NASD

Notice To Members

National Association of Securities Dealers, Inc. August 1992

Number 92-41

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 Article III, Section 26 of the NASD Rules of Fair Practice Regarding Limitations on Mutual Fund Asset-Based Sales Charges; Effective July 7, 1993

EXECUTIVE SUMMARY

On July 7, 1992, the Securities and Exchange Commission (SEC) approved amendments to Article III, Section 26 of the NASD Rules of Fair Practice relating to asset-based sales charges by mutual funds. The amendments establish limits on all types of sales charges whether imposed individually or in combination, with or without service fees, and prohibit certain practices in the marketing of mutual funds. The amendments prohibit members from selling mutual funds that have sales charges in excess of 6.25 percent of new gross sales if the fund also pays a service fee, or 7.25 percent if it does not pay a service fee. The amendments also limit asset-based sales charges to .75 percent of net assets.The amendments take effect on July 7, 1993.

BACKGROUND

The SEC has approved amendments to subsections (b) and (d) of Article III, Section 26 of the NASD Rules of Fair Practice that subject asset-based sales charges of mutual funds to the provisions of the NASD's maximum sales charge rule. Currently, the rule governs only front-end and deferred sales charges.

At the time the maximum sales charge rule was originally adopted, the primary method used by mutual funds to finance sales related expenses was a front-end sales charge deducted from the offering price of mutual fund shares. Consequently, the rule specifically addressed front-end sales charges. Since its adoption in 1975, the mutual fund industry has devised other methods of assessing sales related charges. These methods include "asset-based sales charges" and "deferred sales charges," which include "contingent deferred sales charges," or "CDSCs." Contingent deferred sales charges are "contingent" since they are paid only on redemptions within a specified period after purchase. These charges may be expressed as a percentage of either the original purchase price or the redemption proceeds.

The NASD has applied the existing maximum sales charge rule to contingent deferred sales charges even though such charges arguably do not fit within the literal definition of sales load con-

tained in Section 2(a)(35) of the Investment Company Act of 1940 (Act).[1] The rule has not been applied to asset-based sales charges, however. Such charges are the only type of mutual fund sales compensation not currently subject to NASD regulation. With the advent of these new methods of assessing sales charges on mutual funds, the NASD believed the Rules of Fair Practice should be specifically amended to encompass all sales charges. The NASD wanted to assure a level playing field for all members selling mutual fund shares. Moreover, it believed additional amendments were needed to prevent circumvention of the existing maximum sales charge rule. Funds could use plans approved under SEC Rule 12b-1, either separately or combined with initial or deferred sales loads, to charge investors more for distribution than could have been charged as an initial sales load under the existing maximum sales charge rule.

DESCRIPTION OF AMENDMENTS

The proposed rule change amends Sections (b) and (d) of Article III, Section 26 of the Rules of Fair Practice. Section (b) provides definitions applicable to transactions within Section 26, and Section (d) outlines the maximum sales charge provisions for the offer and sale of mutual fund shares by NASD members.

A. Definitions.

"Person." Section 26(b)(4) has been amended to define "person" as it is defined in the definitions section of the Act.

"Sales Charges." Section 26(b)(8) has been added to define the term "sales charge(s)" to include all charges and fees described in the prospectus that are used to finance sales related expenses. Included in the definition are definitions of the terms front-end as well as deferred and asset-based sales charges. The NASD believes this definition will effectively capture all sales charges for sales-related expenses, no matter how they are imposed, and subject them to the NASD's maximum sales charge rule. The provisions of the rule govern only sales-related charges described as such in the mutual fund prospectus and members may rely on such prospectus disclosure for purposes of this section.

Nominal, i.e., small or minimal, charges incurred by shareholders on redemption of mutual fund shares for special services are excluded from the definition of "deferred sales charges," as are redemption charges that, as described in a prospectus, discourage short-term trading and, generally, apply within one year of purchase of shares. Such nominal and short-term charges may not cover sales-related expenses and must be returned to the mutual fund.

The term "asset-based sales charge" is not defined in terms of a specific rule, such as Rule 12(b)-1 under the Act. It is intended to encompass charges against net assets, disclosed in the prospectus, that are used to pay for sales-related expenses.

