

# Notice To Members

National Association of Securities Dealers, Inc.

May 1992

## Number 92-25

### Suggested Routing:\*

- |   |  |  |                                    |
|---|--|--|------------------------------------|
| <input checked="" type="checkbox"/> Senior Management | <input type="checkbox"/> Internal Audit                | <input checked="" type="checkbox"/> Operations | <input type="checkbox"/> Syndicate |
| <input type="checkbox"/> Corporate Finance            | <input checked="" type="checkbox"/> Legal & Compliance | <input type="checkbox"/> Options               | <input type="checkbox"/> Systems   |
| <input type="checkbox"/> Government Securities        | <input type="checkbox"/> Municipal                     | <input type="checkbox"/> Registration          | <input type="checkbox"/> Trading   |
| <input type="checkbox"/> Institutional                | <input checked="" type="checkbox"/> Mutual Fund        | <input type="checkbox"/> Research              | <input type="checkbox"/> Training  |

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

## MAIL VOTE

**Subject: Proposed Amendment to Article III, Section 15 of the NASD Rules of Fair Practice  
Re: Exemption for Negative-Response Letters Used to Facilitate Certain Bulk Exchanges of Money Market Mutual Funds**

### EXECUTIVE SUMMARY

The NASD invites members to vote on a proposed amendment to Article III, Section 15 of the NASD Rules of Fair Practice that would permit members to use negative-response letters in bulk exchanges of money market funds in situations involving mergers or acquisitions, changes of clearing members, and exchanges of money market funds used in sweep accounts.

### BACKGROUND

In *Notice to Members 91-80* (December 1991), the NASD Board of Governors requested comments on a proposed amendment to Article III, Section 15 of the NASD Rules of Fair Practice. The amendment would permit members to use negative-response letters to facilitate bulk exchanges of money market funds in certain situations. These situations would include mergers and acquisitions, changes of clearing members, and exchanges of money market funds used in sweep accounts when investment performance is not the primary reason for the exchange.

Article III, Section 15 requires written author-

ity from a customer before a member or a registered representative can exercise discretion in the customer's account. Negative-response letters permit the automatic execution of a recommendation in such letters if a customer does not respond to the letter by a specific date. Absent prior written authority from a customer, the use of a negative-response letter to facilitate an exchange of securities in a customer account would normally violate Article III, Section 15.

The NASD received 10 letters in response to *Notice to Members 91-80* requesting comment on the proposed amendment. All were in favor of the proposed amendment. Seven of the commenters suggested various changes to the proposed amendment.

One commenter believes that the requirement in the amendment for a tabular comparison of the fees charged by each fund would produce inexact figures that would be difficult to obtain. The commenter suggests that it should be replaced by a comparison of the yields of the two funds for the most recent practical data computed, and if desired by the member, the historical performance for each of the funds over comparable time periods. The commenter's rationale is that yields reflect all charges and expenses. The Board notes that it was

the intention of the Investment Companies Committee, when drafting the proposal, that a tabular comparison would reflect the various fees that are disclosed in the front pages of every money market fund prospectus. These fees are exact and easily obtainable. Comparative yield figures do not, in the opinion of the Board, provide an adequate disclosure of fees.

Two commenters questioned applying the proposal to mergers and acquisitions because they are subject to a vote of shareholders. One suggested that, although it might be superfluous to include mergers and acquisitions, applying the proposal to these situations might obviate the need for a merger or acquisition. The other commenter suggested that the amendment might cause members to believe that a merger or an acquisition could be accomplished by using negative-response letters rather than a shareholder vote. The Board does not agree.

The Board also disagrees with the opinion of another commenter that a negative-response letter should be permitted when a "nonsweep account" is changed to a sweep account. The Board believes that such a change requires the authorization of the customer.

