market price for markup purposes before permitting such quotes to be used as a basis from which markups or markdowns are computed.[11]

In the absence of executed interdealer sales or validated quotes, the market maker's contemporaneous cost is the next best indicator of the prevailing market price. Should any other measure be used under these circumstances, the broker/dealer has the burden of demonstrating that the use of contemporaneous cost is not appropriate for computing markups or markdowns. For example, the NASD Board and the SEC have said that the burden is on broker/dealers, if they wish to base markups on another dealer's ask quotation, to demonstrate "the competitiveness of the market and the reliability of the quotations."[12]

Importantly, members should not confuse the requirement of validating quotes through a review of actual trades with the so-called "three call rule" under Article III, Sections 1[13] and 21(b) of the NASD's Rules of Fair Practice. These sections require members to make a notation on the order ticket, before executing a transaction in a NNOTC security, which identifies the names of three dealers (or all dealers if less than three) contacted and the quotations received from each. *Notice to Members 88-83* announcing the amendments to Article III, Section 21 states that the amendments do not change the NASD's markup policy and that "compliance with the new amendments will not necessarily assure compliance with the NASD Markup Policy." Thus, members may not automatically mark up or mark down an NNOTC security from quotations received from other dealers either over the telephone, electronically, or by other means, as those quotes are not validated and may be substantially different than the prevailing market price. So, for example, the mere fact that an inside bid/ask calculation appears with respect to a security quoted in the NASD's OTC Bulletin Board® does not serve to validate the quotes or permit automatic execution at these prices. The validation process remains necessary, and the use of quotations is still secondary to reliance on actual interdealer transactions.

### B. Prevailing Market Price in Dominated and Controlled Markets

Domination and control occurs when real competition is not present in the marketplace, and the wholesale and retail trading by a single market maker, or by two or more market makers willfully acting together, accounts for a substantial percentage of the volume and transactions during the particular period. In these circumstances, the result is that the market price for the security is arbitrarily established by the market maker(s). It is clearly in-

[11] *See, Alstead; Gateway Stock and Bond, Inc.*, 43 S.E.C. 191 (1966); *Naftalin & Co., Inc.*, 41 S.E.C. 823 (1964).

[12] *Hampton*; *See also, James E. Ryan*, SEC Exchange Act Release No. 18617 (April 5, 1982); *Powell & Associates, Inc.*, 47 S.E.C. 746 (1982); *First Pittsburgh Securities Corp.*, 47 S.E.C. 299 (1980); *Charles Michael West*, 47 S.E.C. 39 (1979).

[13] *See, NASD Manual* (CCH) ¶2151.03.

appropriate for a market maker to use quotations rather than its cost in actual interdealer transactions as the prevailing market price where that market maker dominates and controls the market for the security. As already discussed, case law has not developed a "bright line" test for domination and control. A member should, therefore, monitor the nature and volume of its activity in a particular security to determine whether it is in a dominant and controlling position that would require the use of cost to arrive at prevailing market price.

A dominant and controlling market maker generally has the ability to set arbitrary and noncompetitive price quotations and spreads, and control trading, since other market professionals have no real competitive interest or influence in the security. In the absence of a competitive interdealer market for the security, the dominant and controlling market maker is usually the only market "player" for the security. Therefore, a bona fide best bid and offer quotation among market makers does not usually exist, and the dominant and controlling market maker can quote an artificial price without any practical fear that competitive forces will establish the market price or limit the spread.

Moreover, as the Commission in *Alstead* said:

> By their very nature, quotations only propose a transaction; they do not reflect the actual result of a completed arms-length sale. Thus, as we have frequently pointed out, quotations for obscure securities with limited interdealer trading activity may have little value as evidence of the current market. They often show wide spreads between the bid and ask prices and are likely to be subject to negotiation.

Given the character of a dominated and controlled market and the principles of *Alstead*, neither quotations nor sales to other dealers would be deemed the best indicators of the prevailing interdealer market. Rather, the actual cost to the dominant and controlling market maker based on prices it paid to other broker/dealers, not quotations or its interdealer sales, is the best indicator of the prevailing market price. However, where a member has only a few contemporaneous purchases from other dealers but many contemporaneous purchases from customers in a dominated and controlled market, it may be far more appropriate to use the retail purchase prices as the prevailing market price in lieu of its wholesale cost. This is especially relevant where the isolated wholesale transactions could be called into question due to size, frequency, price, or other features that suggest that these are not bona fide trades but rather are designed to artificially establish a particular prevailing market price.

Therefore, in the absence of bona fide, ongoing, contemporaneous purchases by a market maker from other broker/dealers, the next best indicator of the prevailing market price in such noncompetitive market situations would be the price paid contemporaneously by the firm to customers (as adjusted for an appropriately imputed markdown based on the 5% Policy.) This latter procedure was affirmed by the SEC in *LSCO Securities, Inc.*, SEC Exchange Act Release No. 28994 (March 21, 1991) and in *Manthos, Moss & Co., Inc.*, 40 S.E.C. 542 (1961).[14]

**For the reasons discussed above, a dominant and controlling market maker is not entitled to any "dealer spread" between the bid and ask quotations.** The NASD expressly addressed this issue in a notice distributed to the membership in 1988, stating that: "[i]n 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."[15] That spread is designed to compensate the market maker in an active, independent market for its risk in maintaining markets and the capital commitment required to do so. A dominating and controlling market maker is entitled only to an appropriate markup above the prevailing market price, which in a dominated and controlled market is the member's cost because there is no independent market for the security.

A dominating and controlling market maker may attempt to present countervailing evidence showing that its cost in transactions with other broker/dealers or customers is not the best indication of the prevailing market. However, in dominated and controlled market situations, the NASD staff

[14] *See also*, SEC Exchange Act Release No. 29093 (April 17, 1991 at 1189) in which the Commission explicitly accepted the use of contemporaneous purchases from retail customers as indicative of prevailing market price in a dominated and controlled environment that lacks interdealer purchases by the subject firm.