"Service Fees." Further, the NASD wishes to clearly distinguish sales charges from service fees for the purposes of the maximum sales charge rule to ensure that members would be able to apply the appropriate caps. Accordingly, the definition of "asset-based sales charges" specifically excludes service fees, and Subsection (b)(9) has been amended to define the term "service fees" as payments by an investment company for personal service and/or the maintenance of shareholder accounts.

During the comment period on these amendments, two commenters requested that the definition of service fees be amended to specifically exclude transfer agent, maintenance, and custodian fees. Service fees are intended to be distinguished from other fees because they relate to personal services provided to the customer, such as a registered representative providing information on investments. Service fees, therefore, do not include recordkeeping charges, accounting expenses, transfer costs, or custodian fees.

Section 26(b)(10) has been added to define the term "prime rate" as the most preferential rate of interest charged by the largest commercial banks on loans to their corporate clients. The prime rate appears daily in *The Wall Street Journal.*

B. Sales Charge Rule.

Section 26(d) embodies the NASD's maximum sales charge rule on mutual fund sales. Under the current rule, NASD members are prohibited from offering or selling shares of an open-end in-

[1] In Section 2(a)(35) of the 1940 Act, the term "sales load" is defined as the difference between the offering price and that part of the offering price that is retained for investment, less any charges that are not for sales or promotional activities. 15 U.S.C. Section 80a-2(a)(35). The NASD interpreted this definition to apply to contingent deferred sales charges and therefore informed its members that it was a misrepresentation to assert that a fund with a contingent deferred sales load was a "no load fund." See, *NASD Notice to Members 89-35*, April 1989.

vestment company "if the public offering price includes a sales charge which is excessive." The NASD has amended this section to be applicable to all types of sales charges, whether they are front-end, deferred, or asset-based. Accordingly, Section 26(d) has been amended to prohibit members from offering or selling mutual fund shares if "sales charges described in the prospectus are excessive." The maximum sales charge rule does not directly govern the mutual fund itself in setting fees. Rather, it governs the NASD member who underwrites and distributes the fund's shares to investors. Sales charges shall be deemed excessive if they do not conform to the provisions of Section 26(d).

Section 26(d)(1) addresses mutual funds that do not have an asset-based sales charge and is substantially the same as the current provision with minor changes designed to include deferred sales charges. New Subsections (d)(1)(E) and (d)(1)(F) codify the principle that, if charges are made for services, or if services are not offered but charges are incurred, an appropriate reduction will be made from the maximum permitted sales charge. Subsection (d)(1)(E) prohibits an NASD member from offering or selling shares in a mutual fund that has an aggregate sales charge of more than 7.25 percent of the offering price if the fund also has a service fee. Subsection (d)(1)(F) permits a fund without an asset-based sales charge that reinvests dividends at the offering price to have a service fee provided that: (1) the aggregate front-end and/or deferred sales charges do not exceed 6.25 percent of the offering price and (2) the fund offers quantity discounts and rights of accumulation.

New Section 26(d)(2) has been added to expand the rule to govern the sale of mutual funds shares with asset-based sales charges. Subsection (d)(2)(A) establishes a sales charge cap of 6.25 percent of new gross sales, plus an interest rate equal to the prime rate plus one percent per annum of the total charges — asset-based, front-end, and deferred — levied by a mutual fund that pays a service fee. Under Subsection (d)(2)(B), a mutual fund with asset-based sales charges, but no service fee, is subject to a sales charge cap of 7.25 percent of the total new gross sales, rather than 6.25 percent, plus an interest rate equal to the prime rate plus one percent, per annum. The caps in new Subsections (d)(2)(A) and (B) are calculated against new gross sales made after the effective date of the new rules. However, these caps also apply to all sales charges which may be imposed on existing shareholders in connection with any transaction which occurs after the effective date of the new rules.

Subsection (d)(2)(C) permits a mutual fund that has had an asset-based sales charge in the past to increase its maximum aggregate sales charge on total new gross sales by applying the appropriate cap of 6.25 percent or 7.25 percent to new gross sales retrospectively from the time it first adopted an asset-based sales charge until the effective date of the amendments. The amount thus calculated is increased by an interest rate equal to the prime rate plus 1 percent per annum and reduced by any sales charges — front-end, deferred, or asset-based — on such sales or from net assets resulting from such sales. The net total is added to the total calculated by the application of the provisions of Subsections (d)(2)(A) or (B). The grand total would be reduced over time by sales charges received after the effectiveness of the proposed amendments. New Subsection (d)(2)(C) permits past unreimbursed sales-related expenses to be accommodated within the provisions of the sales charge rule and provides for their gradual amortization.