The Board had a similar reaction to two commenters who wish to expand the proposal to include, within the definition of bulk exchanges, changes in investment advisers and changes in accounts where a member or its affiliates provide sub-transfer agent or other support services. Another commenter suggested that any legitimate exchange of a money market fund should permit the use of a negative-response letter. The Board reiterates that any discretionary activity by a member or a registered representative in a customer's account would normally require a customer's written authorization. The narrow exemption provided by the proposed amendment in certain limited situations involving bulk transfers of money market funds is the only relief from the rule that the Board is currently prepared to grant on an across-the-board basis.

Another commenter recommended that exchanges required by administrative or judicial order not be subject to the 30-day delay in execution after a negative-response letter is mailed. The Board concluded that the nature of such an order will determine whether the 30-day requirement can be applied. Each such case, of which there

will probably be few, will be considered on its merits and there is no necessity to amend the proposal.

Finally, a commenter suggested broadening the term "sweep account" to include those accounts where each "sweep" must be authorized by an employee of the member firm. The Board believes that, assuming that the customer has previously authorized credit balances to be swept periodically into a money market fund, the procedures adopted by a member to authorize each "sweep" would not cause such a sweep account to lose its "sweep" status.

### REQUEST TO VOTE

The NASD Board of Governors concludes that the comments received do not warrant any changes to the original proposal. The Board considers that the proposed amendment to Article III, Section 15 of the NASD Rules of Fair Practice is necessary and appropriate. It recommends that members vote their approval. Please mark the enclosed ballot according to your convictions and return it in the enclosed stamped envelope to the Corporation Trust Company. Ballots must be post-marked **no later than June 22, 1992**.

Questions concerning this Notice may be directed to the Investment Companies/Insurance Affiliated Member Department at (202) 728-8329.

### PROPOSED AMENDMENTS TO ARTICLE III, SECTION 15 OF THE OF THE NASD RULES OF FAIR PRACTICE

(Note: New text is underlined.)

#### Discretionary Accounts

##### Sec. 15.

##### Excessive transactions

(a) No member shall effect with or for any customer's account in respect to which such member or his agent or employee is vested with any discretionary power any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account.

##### Authorization and acceptance of account

(b) No member or registered representative shall exercise any discretionary power in a customer's account unless such customer has given prior written authorization to a stated individual or individuals and the account has been accepted by

the member, as evidenced in writing by the member or the partner, officer or manager, duly designated by the member, in accordance with Section 27 of these rules.

**Approval and review of transactions**

(c) The member or the person duly designated shall approve promptly in writing each discretionary order entered and shall review all discretionary accounts at frequent intervals in order to detect and prevent transactions which are excessive in size or frequency in view of the financial resources and character of the account.

**Exceptions**

(d)(1) This section shall not apply to discretion as to the price at which or the time when an order given by a customer for the purchase or sale of a definite amount of a specified security shall be executed.

(d)(2) This section shall not apply to bulk exchanges of money market mutual funds ("funds") utilizing negative response letters provided:

(i) The bulk exchange is limited to situations involving mergers and acquisitions of funds, changes of clearing members and exchanges of funds used in sweep accounts.

(ii) The negative response letter contains a tabular comparison of the nature and amount of the fees charged by each fund.

(iii) The negative response letter contains a comparative description of the investment objectives of each fund and a prospectus of the fund to be purchased.

(iv) The negative response feature will not be activated until at least 30 days after the date on which the letter was mailed.

# Notice To Members

National Association of Securities Dealers, Inc.

May 1992

## Number 92-26

### Suggested Routing:\*

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|---|--|--|---|
| <input checked="" type="checkbox"/> Senior Management | <input checked="" type="checkbox"/> Internal Audit     | <input checked="" type="checkbox"/> Operations | <input checked="" type="checkbox"/> Syndicate |
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## Subject: SEC Approval of Trade Reporting for Regular Nasdaq Securities

### EXECUTIVE SUMMARY

On March 10, the Securities and Exchange Commission (SEC) approved amendments to Schedule D regarding trade reporting for regular Nasdaq<sup>®</sup> equity securities. The trade reporting requirements are similar to those currently in place for Nasdaq National Market System (Nasdaq/NMS<sup>®</sup>) securities. Trade reporting of all Nasdaq equity issues will enhance the information available to the public and provide investors with instant, up-to-the-minute information on the securities traded in The Nasdaq Stock Market.<sup>SM</sup> Trade reporting will also greatly improve the NASD's ability to detect or deter manipulative or abusive trading practices.