[15] *NASD Regulatory & Compliance Alert*, Volume 2, No. 3 (October 1988).

will closely review claims of countervailing evidence. As a result, the validity and reliability of such evidence must be demonstrated by the member. Importantly, countervailing evidence of the prevailing market price is not to be confused with the "Relevant Factors" outlined in the Board of Governors' Interpretation on markups that concern the permissible markup/markdown percentage under the circumstances of a particular trade.

### C. Prevailing Market Price in Competitive, Inactive Markets

Market makers may be involved in an inactive yet competitive market for a particular security. The facts giving rise to this market condition vary widely. An example would be where there are two or three market makers, none of which dominates and controls trading in the security. There may also be very little activity in the security, with transactions occurring infrequently, sometimes weeks or more apart, and the inside bid and ask quotations remaining constant or nearly constant.

A market maker operating in a competitive, inactive market for a security should look to its contemporaneous sales prices to other broker/dealers as the best evidence of prevailing market price. In the absence of any contemporaneous interdealer sales, the low ask quotation for the security may be used if properly validated. Where quotations cannot be properly validated with actual transactions, the market maker must use its contemporaneous cost (preferably wholesale cost) as the best evidence of the prevailing market price, absent countervailing evidence.

Where the market maker in a competitive, inactive market seeks to purchase that security from its retail customers, the best evidence of the prevailing market price for markdown purposes would be the market maker's actual contemporaneous purchases from other broker/dealers, then the validated high bid quotation, and finally its contemporaneous sales. During any examination or investigation of the market maker's retail pricing practices, the NASD would consider the market maker's documentation of any countervailing evidence.

## V. Markups/Markdowns by a Non-Market Maker

Where the subject member is not a market maker in the security (whether Nasdaq/NMS, regular Nasdaq, or NNOTC), the price that the firm pays other broker/dealers (i.e., its cost) contemporaneously with retail sales is the best indicator of the prevailing market price.[16] If there are contemporaneous purchases from customers but no or very few wholesale purchases during the period, firms should consider using the prices contemporaneously paid to retail, after adjusting for an appropriate markdown.

Moreover, just because a dealer lists itself in a quotations medium does not necessarily mean that it has achieved market-maker status for purposes of the markup/markdown analysis and 10b-10 confirmation disclosure purposes. In *LSCO Securities Inc.*, SEC Exchange Act Release No. 26779 (May 3, 1989), the SEC found that although LSCO held itself out as a market maker, the firm was not acting as a market maker in the subject security. The factors that the SEC found relevant to the *LSCO* case in concluding that the firm was not a market maker were that the firm: (1) did not enter quotes in the "Pink Sheets" (the interdealer quotation medium relevant to the case); (2) did not sell the security to other dealers; (3) did not provide quotations on the security to other dealers; and (4) simply acquired the stock for resale to retail customers. Thus, LSCO was not a market maker and thereby could not base its markups on its sales to other dealers.

## VI. Validation of Quotes

As noted, the Commission has required strong evidence that quotations accurately reflect prevailing market price.[17] In this regard, the circumstances required for the validation of inside ask quotes are as follows:

(1) a competitive market for the security exists;

(2) interdealer sales occur with some frequency, although not necessarily contemporaneously; and

(3) on the days when interdealer sales occur, they are consistently effected at prices at or around

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[16]Rule 10b-10 requires broker/dealers, other than market makers, that execute riskless principal trades in equity securities to disclose on the confirmation the amount of any markup, markdown, or similar remuneration received in the transaction. This confirmation disclosure does not alter the broker/dealer's responsibilities under the markup policy or the anti-fraud provision of Article III, Section 18 of the Rules of Fair Practice and the federal securities laws.

[17]*See Alstead; Gateway Stock and Bond, Inc.; Naftalin & Co.*

the quoted offers.

Addressing the procedure for validation of quotations, the SEC in *Alstead* stated that:

> Where there is an active, independent market for a security, and the reliability of quoted offers can be tested by comparing them with actual inter-dealer transactions during the period in question, such quotations may provide a proper basis for computing markups. Thus, if inter-dealer sales occur with some frequency, and on the days when they occur they are consistently effected at prices at or around the quoted offers, it may properly be inferred that on other days such offers provide an accurate indication of the prevailing market.

Thus, in order to use a quotation in the absence of actual interdealer trades, the reliability of the bid and offer prices generally must be validated over time by comparing them with executed interdealer transactions. **Retail transactions may not be used to validate quotations.**

## VII. Contemporaneous Dealer Transactions

"Contemporaneous transactions" in determining the prevailing market price are defined in SEC cases as transactions being "closely related in time." Thus, "same day" transactions are most preferable, although less contemporaneous wholesale trades occurring up to five business days prior to or subsequent to the retail sales have been considered contemporaneous.[18] Clearly, during the "five day window," wholesale trades on the same day as or closest in time prior to the retail transactions are better indicators of prevailing market price than are trades occurring further away in time to the subject retail trades.

In the absence of wholesale purchases (or to the extent wholesale transactions are so *de minimis*, they may not be indicative of the prevailing market price), purchases by a market maker from customers are looked to as indicative of prevailing market price in dominated and controlled markets. In these instances, competitive forces are not at work with respect to the market maker's activity with its retail client base and, absent convincing countervailing evidence, cost is the best indicator of market price. Similarly, a market maker operating in what appears to be an inactive competitive market may have to look to its purchases from customers as the prevailing market price from which to calculate markups where it has no contemporaneous interdealer activity and quotations cannot be validated.

## VIII. Additional Compliance Considerations

The focus of the Board of Governors' Mark-Up Policy is on fair and reasonable prices charged to customers and to prohibit markups and markdowns that are excessive. In this regard, members must be mindful of unusual situations, in any market environment, involving, for example, the lack of any markup at all, negative markups, or the averaging of various transactions as a means of determining whether markup or markdown percentages are fair.[19] The absence of quotations also should cause a member to question the method by which its traders, registered representatives, and others are arriving at execution prices for specified securities.