During the comment period on the amendments, a commenter noted that the term "plus interest charges on such amount" used in proposed Subparagraphs (d)(2)(A), (d)(2)(B), and (d)(2)(C) would require that interest be calculated on the gross cap rather than the remaining balance and, furthermore, noted that there is no standard mandating the frequency at which the remaining balance be determined. The NASD is therefore clarifying that the interest should be calculated on the remaining balance and not the gross cap.

Under new Subsection (d)(2)(D), mutual funds are permitted to keep records of exchanges between mutual funds in the same complex, between classes of shares of mutual funds with multiple classes, and between series shares of series mutual funds. Such mutual funds may increase the maximum aggregate sales charges permitted under the previous sections by including such exchanges as new gross sales, provided the maximum aggregate sales charges of the mutual fund, class, or series of the redeeming mutual fund are reduced by the amount of the increase.

With regard to exchanges, during the comment period on these amendments, clarification

was requested as to: (i) whether exchanges are treated as new sales or if the number of years in which sales charges were previously paid are taken into consideration; (ii) whether the current market value or the original cost is used; and (iii) what transpires if the "from" fund cap is already at zero. It is the position of the NASD that exchanges are treated as new sales of the fund into which monies are transferred; the current market value of the new fund is used to determine cost and all associated charges; and if the "from" fund is at zero, the new fund sets up new maximums and the old caps would no longer be applicable.

New Subsection (d)(2)(E)(i) prohibits NASD members from offering or selling the shares of a mutual fund that has an asset-based sales charge in excess of .75 percent of its average annual net assets. Subsection 26(d)(2)(E)(ii) prohibits a member from offering or selling the shares of a mutual fund if the caps described in Subsections (d)(2)(A), (B), (C), and (D) are reduced to zero, a mutual fund still continues to receive deferred sales charges on redemption, and such sales charges are used to pay for sales related expenses.

New Section 26(d)(3) prohibits any NASD member or associated person from describing a fund orally or in writing as a "no-load" fund or as having "no sales charge" if the fund has a front-end, deferred, or asset-based sales charge, except for funds which have only combined asset-based sales charges and service fees of no more than .25 percent of average annual net assets. The NASD added this de minimis exception in response to the request of a commenter who argued that funds with Rule 12b-1 fees of .25 percent or less resemble traditional "no-load" funds (funds with no front-end or deferred loads and no Rule 12b-1 fees) much more than load funds (funds with front-end or deferred loads or larger Rule 12b-1 fees). The commenter contended that, without the exception, it would be difficult for investors to distinguish between funds that use relatively small Rule 12b-1 fees to finance advertising and other sales promotion activities and funds that use larger Rule 12b-1 fees as alternatives to front-end sales loads.

New Section 26(d)(4) addresses issues raised by the different accounting approaches used to calculate the maximum sales charge. Because the amendments contemplate a minimum standard of fund-level accounting rather than individual shareholder accounting, it is possible that long-term shareholders in a mutual fund that has an asset-based sales charge may pay more in total sales charges than they would have paid if the mutual fund did not have an asset-based sales charge. In light of this possibility, Section 26(d)(4) prohibits a member from offering or selling shares of such mutual funds if the fund does not disclose this information near the fee table at the front of the prospectus.

Finally, new Section 26(d)(5) prohibits NASD members and their associated persons from offering or selling the shares of a mutual fund if it pays a service fee in excess of .25 of 1 percent of its average annual net assets. With regard to the service fee limitations, one commenter noted that the language of the rule change does not specifically limit fees paid by an "underwriter" to the actual party providing services to the customer. In responding to the comment, the NASD pointed out that, as a matter of NASD jurisdiction, fees paid directly to a member by an investment company may be, and are, limited. Thus, where the "underwriter" uses another member to actually provide the service to the customer, the rule change will limit the investment company's fees to the "underwriter," and the fees paid by the "underwriter" to the member provider may not exceed the limitations set forth in the rule.