Beginning June 15, members will be required to report both broker-to-broker and internalized transactions in regular Nasdaq securities to the Automated Confirmation

Transaction (ACT)<sup>SM</sup> service within 90 seconds after execution. Quotations and trade reports in regular Nasdaq securities will be identified by the system with an "s" market center indicator; quotes and last-sale reports of Nasdaq/NMS issues will be identified with a "q" indicator. All Nasdaq securities will be exempt from the SEC's new "penny stock" rules, but transaction reporting for regular Nasdaq securities will not make these issues eligible automatically for margin treatment or for state "blue sky" exemptions. Finally, the new transaction reporting requirements will not apply to transactions in convertible debt securities.

The amendments will be effective on June 15 when end-of-day volume reports for regular Nasdaq equity securities will no longer be necessary. The text of the amendments follows the discussion below.

### BACKGROUND AND DESCRIPTION OF AMENDMENTS

The SEC's approval of transaction reporting for regular Nasdaq securities represents a significant evolutionary step that will materially enhance the visibility and integrity of The Nasdaq Stock Market. Transaction reporting increases transpar-

ency of information for investors and issuers, facilitates best execution, permits immediate collection and scrutiny of trading information for regulatory purposes, and permits the compilation of historical price and volume data for analysis and research. Moreover, the introduction of trade reporting places regular Nasdaq securities on an equal foot-

ing with Nasdaq/NMS and exchange-listed securities in terms of real-time information available to broker/dealers and their customers. The NASD has nine years of experience with real-time reporting of Nasdaq/NMS securities and believes that the increased visibility associated with trade reporting will expand the universe of institutional and public investors interested in purchasing these securities. This will provide increased liquidity in the marketplace for the benefit of all investors.

Real-time transaction reporting and the related regulatory benefits will also permit the exemption of regular Nasdaq securities from the application of the SEC's "Penny Stock Disclosure Rules," some of which will take effect on July 15. Generally, the SEC rules define any stock selling for less than \$5 per share as a penny stock and subject those securities to additional regulatory requirements. Exempted from the rules, however, are those lower priced stocks that remain fully qualified for inclusion in the Nasdaq market. The SEC has granted this exemption from the penny stock rules for securities listed on Nasdaq, based, in part, on the significantly enhanced transactional information that will be made available to investors through the trade-reporting function.

From a regulatory perspective, real-time reporting requirements will enhance significantly the automated market surveillance oversight performed by the NASD and provide more immediate and useful information for investigating questionable conduct, such as insider trading and manipulative activity. Presently, NASD Market Surveillance primarily uses end-of-day volume statistics as the source of information for trades in regular Nasdaq securities. Real-time trade reports significantly improve the NASD's ability to effectively monitor trading as it occurs. For example, as real-time trade reporting is fully implemented, the trading data will be available on the NASD's equity audit trail, which integrates last-sale, clearing, and inside quotation data for reported securities. In addition, transaction data will be added to daily quote and trade-comparison reports and to exception-based systems that monitor for marking-the-close violations, trading during trading halts, volume concentrations, late trade reporting, and other activity monitored by Market Surveillance. Collectively, these surveillance advances will reinforce the integrity and image of Nasdaq as a world-class securities market.

The amendments to Schedule D contain trade-reporting requirements that closely parallel those currently in place for Nasdaq/NMS securities. The new rules will require transactions in regular Nasdaq securities to be reported to the NASD within 90 seconds after execution. Members are currently reporting broker-to-broker transactions in regular Nasdaq securities into the ACT service for comparison processing and are reporting total volume of purchases and sales in Nasdaq securities at the end of the day. The new requirements reduce the current time frames for entering transactions into ACT from 15 minutes to 90 seconds and expand the securities eligible for reporting through ACT to include all internalized transactions. Given the implementation of trade-by-trade reporting, the existing requirement for end-of-day volume reporting of regular Nasdaq securities will be eliminated. Members should note, however, that transactions in convertible debt securities will remain subject to end-of-day volume reporting requirements, similar to those currently in place for all regular Nasdaq securities.