Furthermore, the facts and circumstances of a particular case may show that traders, registered representatives, or other associated persons share in a member's liability for excessive markups or markdowns or unfair pricing to customers. This liability could result even though the individual is not involved in establishing or setting the pricing and markup policies for the member, or may not possess the same degree of knowledge as the member firm about facts surrounding the retail trades. For example, part of the responsibility of being a trader is to determine the prevailing market price. A

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[18] *See, LSCO Securities, Inc.*, ("absent some showing of a change in the prevailing market, a dealer's inter-dealer cost may be used to establish market price for a period up to five business days from the date of the dealer's purchase."); *Alstead*, (same day or day before sales); *First Pittsburgh Securities Corp.* (Sales within one business day of the firm's purchases are closely related in time); *Linder Bilotti & Co., Inc.*, 42 S.E.C. 807 (1965) (If no same-day purchase occurred, the price at which registrant made the most nearly contemporaneous purchase within three days before or after the sale.) *Compare, Nicholas A. Codispoti*, SEC Exchange Act Release No. 24946 (Sept. 29, 1987) (Firm purchases of municipal securities within five days of its sales to customers.); *Naftalin & Co., Inc.*, at 829 n. 16 (no purchase on the day of sales but purchases made on the preceding day as well as the succeeding day.)

[19] For example: "Transactions occurring over a period of time cannot be lumped together for the purpose of determining whether markdowns or markups are fair." Markups and markdowns must be reasonably related to the prevailing market price at the time each transaction is executed. *Hamilton Bohner, Inc.*, SEC Exchange Act Release No. 27232 (September 8, 1989).

trader cannot simply delegate this function.[20]

Thus, traders may be positioned to recognize that they are engaging in little, or no, interdealer activity in a security, putting them on notice of the potential lack of an independent, competitive market. They may also see that they are simply absorbing stock from the street for resale to retail customers, placing them on notice that their firm could be dominating and controlling the market or that the firm is not actually a market maker. Similarly, registered representatives, particularly those reaping some of the ill-gotten gains derived from unfair pricing to customers, may also be held responsible for excessive markups and unfair pricing to customers. A salesperson may certainly be deemed to share responsibility where he participates in determining the prices the firm charges customers, and also where he knew or should have known that the prices being charged are excessive based on a comparison of the gross commission or markup to the total price charged the customer. Registered representatives do not merely function as salespersons; they are securities professionals operating in a highly regulated environment, and they are required to know and comply with the relevant laws and rules. Registered representatives may not claim ignorance of the NASD's markup policy or case histories to avoid being included in an investigation of a firm's role with respect to particular securities. In short, they cannot solicit transactions for excessive gains with regulatory impunity.

In addition, where a member discovers that large discrepancies exist through a comparison of markups or markdowns calculated on a quotation and the same markup or markdown calculated with an appropriate contemporaneous transaction, the transactional information should generally prevail. Members should also monitor for markup-policy compliance by continually reviewing for: (1) sales to customers executed at apparently unfair or excessively marked-up prices when compared with the firm's determination of prevailing market price; (2) disparate execution prices with customer trades occurring at or about the same time in relatively similar volume; (3) wide spreads; and (4) only limited trading activity with, or between, other broker/dealers. Furthermore, any additional fees charged to customers must be considered when determining the final markup percentage. Many such "miscellaneous" fees must be included in the markup calculation so that the total cost of the trade to the customer is considered. Specifically, the Board Interpretation on markups precludes firms from simply passing expenses on to customers, stating that "[a] member may not justify markups on the basis of expenses which are excessive."[21] This Board position takes into account that the markup or markdown includes compensation to the member for its customary costs associated with the transaction that must be fair and reasonable at any price.

The referenced questionable situations identify just some of the potential compliance issues that members should be aware of so that appropriate procedures may be adopted and implemented. Members are reminded of their obligation to have in place adequate, written supervisory procedures designed to address their business activities, including markups and markdowns.

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Questions concerning this Notice may be directed to your local NASD district office, or to William R. Schief (Vice President) or Daniel M. Sibears (Director), NASD Compliance Division, 1735 K Street, NW, Washington, DC 20006-1506.

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[20] *See R.B. Marich, Inc., et. al.*, NASD, MS-849 (Dec. 23, 1991).

[21] *See General Investing Corporation*, 41 S.E.C. 952 (1964).

# APPENDIX A: MARKUPS*

## General Guidelines for Determining the Best Evidence of Prevailing Market Price in Order of Priority for a Normal-Size Trade

| | Market Maker | Non-Market Maker |
|---|---|---|
| Active Competitive Market | **Nasdaq/NMS**<br>A. Comparable sales to other broker/dealers immediately surrounding retail sales.<br>B. Lowest ask (inside ask) quotation reflected in Nasdaq at time of sale to customer (if validated).<br><br>**Regular Nasdaq**<br>A. Comparable sales to other broker/dealers immediately surrounding retail sales.<br>B. Lowest ask (inside ask) quotation reflected in Nasdaq at time of sale to customer if validated by a comparison with interdealer transactions.<br><br>**NNOTC**<br>A. Contemporaneous sales to other broker/dealers.<br>B. Lowest ask quotation if validated by a comparison with interdealer transactions.<br>C. Contemporaneous purchases from other broker/dealers (i.e., cost).<br>D. Contemporaneous purchases from customers adjusted for appropriate imputed markdowns. | **All Securities**<br>A. Contemporaneous purchases from other broker/dealers (i.e., cost).<br>B. Contemporaneous purchases from customers adjusted for appropriate imputed markdown. |
| Inactive Competitive Market | **All Securities**<br>A. Contemporaneous sales to other broker/dealers.<br>B. Lowest ask quotation if validated by a comparison with interdealer transactions.<br>C. Contemporaneous purchases from other broker/dealers (i.e., cost).<br>D. Contemporaneous purchases from customers adjusted for appropriate imputed markdown. | **All Securities**<br>A. Contemporaneous purchases from other broker/dealers (i.e., cost).<br>B. Contemporaneous purchases from customers adjusted for appropriate imputed markdown. |
| Dominated and Controlled Market | **All Securities**<br>A. Contemporaneous purchases from other broker/dealers (i.e., cost).<br>B. Contemporaneous purchases from customers adjusted for appropriate imputed markdown. | **All Securities**<br>A. Contemporaneous purchases from other broker/dealers (i.e., cost).<br>B. Contemporaneous purchases from customers adjusted to account for appropriate imputed markdown. |