These amendments will be effective on July 7, 1993, one year from the date of the SEC's approval. Questions concerning this Notice should be directed to Clark Hooper, Vice President, Investment Companies/Insurance Affiliates at (202) 728-8329 or Elliott R. Curzon, Senior Attorney, Office of General Counsel at (202) 728-8451.

TEXT OF AMENDMENTS TO SECTION 26 OF THE RULES OF FAIR PRACTICE

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

Investment Companies

Sec. 26

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Definitions

(b)

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(4) Person ["Any person"] shall mean "person" ["any person"] as defined in [subsection (a), or "purchaser" as defined in subsection (b), of Rule 22d-1 under] the Investment Company Act of 1940.

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(8) "Sales charge" and "sales charges" as used in subsection (d) of this section shall mean all charges or fees that are paid to finance sales or sales promotion expenses, including front-end, deferred and asset-based sales charges, excluding charges and fees for ministerial, recordkeeping or administrative activities and investment management fees. For purposes of this section, members may rely on the sales-related fees and charges disclosed in the prospectus of an investment company.

(A) A "front-end sales charge" is a sales charge that is included in the public offering price of the shares of an investment company.

(B) A "deferred sales charge" is a sales charge that is deducted from the proceeds of the redemption of shares by an investor, excluding any such charges that are (i) nominal and are for services in connection with a redemption or (ii) to discourage short-term trading, that are not used to finance sales-related expenses, and that are credited to the net assets of the investment company.

(C) An "asset-based sales charge" is a sales charge that is deducted from the net assets of an investment company and does not include a service fee.

(9) "Service fees" as used in subsection (d) of this section shall mean payments by an investment company for personal service and/or the maintenance of shareholder accounts.

(10) "Prime rate" as used in subsection (d) of this section shall mean the most preferential interest rate on corporate loans at large U.S. money center commercial banks.

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Sales Charges

(d) No member shall offer or sell the shares of any open-end investment company or any "single payment" investment plan issued by a unit investment trust (collectively "investment companies") registered under the Investment Company Act of 1940 if the sales charges described in the prospectus are excessive. [if the public offering price includes a sales charge which is excessive, taking into consideration all relevant circumstances.] Aggregate [S]sales charges shall be deemed excessive if they do not conform to the following provisions:

(1) Investment Companies Without an Asset-Based Sales Charge

[(1)](A) Front-end and/or deferred sales charges described in the prospectus which may be imposed by an investment company without an asset-based sales charge [The maximum sales charge on any transaction] shall not exceed 8.5% of the offering price.

[(2)(A)](B)(i) Dividend reinvestment may [shall] be made available at net asset value per share to any person who requests such reinvestment [at least ten days prior to the record date subject only to the right to limit the availability of dividend reinvestment to holders of securities of a stated minimum value, not greater than $1,200].

[(B)](ii) If dividend reinvestment is not made available as specified [on terms at least as favorable as those] in subparagraph (B)(i) [(2)(A)], the maximum aggregate sales charge [on any transaction] shall not exceed 7.25% of the offering price.

[(3)(A)](C)(i) Rights of accumulation (cumulative quantity discounts) may [shall] be made available to any person [for a period of not less than 10 years from the date of first purchase] in accordance with one of the alternative quantity discount schedules provided in subparagraph (D)(i) [(4)(A)] below, as in effect on the date the right is exercised.

[(B)](ii) If rights of accumulation are not made available on terms at least as favorable as those specified in subparagraph (C)(i) [(3)(A)] the maximum aggregate sales charge [on any transaction] shall not exceed:

[(i)](a) 8% of offering price if the provisions of subparagraph (B)(i) [(2)(A)] are met; or

[(ii)](b) 6.75% of offering price if the provisions of subparagraph (B)(i) [(2)(A)] are not met.

[(4)(A)](D)(i) Quantity discounts, if offered, shall be made available on single purchases by any person in accordance with one of the following two alternatives:

[(i)](a) A maximum aggregate sales charge of 7.75% on purchases of $10,000 or more and a maximum aggregate sales charge of 6.25% on pur-

chases of $25,000 or more, or
(b) A maximum aggregate sales charge of 7.50% on purchases of $15,000 or more and a maximum aggregate sales charge of 6.25% on purchases of $25,000 or more.