The new rules specify which party to a transaction is required to report (in most transactions, the market maker registered in the Nasdaq security is the reporting party). They also provide reporting requirements, such as reporting transactions at the selling or purchasing price, irrespective of mark-ups, markdowns, or commissions. The trade-reporting rules state that aggregating trade reports is allowable under certain circumstances and sets forth permissible aggregation practices. Members should note that for ACT comparison purposes, however, members may need to indicate separate trades with separate contra-parties. These requirements also parallel those currently in place for Nasdaq/NMS securities.

For members that account for five or fewer trades per day, the NASD will provide an alternative means to effectuate trade reports through the ACT service desk. The NASD operates the ACT service desk to facilitate members that account for fewer than five trades a day on average and that do not have Nasdaq Workstation<sup>®</sup> equipment. For more information on the ACT service desk, contact ACT Operations at (212) 858-4342.

Last-sale information for regular Nasdaq equity securities will be disseminated to the marketplace through information vendors on a real-time basis throughout the trading day. With the advent

of trade reporting in regular Nasdaq and the corresponding increase in information that will be provided to members and investors, the NASD will revise the fee schedule for receipt of last-sale information for both Nasdaq/NMS and regular Nasdaq securities. The current service charge of \$7.50 will be increased to \$9. The modest increase will recover the costs of collecting, processing, and disseminating the additional information.

Vendors will receive the additional data over high-speed lines. A market center identifier, attached to both last-sale data and to quotations, will differentiate regular Nasdaq securities from Nasdaq/NMS securities. Regular Nasdaq quotes and transaction reports will carry an "s" identifier; Nasdaq/NMS quotes and last-sale data will be displayed with the "q" identifier. This information will be generated by the Nasdaq processor and does not require data entry by reporting parties.

Members should note that Nasdaq/NMS equity securities will continue to receive separate regulatory treatment in areas such as margin accounts and state securities commissions' merit review requirements. Transaction reporting in regular Nasdaq issues does not render these stocks automatically eligible for sales to margin account customers nor for exemptions from state "blue sky" regulations. Members should alert their associated persons to maintain the regulatory distinctions between regular Nasdaq and Nasdaq/NMS securities, especially as they pertain to margin and blue-sky treatment.

The new trade-reporting rules become effective June 15. Questions regarding this Notice may be directed to Bernard Thompson, Assistant Director, Market Surveillance, at (301) 590-6436 or to Beth E. Weimer, Associate General Counsel, at (202) 728-6998.

### TEXT OF NEW RULES

The rule change adds a new Part XIII to Schedule D to the NASD By-Laws and amends the ACT Rules. (Note: Additions are in italics; deletions are in brackets.)

#### PART XIII

#### REPORTING TRANSACTIONS IN NASDAQ SECURITIES

*This Part has been adopted pursuant to Article VII of the Corporation's By-Laws and sets forth*

*the applicable reporting requirements for transactions in Nasdaq securities (excluding convertible bonds that are quoted through the Nasdaq system) ("designated securities") that are not classified as Nasdaq/National Market System securities. Members shall utilize the Automated Confirmation Transaction Service ("ACT") for transaction reporting.*

#### Section 1 — Definitions

(a) *Terms used in this Part shall have the same meaning as those defined in the Association's By-Laws and Rules of Fair Practice, unless otherwise specified herein.*

(b) *"Automated Confirmation Transaction service" is the service that, among other things, accommodates reporting and dissemination of last sale reports in designated securities.*