*** This matrix is part of *Notice to Members 92-16* and cannot be relied on as a separate document. Consult the full text of the Notice when using this guide.**

# APPENDIX A: MARKDOWNS*

## General Guidelines for Determining the Best Evidence of Prevailing Market Price in Order of Priority for a Normal-Size Trade

| | Market Maker | Non-Market Maker |
|---|---|---|
| Active Competitive Market | **Nasdaq/NMS**<br>A. Comparable purchases from other broker/dealers immediately surrounding retail sales.<br>B. Highest bid (inside bid) quotation reflected in Nasdaq at time of purchase from customer (if validated).<br><br>**Regular Nasdaq**<br>A. Comparable purchases from other broker/dealers immediately surrounding retail sales.<br>B. Highest bid (inside bid) quotation reflected in Nasdaq at time of purchase from customer if validated by a comparison with interdealer transactions.<br><br>**NNOTC**<br>A. Contemporaneous purchases from other broker/dealers.<br>B. Highest bid quotation if validated by a comparison with interdealer transactions.<br>C. Contemporaneous sales to other broker/dealers.<br>D. Contemporaneous sales to customers adjusted for appropriate imputed markup. | **All Securities**<br>A. Contemporaneous sales to other broker/dealers.<br>B. Contemporaneous sales to customers adjusted for appropriate imputed markup. |
| Inactive Competitive Market | **All Securities**<br>A. Contemporaneous purchases from other broker/dealers.<br>B. Highest bid quotation if validated by a comparison with interdealer transactions.<br>C. Contemporaneous sales to other broker/dealers.<br>D. Contemporaneous sales to customers adjusted for appropriate imputed markup. | **All Securities**<br>A. Contemporaneous sales to other broker/dealers.<br>B. Contemporaneous sales to customers adjusted for appropriate imputed markup. |
| Dominated and Controlled Market | **All Securities**<br>A. Contemporaneous sales to other broker/dealers.<br>B. Contemporaneous sales to customers adjusted for appropriate imputed markup. | **All Securities**<br>A. Contemporaneous sales to other broker/dealers.<br>B. Contemporaneous sales to customers adjusted for appropriate imputed markup. |

*** This matrix is part of *Notice to Members 92-16* and cannot be relied on as a separate document. Consult the full text of the Notice when using this guide.**

NASD

# Notices To Members

April 1992 National Association of Securities Dealers, Inc. Pages 101-139

## Inside



*continued*

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## Board Briefs



## Disciplinary Actions



## For Your Information

NASD

# Notice To Members

National Association of Securities Dealers, Inc. April 1992

**Number 92-17**

**Suggested Routing:***

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

*These are suggested departments only. Others may be appropriate for your firm.

**Subject: Adoption of Amendments to Interpretation of the Board of Governors — Forwarding Of Proxy and Other Materials, Article III, Section 1 of the NASD Rules of Fair Practice Re: Forwarding Proxy Material on the Request of Stockholders**

**EXECUTIVE SUMMARY**

The Securities and Exchange Commission has approved amendments to the Interpretation of the Board of Governors — Forwarding of Proxy and Other Materials, Article III, Section 1 of the NASD Rules of Fair Practice to require NASD members to forward proxy material to beneficial owners at the request of persons other than the issuer (i.e., stockholders). The text of this amendment, which took effect March 16, 1992, follows this Notice.

## BACKGROUND AND SUMMARY OF AMENDMENTS

In May 1991, the staff of the Division of Market Regulation of the Securities and Exchange Commission (SEC or the "Commission") requested that the NASD consider amending the Interpretation of the Board of Governors — Forwarding of Proxy and Other Material, Article III, Section 1 of the NASD Rules of Fair Practice (the "Interpretation") to require NASD members to forward proxy material to beneficial owners at the request of persons other than the issuer (i.e., stockholders). Prior to approval of these amendments, the Interpretation required NASD members to forward proxy material to beneficial owners on the request of the issuer, but did not extend the duty to forward on a request by a person who is a stockholder of the issuer.[1]

On review of the SEC staff request, the NASD determined that a potential exists for disruption in proxy communications in circumstances where a stockholder in possession of the issuer's stockholder list requests NASD members to forward proxy material to beneficial owners. It was noted that only those NASD members that are affiliated with the New York Stock Exchange (NYSE) and the American Stock Exchange (Amex) were required, pursuant to the rules of those exchanges, to forward such proxy material on the request of a "person" other than the issuer of the stock.[2]

The NASD further noted that the forwarding of such proxy material for a stockholder of the is-

[1]The Interpretation was recently amended to require the forwarding of material other than proxy material on the request of the issuer. SEC Release No. 34-29512 (July 31, 1991); *Notice to Members 91-57* (September 1991).