[(B)](ii) If quantity discounts are not made available on terms at least as favorable as those specified in subparagraph (D)(i) [(4)(A)] the maximum aggregate sales charge [on any transaction] shall not exceed:

[(i)](a) 7.75% of the offering price if the provisions of subparagraphs (B)(i) and (C)(i) [(2)(A) and (3)(A)] are met.

[(ii)](b) 7.25% of the offering price if the provisions of subparagraph (B)(i) [(2)(A)] are met but the provisions of subparagraph (C)(i) [(3)(A)] are not met.

[(iii)](c) 6.50% of the offering price if the provisions of subparagraph (C)(i) [(3)(A)] are met but the provisions of subparagraph (B)(i) [(2)(A)] are not met.

[(iv)](d) 6.25% of the offering price if the provisions of subparagraphs (B)(i) and (C)(i) [(2)(A) and (3)(A)] are not met.

(E) If an investment company without an asset-based sales charge pays a service fee, the maximum aggregate sales charge shall not exceed 7.25% of the offering price.

(F) If an investment company without an asset-based sales charge reinvests dividends at offering price, it shall not offer or pay a service fee unless it offers quantity discounts and rights of accumulation and the maximum aggregate sales charge does not exceed 6.25% of the offering price.

(2) Investment Companies With an Asset-Based Sales Charge

(A) Except as provided in subparagraphs (2)(C) and (2)(D), the aggregate asset-based, front-end and deferred sales charges described in the prospectus which may be imposed by an investment company with an asset-based sales charge, if the investment company has adopted a plan under which service fees are paid, shall not exceed 6.25% of total new gross sales (excluding sales from the reinvestment of distributions and exchanges of shares between investment companies in a single complex, between classes of shares of an investment company with multiple classes of shares or between series shares of a series investment company) plus interest charges on such amount equal to the prime rate plus one percent per annum. The maximum front-end or deferred sales charge resulting from any transaction shall be 6.25% of the amount invested.

(B) Except as provided in subparagraphs (2)(C) and (2)(D), if an investment company with an asset-based sales charge does not pay a service fee, the aggregate asset-based, front-end and deferred sales charges described in the prospectus shall not exceed 7.25% of total new gross sales (excluding sales from the reinvestment of distributions and exchanges of shares between investment companies in a single complex, between classes of shares of an investment company with multiple classes of shares or between series shares of a series investment company) plus interest charges on such amount equal to the prime rate plus one percent per annum. The maximum front-end or deferred sales charge resulting from any transaction shall be 7.25% of the amount invested.

(C) The maximum aggregate sales charge on total new gross sales set forth in subparagraphs (2)(A) and (B) may be increased by an amount calculated by applying the appropriate percentages of 6.25% or 7.25% to total new gross sales which occurred after an investment company first adopted an asset-based sales charge until July 7, 1993, plus interest charges on such amount equal to the prime rate plus one percent per annum less any front-end, asset-based or deferred sales charges on such sales or net assets resulting from such sales.

(D) The maximum aggregate sales charges of an investment company in a single complex, a class of shares issued

by an investment company with multiple classes of shares or a separate series of a series investment company, may be increased to include sales of exchanges shares provided that such increase is deducted from the maximum aggregate sales charges of the investment company, class or series which redeemed the shares for the purpose of such exchanges.

(E) No member shall offer or sell the shares of an investment company with an asset-based sales charge if:

(i) The amount of the asset-based sales charge exceeds .75 of 1% per annum of the average annual net assets of the investment company, or

(ii) Any deferred sales charges deducted from the proceeds of a redemption after the maximum cap described in subparagraphs (2)(A), (B), (C) and (D) has been attained are not credited to the investment company.

(3) No member or person associated with a member shall, either orally or in writing, describe an investment company as being "no load" or as having "no sales charge" if the investment company has a front-end or deferred sales charge or whose total charges against net assets to provide for sales related expenses and/or service fees exceed .25 of 1% of average net assets per annum.

(4) No member or person associated with a member shall offer or sell the securities of an investment company with an asset-based sales charge unless its prospectus discloses that long-term shareholders may pay more than the economic equivalent of the maximum front-end sales charges permitted by this section. Such disclosure shall be adjacent to the fee table in the front section of a prospectus.

(5) No member or person associated with a member shall offer or sell the securities of an investment company if the service fees paid by the investment company, as disclosed in the prospectus, exceed .25 of 1% of its average annual net assets or if a service fee paid by the investment company, as disclosed in the prospectus, to any person who sells its shares exceeds .25 of 1% of the average annual net asset value of such shares.