(c) *"Registered Reporting Market Maker" means a member of the Association that is registered as a Nasdaq market maker in a particular designated security. A member is a Registered Reporting Market Maker in only those designated securities for which it is registered as a Nasdaq market maker. A member shall cease being a Registered Reporting Market Maker in a designated security when it has withdrawn or voluntarily terminated its quotations in that security or when its quotations have been suspended or terminated by action of the Corporation.*

(d) *"Non-Registered Reporting Member" means a member of the Association that is not a Registered Reporting Market Maker.*

#### Section 2 — Transaction Reporting

(a) *When and How Transactions are Reported*

(1) *Registered Reporting Market Makers shall, within 90 seconds after execution, transmit through ACT last sale reports of transactions in designated securities executed during normal market hours. Transactions not reported within 90 seconds after execution shall be designated as late.*

(2) *Non-Registered Reporting Members shall, within 90 seconds after execution, transmit through ACT or the ACT service desk (if qualified pursuant to Part IX of Schedule D to the By-Laws), or if ACT is unavailable due to system or transmission failure, by telephone to the Market Operations Department in New York City, last sale reports of transactions in designated securities executed during normal market hours unless all of the following*

criteria are met:

(A) The aggregate number of shares of designated securities which the member executed and is required to report during the trading day does not exceed 1,000 shares; and

(B) The total dollar amount of shares of designated securities which the member executed and is required to report during the trading day does not exceed \$25,000; and

(C) The member's transactions in designated securities have not exceeded the limits of (A) or (B) above on five or more of the previous ten trading days.

Transactions not reported within 90 seconds after execution shall be designated as late. If the member has reason to believe its transactions in a given day will exceed the above limits, it shall report all transactions in designated securities within 90 seconds after execution; in addition, if the member exceeds the above limits at any time during the trading day, it shall immediately report and designate as late any unreported transactions in designated securities executed earlier that day.

(3) Non-Registered Reporting Members shall report weekly to the Nasdaq Operations Department in New York City, on a form designated by the Board of Governors, last sale reports of transactions in designated securities which are not required by paragraph (2) to be reported within 90 seconds after execution.

(4) Last sale reports of transactions in designated securities executed between the hours of 4:00 pm. and 5:00 p.m. Eastern Time shall be transmitted through the ACT system within 90 seconds after execution; trades reported after 4:10 p.m. Eastern Time shall be designated as ".T" or after hours trades.

(5) All members shall report weekly to the Nasdaq Operations Department in New York City, on a form designated by the Board of Governors, last sale reports of transactions in designated securities executed outside the hours of 9:30 a.m. and 5:00 p.m. Eastern Time.

(6) All trade tickets for transactions in eligible securities shall be time-stamped at the time of execution.

(7) A pattern or practice of late reporting without exceptional circumstances may be considered conduct inconsistent with high standards of commercial honor and just and equitable principals of trade, in violation of Article III, Section 1

of the Rules of Fair Practice.

(b) Which Party Reports Transaction

(1) In transactions between two Registered Reporting Market Makers, only the member representing the sell side shall report.

(2) In transactions between a Registered Reporting Market Maker and a Non-Registered Reporting Member, only the Registered Reporting Market Maker shall report.

(3) In transactions between two Non-Registered Reporting Members, only the Member representing the sell side shall report.

(4) In transactions between a member and a customer, the member shall report.

(c) Information To Be Reported

Each last sale report shall contain the following information:

(1) Nasdaq symbol of the designated security;

(2) Number of shares, excluding odd lots;

(3) Price of the transaction as required by paragraph (d) below;

(4) A symbol indicating whether the transaction is a buy, sell, or cross.

(d) Procedures for Reporting Price and Volume<sup>1</sup>

Members that are required to report pursuant to paragraph (b) above shall transmit last sale reports for all purchases and sales in designated securities in the following manner:

(1) For agency transactions, report the number of shares and the price excluding the commission charged.

(2) For dual agency transactions, report the number of shares only once, and report the price excluding the commission charged.