[2]NYSE-affiliated members currently must forward proxy material on the request of a "person" pursuant to NYSE Rule 451. Amex-affiliated members currently are required to forward proxy material on the request of a "person" pursuant to Amex Rule 576.

suer is not currently required under the proxy rules adopted by the Commission in accordance with the Securities Exchange Act of 1934 (the "Act"). Pursuant to Rule 14a-7 of Regulation 14A of the Act, an issuer may choose to give the list of record holders to a stockholder for purposes of proxy solicitation. Pursuant to Rule 14b-1(e)(1) of the Act, registered brokers and dealers are required to forward material to beneficial owners only if a "registrant" provides assurance of reimbursement of reasonable expenses. Under current practice, a registrant normally would not provide to a broker or dealer an assurance of reimbursement for services rendered by a member in forwarding proxy material on the request of a person that is not the issuer. Therefore, a broker's or dealer's duty to forward under Rule 14b-1(e)(1) would not normally exist regarding nonissuer requests to forward proxy material.

The NASD is not aware of an occurrence when proxy material has not been forwarded by NASD members to beneficial owners on the request of a stockholder of an issuer. However, the NASD decided to eliminate the potential for any such disruption in the forwarding of proxy material to beneficial owners. As amended, the Interpretation now provides that NASD members are required to forward proxy material to beneficial owners on the request of either the issuer of the securities or a stockholder of such issuer. Furthermore, a stockholder must provide sufficient copies of all soliciting material and satisfactory assurance of reimbursement to the NASD member before the NASD member is required to forward the stockholder's proxy material.

* * * * *

Questions concerning this Notice may be directed to Mike Kelly, Nasdaq Company Services, at (202) 728-8185.

## TEXT OF RULE CHANGE

### Article III
### Rules of Fair Practice
### Business Conduct of Members

(**Note:** New language is underlined; deleted language is in brackets.)

**Section 1.** A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.

* * * * *

### Interpretation of the Board of Governors Forwarding of Proxy and Other Materials Introduction

**.05** A member has an inherent duty in carrying out high standards of commercial honor and just and equitable principles of trade to forward (i) all proxy material[,] which is properly furnished to it by the issuer of the securities or a stockholder of such issuer, to each beneficial owner of shares of that issue which are held by the member for the beneficial owner thereof and (ii) all annual reports, information statements and other material sent to stockholders, which are properly furnished to it by the issuer of the securities, to each beneficial owner of shares of that issue which are held by the member for the beneficial owner thereof. For the assistance and guidance of members in meeting their responsibilities, the Board of Governors has promulgated this interpretation. The provisions hereof shall be followed by all members and failure to do so shall constitute conduct inconsistent with high standards of commercial honor and just and equitable principles of trade in violation of Article III, Section 1 of the Rules of Fair Practice of the Association.

### Interpretation

* * * * *

Section 2. Whenever an [person] issuer or stockholder of such issuer soliciting proxies shall timely furnish to a member:

(1) sufficient copies of all soliciting material which such person is sending to registered holders, and

(2) satisfactory assurance that he will reimburse such member for all out-of-pocket expenses, including reasonable clerical expenses incurred by such member in connection with such solicitation, such member shall transmit promptly to each beneficial owner of stock of such issuer which is in its possession or control and registered in a name other than the name of the beneficial owner all such material furnished. Such material shall include a signed proxy indicating the number of shares held for such beneficial owner and bearing a symbol identifying the proxy with proxy records maintained by the member, and a letter informing the beneficial owner of the time limit and necessity for completing the proxy form and forwarding it to the person soliciting proxies prior to the expiration

of the time limit in order for the shares to be represented at the meeting. A member shall furnish a copy of the symbols to the person soliciting the proxies and shall also retain a copy thereof pursuant to the provisions of Rule 17a-4 of the General Rules and Regulations under the Securities Exchange Act of 1934, 17 C.F.R. 240.17a-4. Notwithstanding the provisions of this section, a member may give a proxy to vote any stock pursuant to the rules of any national securities exchange to which the member is also responsible provided that the records of the member clearly indicate which procedure it is following.

This section shall not apply to beneficial owners residing outside of the United States of America though members may voluntarily comply with the provisions hereof in respect to such persons if they so desire.

NASD

# Notice To Members

National Association of Securities Dealers, Inc. — April 1992

**Number 92-18**

**Suggested Routing:***

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

*These are suggested departments only. Others may be appropriate for your firm.

## Subject: SEC Approval of Amendments to the Definition of the Term "Branch Office" in Article III, Section 27 of the Rules of Fair Practice

**EXECUTIVE SUMMARY**

On March 24, 1992, the Securities and Exchange Commission (SEC) approved amendments to Article III, Section 27(g) of the Rules of Fair Practice codifying certain interpretations of the term "branch office." The amendments will become effective April 30, 1992. The text of the amendments follows the discussion below.

### BACKGROUND AND DESCRIPTION OF AMENDMENTS

On March 24, 1992, the SEC approved amendments to the NASD's supervision rule in Article III, Section 27 of the Rules of Fair Practice regarding the definition of the term "branch office" in Subsection 27(g). The amendments codify interpretations of the term that have been applied to the activities of certain members in the last few years.

In 1989, in response to requests from members, a committee of the Board of Governors ("Board") issued several interpretations under Article III, Section 27(g)(2) of the NASD Rules of Fair Practice to clarify the rule's definition of branch office and the exemptions from branch-office registration available for nonbranch business locations that meet certain conditions under the rule. These interpretations were reviewed by the Board in November 1989 and were approved for publication in the *NASD Regulatory & Compliance Alert* (February 1990). The interpretations were relied on for more than a year and were found to be workable in practice. Consequently, the NASD decided to codify the terms of the interpretations.

Under the current language of Article III, Section 27(g) of the Rules of Fair Practice, a location could be exempt from registration as a branch office if it was identified to the public only in telephone-book listings, on business cards, or on stationery, that also included the address and telephone number of the branch office or the office of supervisory jurisdiction (OSJ) responsible for supervising the nonbranch business location. Under new Subsection (g)(2)(ii) to Article III, Section 27, a location is also exempt from registration if the member's advertisement includes a local telephone number and/or a local post-office box so long as the advertisement also identifies the location and telephone number of the appropriate supervising branch office or OSJ. The advertisement may not, however, include the address of the nonbranch location. In addition, under new Subsection (g)(2)(iii), a member's sales literature may also include the local address of a nonbranch business location, so long as the location and telephone number of the

appropriate supervisory branch office or OSJ of the member is identified.