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NASD

Notice To Members

National Association of Securities Dealers, Inc. August 1992

Number 92-42

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: Penny Stock Risk Disclosure Document

EXECUTIVE SUMMARY

The NASD is providing for members' use the *Penny Stock Risk Disclosure Document* as recently amended by the Securities Exchange Commission (SEC), which brokers/dealers are required to furnish customers prior to engaging in transactions in penny stocks, as defined by the SEC's Penny Stock Disclosure Rules.

SEC Rule 15g-2 is part of the Penny Stock Disclosure Rules adopted pursuant to the *Securities Enforcement Remedies and Penny Stock Reform Act of 1990*. Under Rule 15g-2, which became effective on July 15, 1992, a broker/dealer before effecting a transaction in a penny stock for a customer, must furnish that customer with a *Penny Stock Risk Disclosure Document* containing the precise language and format in Schedule 15G to the Rule. The SEC amended Schedule 15G to include a brief description of a broker/dealer's responsibilities pursuant to SEC Rule 15c2-6[1] and to reflect January 1, 1993 as the effective date for the required disclosure of the: (1) current bid and ask quotation, if any; (2) compensation of the broker/dealer and the salesperson in the transaction; and (3) monthly account statements showing the market value of each penny stock held in the customer's account.

The rule forbids a broker/dealer from omitting, adding to, or altering in any way the language of the disclosure document. The rule also forbids any change in the format of the document and sets minimum typesize requirements.

To assist members in complying with SEC Rule 15g-2, the NASD is publishing the *Penny Stock Risk Disclosure Document* in this Notice. Members are encouraged to photocopy the document onto plain paper for distribution to customers. The SEC staff has advised that members may not use their letterhead paper for copying the document.

Questions concerning this Notice should be directed to Daniel Sibears or Gary Carleton, NASD Compliance Division, at (202) 718-8959.

[1] SEC Release No. 34-30917 (July 13, 1992).

IMPORTANT INFORMATION ON PENNY STOCKS

This statement is required by the U.S. Securities and Exchange Commission (SEC) and contains important information on penny stocks. You are urged to read it before making a purchase or sale.

Penny stocks can be very risky.

• Penny stocks are low-priced shares of small companies not traded on an exchange or quoted on NASDAQ. Prices often are not available. Investors in penny stocks often are unable to sell stock back to the dealer that sold them the stock. Thus, you may lose your investment. Be cautious of newly issued penny stock.

• Your salesperson is not an impartial advisor but is paid to sell you the stock. Do not rely only on the salesperson, but seek outside advice before you buy any stock. If you have problems with a salesperson, contact the firm's compliance officer or the regulators listed below.

Information you should get.

• **Before you buy penny stock**, **[effective January 1, 1993]** federal law requires your salesperson to tell you the "**offer**" and the "**bid**" on the stock, and the "**compensation**" the salesperson and the firm receive for the trade. The firm also must mail a confirmation of these prices to you after the trade.

• You will need this price information to determine what profit, if any, you will have when you sell your stock. The offer price is the wholesale price at which the dealer is willing to sell stock to other dealers. The bid price is the wholesale price at which the dealer is willing to buy the stock from other dealers. In its trade with you, the dealer may add a retail charge to these wholesale prices as compensation (called a "markup" or "markdown").

• The difference between the bid and the offer price is the dealer's "**spread**." A spread that is large compared with the purchase price can make a resale of a stock very costly. To be profitable when you sell, the bid price of your stock must rise above the amount of this spread **and** the compensation charged by both your selling and purchasing dealers. If the dealer has no bid price, you may not be able to sell the stock after you buy it, and may lose your whole investment.

Brokers' duties and customer's rights and remedies.

• If you are a victim of fraud, you may have rights and remedies under state and federal law. You can get the disciplinary history of a salesperson or firm from the NASD at 1-800-289-9999, and additional information from your state securities official, at the North American Securities Administrators Association's central number: (202) 737-0900. You also may contact the SEC with complaints at (202) 272-7440.