(3) For principal transactions, except as provided below, report each purchase and sale transaction separately and report the number of shares and the price. For principal transactions that are executed at a price which includes a mark-up, mark-down or service charge, the price reported shall exclude the mark-up, markdown or service charge. Such reported price shall be reasonably related to the prevailing market, taking into consider-

<sup>1</sup>For examples of reporting procedures, refer to Part XII of this Schedule, "Reporting Transactions in Nasdaq National Market System Securities."

ation all relevant circumstances including, but not limited to, market conditions with respect to the security, the number of shares involved in the transaction, the published bids and offers with size at the time of the execution (including the reporting firm's own quotation), the cost of execution and the expenses involved in clearing the transaction.

Exception: A "riskless" principal transaction in which a member that is not a market maker in the security after having received from a customer an order to buy, purchases the security as principal from another member or customer to satisfy the order to buy or, after having received from a customer an order to sell, sells the security as principal to another member or customer to satisfy the order to sell, shall be reported as one transaction in the same manner as an agency transaction, excluding the mark-up or mark-down.

*(e) Transactions Not Required To Be Reported*

The following types of transactions shall not be reported:

(1) transactions executed through the Computer Assisted Execution System ("CAES"); the Small Order Execution System ("SOES") or the SelectNet service.

(2) transactions which are part of a primary distribution by an issuer or of a registered secondary distribution (other than "shelf distributions") or of an unregistered secondary distribution;

(3) transactions made in reliance on Section 4(2) of the Securities Act of 1933;

(4) transactions where the buyer and seller have agreed to trade at a price substantially unrelated to the current market for the security, e.g., to enable the seller to make a gift;

(5) purchases or sales of securities effected upon the exercise of an option pursuant to the terms thereof or the exercise of any other right to acquire securities at a preestablished consideration unrelated to the current market.

*(f) Aggregation of Transaction Reports*

(1) Under the following conditions, individual executions of orders in a security at the same price may be aggregated, for transaction reporting purposes, into a single transaction report.

(A) Orders received prior to the opening of the reporting member's market in the security and simultaneously executed at the opening. Also, orders received during a trading halt in the security

and executed simultaneously when trading resumes. In no event shall a member delay its opening for the purpose of aggregating transactions.

(B) Simultaneous executions by the member of customer transactions at the same price, e.g., a number of limit orders being executed at the same time when a limit price has been reached.

(C) Orders relayed to the trading department of the reporting member for simultaneous execution at the same price.

(D) Orders received or initiated by the reporting member which are impractical to report individually and are executed at the same price within 60 seconds of execution of the initial transaction; provided however, that no individual order of 10,000 shares or more may be aggregated in a transaction report and that the aggregated transaction report shall be made within 90 seconds of the initial execution reported therein. Furthermore, it is not permissible for a member to withhold reporting a trade in anticipation of aggregating the transaction with other transactions.

(2) The reporting member shall identify aggregated transaction reports and order tickets of aggregated trades in a manner directed by the Corporation.

**• • • Interpretation of the Board of Governors**

The Association seeks to emphasize the obligations of members to report transactions in designated securities within 90 seconds after execution. All transactions in designated securities not reported within 90 seconds after execution shall be reported as late, and the Association routinely monitors members' compliance with the 90 second requirement. If the Association finds a pattern or practice of unexcused late reporting, that is, repeated reports of executions in designated securities after 90 seconds without reasonable justification or exceptional circumstances, the member may be found to be in violation of Article III, Section 1 of the Association's Rules of Fair Practice. Exceptional circumstances will be determined on a case by case basis and may include conditions such as extreme volatility in a designated security, or in the market as a whole. Timely reporting of all transactions in designated [eligible] securities is necessary and appropriate for the fair and orderly operation of the Association's marketplace, and the Association will view noncompliance as a rule violation.