New Subsection (g)(3) allows a member to use the firm's main-office address and telephone number on sales literature, advertisements, business cards, and business stationery instead of the address and telephone number of the supervisory branch office or OSJ so long as the member can demonstrate that it maintains a significant and geographically dispersed supervisory system appropriate to its business. Moreover, any complaints received by the main office must be forwarded to the office or offices with jurisdiction over the non-branch business location.

The new exemptions from the branch-office definition in Article III, Section 27(g)(2) are intended as a reasonable accommodation to member firms with widely dispersed sales personnel selling limited product lines such as variable contracts and mutual funds. Any office location that (i) performs any function of an OSJ, (ii) publicly displays signage, (iii) operates from public areas of buildings, such as bank branches, even when such locations are temporarily staffed, or (iv) advertises an address in any public media would still be required to register as a branch office. Such locations hold themselves out to the public as being places where the member conducts a securities business and, thus, come within the definition of a branch office. The NASD will not, however, regard a listing in a lobby directory or a sign on an interior corridor door as holding the location out to the public in such a way as to require branch-office registration unless other indicia of the location's status as a branch office are present.

Article III, Section 27 and the exclusions in the amendments are designed to avoid requiring the registration of locations as branch offices unless their securities activity would require the continuous direct supervision of a principal (i.e., OSJ-type activity) or the location is being held out to the public as a place where the full range of securities activity is being conducted (requiring supervisory oversight of the initial interactions between customers and the member).

Questions regarding this notice may be directed to R. Clark Hooper, Director, Advertising Department, at (202) 728-8330; P. William Hotchkiss, Director, Surveillance Department, at (202) 728-8221; and Elliott R. Curzon, General Counsel's Office, at (202) 728-8451.

## Article III of the NASD Rules of Fair Practice

(**Note:** New language is underlined; deleted language is in brackets.)

**Supervision**

Sec. 27.

* * * * *

Definitions

* * * * *

(g)(2) "Branch Office" means any location identified by any means to the public or customers as a location at which the member conducts an investment banking or securities business, excluding:

(i) any location identified [solely] in a telephone directory line listing or on a business card or letterhead, which listing, card, or letterhead also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch location are directly supervised[.];

(ii) any location referred to in a member advertisement, as this term is defined in Article III, Section 35 of the NASD Rules of Fair Practice, by its local telephone number and/or local post office box provided that such reference may not contain the address of the non-branch location and, further, that such reference also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch locations are directly supervised; or

(iii) any location identified by address in a member's sales literature, as this term is defined in Article III, Section 35 of the NASD Rules of Fair Practice provided that the sales literature also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the non-branch locations are directly supervised.

(g)(3) A member may substitute a central office address and telephone number for the supervisory branch office and OSJ locations referred to in paragraph (g)(2) above provided it can demonstrate to the NASD District Office having jurisdiction over the member that it has in place a significant and geographically dispersed supervisory system appropriate to its business and that any investor complaint received at the central site is provided to and resolved in conjunction with the office or offices with responsibility over the non-branch business location involved in the complaint.

NASD

# Notice To Members

National Association of Securities Dealers, Inc. April 1992

## Number 92-19

**Suggested Routing:***

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

*These are suggested departments only. Others may be appropriate for your firm.

**Subject: Retention of Jurisdiction; SEC Approval of Amendments to Article III, Section 5 and Article IV, Sections 3 and 4 of the Association's By-Laws, and Article IV, Section V Of the Association's Rules of Fair Practice**


### EXECUTIVE SUMMARY

On March 23, 1992, the Securities and Exchange Commission (SEC) approved amendments to Article III, Section 5 and Article IV, Sections 3 and 4 of the Association's By-Laws and Article IV, Section 5 of the Association's Rules of Fair Practice. The amendments permit the Association to bring disciplinary actions against member firms who have resigned their membership and associated persons who have terminated their registration, or whose membership or registration has been canceled or revoked, up to two years following the resignation, termination, cancellation, or revocation of their membership or registration. The amendments also clarify that associated persons are required to provide information to the Association pursuant to Article IV, Section 5 of the Rules of Fair Practice so long as the Association retains jurisdiction to file a complaint. The amendments became effective April 15, 1992. The text of the amendments follows the discussion below.


### BACKGROUND AND DESCRIPTION OF AMENDMENTS

The SEC has approved amendments to the Association's By-Laws to extend the jurisdiction of the Association to bring disciplinary actions against member firms and associated persons to two years following the resignation, termination, cancellation, or revocation of their membership or registration.

Under the current provisions of the By-Laws, the Association has one year from the effective date of the filing of a resignation of membership[1] or a termination of registration[2] to file a complaint for any actionable misconduct prior to the resignation by the member or termination by the associated person. Under the procedures currently employed by the NASD in processing terminations

[1] A member is required to advise the Association of its resignation of membership on a Form BDW.

[2] A member is required to advise the Association of a termination of, or resignation by an associated person, on Form U-5.

of associated persons and resignations of member firms, the Association "holds" the effectiveness of the resignation of the membership of a member firm or the termination of the registration of an associated person if the Association is aware of or is investigating potential violations of the NASD's rules or the federal securities laws by the firm or person.

The Association also retroactively holds resignations of membership or terminations of registration if it becomes aware of matters that would have resulted in a hold after the termination has been allowed to take effect. If the Association is not aware of misconduct by an associated person at the time a termination takes effect, the time period for filing a complaint could run out before action is taken. The current procedure to hold and retroactively hold resignation of memberships and terminations of registration is based on the language of the By-Laws, which allows the Association to declare a termination or resignation effective at its discretion.