**Part XIII renumbered as Part XIV**

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**RULES OF PRACTICE AND PROCEDURES  
FOR THE AUTOMATED CONFIRMATION  
TRANSACTION SERVICE**

\* \* \* \* \*

(d) Trade Report Input

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2. When and how trade reports are submitted to ACT — ACT Participants shall transmit trade reports to the system for transactions in *Nasdaq* secu-

rities [that must be reported to the National Trade Reporting System (e.g., transactions in NMS securities of more than 100 shares)] within 90 seconds after execution, or shall utilize the Browse function in ACT to accept or decline trades within 20 minutes after execution, according to the requirement of paragraph 3 of this section.

[ACT Participants shall transmit trade reports to the system for inter-dealer transactions in all eligible securities that are not required to be reported to the National Trade Reporting system within 15 minutes after execution, or shall utilize the Browse function in ACT to accept or decline trades within 20 minutes after execution, according to the requirements of paragraph 3 of this section.]

# Notice To Members

National Association of Securities Dealers, Inc.

May 1992

**Number 92-27****Suggested Routing:\***

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**Subject: Advertising of Collateralized Mortgage Obligations by NASD Members****EXECUTIVE SUMMARY**

The NASD Fixed Income Securities Committee has considered the need for adequate disclosure in advertising relating to collateralized mortgage obligations (CMOs). The committee has determined that such advertising should not include comparisons with other investment products, should include the final maturity date, should describe the initial issue tranche, and should make disclosures regarding the uncertainty of the yield, based on changes in prepayment assumptions and market conditions. The committee recommends that advertising relating to corporate and government CMOs be filed with the NASD Advertising Department for review prior to use. The committee also created a subcommittee to further study concerns about CMO advertising and sales practices.

As interest rates have continued to decline, many NASD members have directed their marketing efforts toward offering products to investors that provide higher yields than could be realized, for example, by certificates of deposit (CDs) or money market funds. One such effort has focused on the offer of collateralized mortgage obligations

through print, television, and radio advertising.

These advertisements are subject to the standards, including filing requirements, set forth in Section 8 of the NASD Government Securities Rules if the CMOs advertised are agency issues. If they are corporate securities registered under the Securities Act of 1933, they are subject to the standards set forth in Article III, Section 35 of the NASD Rules of Fair Practice. The standards prohibit false and misleading advertising and are essentially identical in each of the rules.

Generally, the advertisements the NASD has seen members using characterize the CMOs as offering high yields, safety, government guarantees and high liquidity, and frequently compare them with CDs. CMOs are extremely complex and require full and fair disclosure to assist the investor in understanding them. An article in the September 1991 edition of the *NASD Regulatory and Compliance Alert* outlined some of the important areas of disclosure that should be addressed in members' sales materials and cautioned members about this type of advertising. The text of that article is included in this Notice.

The NASD Advertising Department has since received an increasing number of CMO advertisements for review; there has also been a substantial increase in the number of complaints involving CMOs. Several NASD members have expressed concerns that the complexity and unpredictability

of the securities necessitates a closer look at the regulations governing the content of such materials. All CMOs do not have the same characteristics, and it is difficult, if not impossible, to distinguish the differences based on the content of an advertisement. Even though two CMOs may have the same underlying collateral, they may differ greatly in their prepayment predictability or volatility.

The NASD's Fixed Income Securities Committee has reviewed the concerns relating to CMO advertisements, and it concurred that CMOs are complex instruments not easily understood by investors. It also supported efforts to clarify the standards for such advertisements and the information provided in them. The committee made several recommendations designed to prevent the content of CMO advertisements from being deemed misleading, and it directed the staff to notify the membership of its determinations in both this Notice and in comments resulting from the review of advertising.

The committee recommends the following standards to ensure that CMO advertising is not false or misleading:

- (1) The advertisement must not contain comparisons between CMOs and any other investment vehicle, including CDs.
- (2) The advertisement must prominently display the final maturity date of the security.
- (3) The advertisement must include a description of the initial issue tranche.

- (4) If the advertisement contains an anticipated yield, it must disclose the prepayment assumption used to calculate the yield. It must also disclose that the anticipated yield and average life of the security will fluctuate depending on the actual prepayment experience and current interest rates. This disclosure and the quotation of anticipated yield must be given equal prominence.

The committee believed that false and/or misleading CMO advertising could be prevented if the material was filed with the NASD Advertising Department for review prior to use, and urges members to do so. This filing would allow the department to comment on the advertisement's fairness and reasonableness before the public receives the information. Problem advertisements could therefore be identified and withheld from or modified prior to publication.

The committee created a subcommittee to explore additional alternatives to address problems in the area of CMO advertising and sales practices.

In the meantime, members are reminded of their existing obligations to weigh the suitability of investments for each customer. Members must also ensure that adequate disclosures, including risks, are being made to customers and that their compliance and supervisory efforts focus on these important areas.

Questions regarding this Notice may be directed to Clark Hooper, Advertising Department, at (202) 728-8330.

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### **NASD ADVERTISING DEPARTMENT NOTES SHORTCOMINGS IN CMO LITERATURE**

The NASD's Advertising Department has received member advertising and sales literature promoting collateralized mortgage obligations (CMOs) that did not comply with NASD requirements.

CMOs are bonds backed by a pool of mortgages or mortgage certificates that are issued by either government agencies or private investment banking firms.

Although the collateral backing CMOs is typically issued by a government or government-sponsored entity, only those CMOs issued by a government entity carry a government guarantee.

Advertisements for government agency issues are subject to regulation under Section 8 of the NASD Government Securities Rules, and those for private-issue CMOs fall under Article III, Section 35 of the NASD Rules of Fair Practice. The standards of Section 8 generally match those of Section 35 with one major exception.

Section 8(c)(1) requires NASD members to file government securities advertisements with the Advertising Department within 10 days of first use.

Therefore, if a member publishes or broadcasts an advertisement for a CMO issued by a government agency, the member must submit the piece for review.

Like yields on other mortgage-backed issues, CMO yields are generally quoted as estimated-bond-equivalent yields based on an assumed prepayment rate derived from the Public Securities Association benchmark.

When preparing this type of yield, NASD member firms must use a prepayment rate that is reasonable under the circumstances.

Although the estimated yield lets an investor compare a CMO with conventional bonds, not all investors realize the yield is an estimate and that the actual yield may vary.

Thus, advertisements should identify the yield as an estimate based on an assumed prepayment rate and explain that the investor's actual yield will vary depending on the actual prepayments and market conditions.

The ad should disclose the prepayment as-

sumption. Members should also provide the coupon rate and price of the security used in computing the yield as well as the effective date for calculating the yield. Communications should accurately depict the guarantees associated with CMO securities.

For example, in most cases, it would be misleading to state that CMOs are government-guaranteed securities. Instead, members may characterize government agency issues as "government agency guaranteed." If a private-issue CMO contains a pool of guaranteed securities, this relationship may be described.

For example, an advertisement could state that a Government National Mortgage Association collateralized issue includes securities that carry the full faith and credit guarantee of the U.S. government.

In addition, advertisements should clearly indicate that the guarantees apply only to the timely payment of principal and interest.

Furthermore, when referring to guarantees, communications should state that neither the market value nor the yield of the CMO is guaranteed.

Both Section 8 and Article III, Section 35 prohibit exaggerated and misleading language. Therefore, members should not overstate the relative safety offered by the bonds.

Although CMOs generally offer low credit risk, like all investment securities they are subject to market risk.

In addition, despite the greater predictability of prepayments provided by the CMO structure, the securities remain subject to prepayment risk, and this fact should be made clear.

Members should avoid describing yields for bonds with particularly long maturities (i.e., more than 10 years) as predictable. Any reference to predictability should be balanced by disclosure of the prepayment risks associated with the securities.

Although private issuers frequently obtain credit ratings for their CMO issues, government agencies do not usually seek these ratings because agency securities are considered to have an implied AAA rating.

While the Advertising Department would not object to member firms describing government agency CMOs as having an "implied AAA rating," members should avoid references to "AAA rated" unless such rating has actually been obtained.