The NASD has amended Articles III and IV to the NASD By-Laws to extend the current one-year jurisdictional period, which runs from the time the Association permits the resignation or termination to take effect, to a fixed two years from the date a resignation or termination is filed or from the date of the Association's revocation or cancellation of a member or associated person. The amendments eliminate the current provisions of the By-Laws that permit the NASD to hold the effectiveness of the resignation of a member or the termination of an associated person.

The amendments to the By-Laws also provide that the Association will retain jurisdiction over member firms whose membership was canceled or revoked and associated persons whose registration was revoked. The changes correct the situation under the current provisions where the Association retains jurisdiction over a member who resigned or an associated person who terminated his registration but loses jurisdiction over members whose membership was canceled or revoked and associated persons whose registration was revoked.

The amendments also provide that the two-year period commences from the date of the filing of the last amendment to a person's Form U-5 that is filed within the two-year period. This provides for the situation where a routine Form U-5 is filed at the time of termination but a subsequent amendment discloses potential violations that would require an investigation. Starting the two-year period at the time the last Form U-5 amendment is filed will prevent a person from avoiding potential disciplinary action through his own active concealment or the dilatory conduct of others. Moreover, because members are required to send any amended Form U-5 to the terminated person, he or she will have notice of the time from which the two-year period will run. The two-year limit is also consistent with current rules that permit a person to become associated with another member without the need to requalify by examination up to two years from his date of termination.

With respect to members and persons whose registration terminations have not been allowed to take effect pursuant to the hold and retroactive hold procedures currently employed, their terminations are considered effective April 15, 1992, the effective date of the amendments. Therefore, the Association will have two years from that date to file a complaint pursuant to the provisions of the amendments.

The amendments also state that associated persons are required to provide information to the Association pursuant to Article IV, Section 5 of the Rules of Fair Practice so long as they remain subject to the Association's jurisdiction (i.e., two years). In addition, the By-Laws have been amended to provide that the Association may bring a disciplinary action against any associated person who fails to provide information pursuant to Article IV, Section 5 of the Rules of Fair Practice while that person remains subject to the Association's jurisdiction. Thus, associated persons are required to provide information to the Association and may be subject to disciplinary action for failing to respond to a request for information even though the registration has been terminated, canceled or revoked.

Finally, Article IV, Section 5 of the Rules of Fair Practice has been amended to provide that any request for information shall be deemed to have been received by the member or person at their last known address as reflected on the Association's records. This requirement is consistent with the obligations of members and associated persons to update Form BD and Form U-4 to keep the information in those forms current. The ability of members and associated persons to receive proper notice of requests for information will depend on the member's and associated person's compliance

with their obligations to update the information on file with the Association.[3]

The amendments are effective on April 15, 1992. Questions concerning this Notice may be directed to Elliott R. Curzon, Office of General Counsel at (202) 728-8451.

## AMENDMENTS TO NASD BY-LAWS

(**Note:** New language is underlined; deleted language is in brackets.)

### ARTICLE III
### Membership

* * * * *

**Resignation of Members**

**Sec. 5[(a)]** Membership in the Association may be voluntarily terminated only by formal resignation. Resignations of members must be in writing and addressed to the Corporation which shall immediately notify the appropriate District Committee. Any member may resign from the Corporation at any time. Such resignation shall not take effect until thirty (30) days after receipt thereof by the Corporation and until all indebtedness due the Corporation from such member shall have been paid in full and so long as any complaint or action is pending against the member [and so long as any examination of such member is in process] under the Code of Procedure. The Corporation, however, may in its discretion declare a resignation effective at any time.

**Retention of Jurisdiction**

[**Sec. 5(b)**] **Sec. 6.** A resigned member or a member that has had its membership canceled or revoked shall continue to be subject to the filing of a complaint under the Code of Procedure based upon conduct which commenced prior to the effective date of the member's resignation from the Corporation or the cancellation or revocation of its membership. Any such complaint, however, shall be filed within [one] two (2) years after the effective date of the resignation, cancellation or revocation.

Current Sections 6-9 renumbered as Sections 7-10, respectively.

### ARTICLE IV
### Registered Representatives and Associated Persons

* * * * *

**Notification by Member to Corporation and Associated Person of Termination; Amendments to Notification**

**Sec. 3(a).** Following the termination of the association with a member of a person who is registered with it, such member shall promptly, but in no event later than thirty (30) calendar days after such termination, give written notice to the Association on a form designated by the Board of Governors of the termination of such association, and concurrently shall provide to the person whose association has been terminated a copy of said notice as filed with the Association. A member [who] which does not submit such notification in writing, and provide a copy thereof to the person whose association has been terminated, within the time period prescribed shall be assessed a late filing fee as specified by the Board of Governors. Termination of registration of such person associated with a member shall not take effect so long as any complaint or action is pending against a member and to which complaint or action such person associated with a member is also a respondent, or so long as any complaint or action is pending against such person individually [or so long as any examination of the member or person associated with such member is in process] under the Code of Procedure. The Corporation, however, may in its discretion declare the termination effective at any time.

(b) The member shall notify the Association in writing by means of an amendment to the notice filed pursuant to paragraph (a) above in the event that the member learns of facts or circumstances causing any information set forth in said notice to become inaccurate or incomplete. Such amendment shall be filed with the Association and provided to the person whose association with the member has been terminated not later than thirty (30) calendar days after the member learns of the fact or circumstances giving rise to the amendment.

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[3] Article IV, Section 2(a)(3)(c) of the Association's By-Laws states that "[e]very application for registration filed with the Corporation shall be kept current at all times by supplementary amendments to the original application." In addition, the Form U-4 specifically states "[a]n applicant is under a continuing obligation to update information required by Form U-4 as changes occur." Because of the amendments to Article IV, Section 5, announced here, members and associated persons may wish to advise the Association of any changes to the information on file that occur after resignation or termination until such time as the Association no longer has jurisdiction to file a complaint or request information.

**Retention of Jurisdiction**

**Sec. 4.** A person whose association with a member has been terminated and is no longer associated with any member of the Corporation or a person whose registration has been revoked shall continue to be subject to the filing of a complaint under the Code of Procedure based upon conduct which commenced prior to the termination or revocation or upon such person's failure, while subject to the Corporation's jurisdiction as provided herein, to provide information requested by the Corporation pursuant to Article IV, Section 5 of the NASD Rules of Fair Practice, but any such complaint shall be filed within:

(a) [one (1)] two (2) years after the effective date of termination of registration pursuant to Section 3 above, provided, however, that any amendment to a notice of termination filed pursuant to Section 3(b) that is filed within two years of the original notice which discloses that such person may have engaged in conduct actionable under any applicable statute, rule or regulation shall operate to recommence the running of the two-year period under this paragraph;

(b) two (2) years after the effective date of revocation of registration pursuant to Article V, Section 2 of the Association's Rules of Fair Practice; or,

(c) in the case of an unregistered person, within [one (1)] two (2) years after the date upon which such person ceased to be associated with the member.

## AMENDMENTS TO NASD RULES OF FAIR PRACTICE

### ARTICLE IV
### Complaints

* * * * *

**Reports and Inspection of Books for Purposes of Investigating Complaints**

**Sec. 5.** For the purpose of any investigation, or determination as to filing of a complaint or any hearing of any complaint against any member of the Corporation or any person associated with a member made or held in accordance with the Code of Procedure, any Local Business Conduct Committee, any District Business Conduct Committee, or the Board of Governors, or any duly authorized member or members of any such Committees or Board or any duly authorized agent or agents of any such Committee or Board shall have the right (1) to require any member of the Corporation, [or] person associated with a member, or person no longer associated with a member when such person is subject to the Corporation's jurisdiction to report, either informally or on the record, orally or in writing with regard to any matter involved in any such investigation or hearing, and (2) to investigate the books, records and accounts of any such member or person with relation to any matter involved in any such investigation or hearing. No such member or person [associated with a member,] shall [refuse] fail to make any report as required in this Section, or [refuse] fail to permit any inspection of books, records and accounts as may be validly called for under this Section. Any notice requiring an oral or written report or calling for an inspection of books, records and accounts pursuant to this Section shall be deemed to have been received by the member or person to whom it is directed by the mailing thereof to the last known address of such member or person as reflected on the Corporation's records.

NASD

# Notice To Members

National Association of Securities Dealers, Inc. April 1992

## Number 92-20

**Suggested Routing:***

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

*These are suggested departments only. Others may be appropriate for your firm.

**Subject: Sale of Direct Participation Program Debt Instruments by Limited Principals and Representatives; SEC Approval of Amendments to Parts II and III of Schedule C To the NASD's By-Laws**


### EXECUTIVE SUMMARY

On March 4, 1992, the Securities and Exchange Commission (SEC) approved amendments to Parts II and III of Schedule C to the NASD's By-Laws permitting Direct Participation Program (DPP) Limited Principals and Representatives to sell DPP debt instruments. The text of the amendments, which took effect March 4, 1992, follows the discussion below.


### BACKGROUND AND DESCRIPTION OF AMENDMENTS

The SEC has approved amendments to Parts II and III of Schedule C to the NASD's By-Laws to permit persons registered as Limited DPP Principals and DPP Representatives to offer and sell direct participation program debt instruments. This amendment results from the NASD's determination that DPP syndicators are offering debt securities of DPPs to pension plans and other institutional accounts that are considered "qualified plans" under the Employee Retirement Income Security Act (ERISA). The NASD found that syndicators are offering such debt instruments in order to avoid having distributions classified as "unrelated business taxable income" under Internal Revenue Service regulations.

Schedule C to the By-Laws allows a person to qualify to sell all types of securities by passing the Series 7 examination (General Securities Examination) or to qualify to sell a specific category of security by passing a more limited examination such as the Series 22 (DPP Examination). The current provisions of Schedule C, however, do not permit a DPP-registered person to sell debt securities. Nevertheless, an initial sale of a DPP debt security does not require general market knowledge or knowledge of the debt securities market because the DPP debt security is typically sold to retirement plans that intend to hold the security to maturity.

The NASD believes that there is no discernible difference between the knowledge required for the initial sale of debt and equity instruments issued by a DPP. Both instruments require that a DPP salesman be familiar with the structure of a DPP and with the DPP's tax consequences. Accordingly, the NASD believes that DPP principals and representatives should be permitted to offer and sell debt instruments of a DPP. Moreover, while the amendments permit DPP-registered persons to sell debt securities in a distribution, the amendments will not permit them to buy or sell DPP debt

securities in the secondary market.

Questions regarding this rule filing may be directed to Carole Hartzog, Qualifications Department, at (301) 590-6696 or Elliott R. Curzon, General Counsel's Office, at (202) 728-8451.

## SCHEDULE C TO THE NASD BY-LAWS

### II
### REGISTRATION OF PRINCIPALS

(**Note:** New language is underlined; deleted language is in brackets.)

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(2) Categories of Principal Registration

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(e) Limited Principal — Direct Participation Programs

(i) Each person associated with a member who is included within the definition of principal in Part II, Section (1) hereof, may register with the Corporation as a Limited Principal — Direct Participation Programs if:

a. his activities in the investment banking and securities business are limited solely to the equity interests in or the debt of [D]direct [P]participation [P]programs as defined in Part II, Section (2)(e)(ii) hereof; and

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### III
### REGISTRATION OF REPRESENTATIVES

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(2) Categories of Representative Registration

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(c) Limited Representative — Direct Participation Programs

(i) Each person associated with a member who is included within the definition of a representative in Part III, Section (1) hereof, may register with the Corporation as a Limited Representative — Direct Participation Programs if:

a. his activities in the investment banking and securities business are limited solely to the solicitation, purchase and/or sale of equity interests in or debt of direct participation programs as defined in Part II, Section (2)(e)(ii) hereof[,]; and