FURTHER INFORMATION

THE SECURITIES BEING SOLD TO YOU HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION. MOREOVER, THE SECURITIES AND EXCHANGE COMMISSION HAS NOT PASSED UPON THE FAIRNESS OR THE MERITS OF THIS TRANSACTION NOR UPON THE ACCURACY OR ADEQUACY OF THE INFORMATION CONTAINED IN ANY PROSPECTUS OR ANY OTHER INFORMATION PROVIDED BY AN ISSUER OR A BROKER OR DEALER.

Generally, penny stock is a security that:

- Is priced under five dollars;
- Is **not** traded on a national stock exchange or on NASDAQ (the NASD's automated quotation system for actively traded stocks);
- May be listed in the "pink sheets" or the NASD OTC Bulletin Board;
- Is issued by a company that has less than $5 million in net tangible assets and has been in business less than three years, by a company that has under $2 million in net tangible assets and has been in business for at least three years, or by a company that has revenues of $6 million for 3 years.

Use caution when investing in penny stocks:

1. **Do not make a hurried investment decision**. High-pressure sales techniques can be a warning sign of fraud. The salesperson is not an impartial advisor, but is paid for selling stock to you. The salesperson also does not have to watch your investment for you. Thus, you should think over the offer and seek outside advice. Check to see if the information given by the salesperson differs from other information you may have. Also, it is illegal for salespersons to promise that a stock will increase in value or is risk-free, or to guarantee against loss. If you think there is a problem, ask to speak with a compliance official at the firm, and, if necessary, any of the regulators referred to in this statement.

2. Study the company issuing the stock. Be wary of companies that have no operating history, few assets, or no defined business purpose. These may be sham or "shell" corporations. Read the prospectus for the company carefully before you invest. Some dealers fraudulently solicit investors' money to buy stock in sham companies, artificially inflate the stock prices, then cash in their profits before public investors can sell their stock.

3. **Understand the risky nature of these stocks**. You should be aware that you may lose part or all of your investment. Because of large dealer spreads, you will not be able to sell the stock immediately back to the dealer at the same price it sold the stock to you. In some cases, the stock may fall quickly in value. New companies, whose stock is sold in an "initial public offering," often are riskier investments. Try to find out if the shares the salesperson wants to sell you are part of such an offering. Your salesperson must give you a "prospectus" in an initial public offering, but the financial condition shown in the prospectus of new companies can change very quickly.

4. **Know the brokerage firm and the salespeople with whom you are dealing**. Because of the nature of the market for penny stock, you may have to rely solely on the original brokerage firm that sold you the stock for prices and to buy the stock back from you. Ask the National Association of Securities Dealers, Inc. (NASD) or your state securities regulator, which is a member of the North American Securities Administrators Association, Inc. (NASAA), about the licensing and disciplinary record of the brokerage firm and the salesperson contacting you. The telephone numbers of the NASD and NASAA are listed on the first page of this document.

5. **Be cautious if your salesperson leaves the firm**. If the salesperson who sold you the stock leaves his or her firm, the firm may reassign your account to a new salesperson. If you have problems, ask to speak to the firm's branch office manager or a compliance officer. Although the departing salesperson may ask you to transfer your stock to his or her new firm, you do not have to do so. Get information on the new firm. Be wary of requests to sell your securities when the salesperson transfers to a new firm. Also, you have the right to get your stock certificate from your selling firm. You do not have to leave the certificate with that firm or any other firm.

YOUR RIGHTS

Disclosures to you. Under penalty of federal law, **[effective January 1, 1993]** your brokerage firm must tell you the following information at two different times--**before** you agree to buy or sell a penny stock, and after the trade, by **written confirmation:**

- **The bid and offer price quotes for penny stock, and the number of shares to which the quoted prices apply**. The **bid** and **offer** quotes are the wholesale prices at which dealers trade among themselves. These prices give you an idea of the market value of the stock. The dealer must tell you these price quotes if they appear on an automated quotation system approved by the SEC. If not, the dealer must use its own quotes or trade prices. You should calculate the **spread**, the difference between the bid and offer quotes, to help decide if buying the stock is a good investment.

A lack of quotes may mean that the market among dealers is not active. It thus may be difficult to resell the stock. You also should be aware that the actual price charged to you for the stock may differ from the price quoted to you for 100 shares. You should therefore determine, before you agree to a purchase, what the actual sales price (before the **markup**) will be for the exact number of shares you want to buy.

- **The brokerage firm's compensation for the trade.** A **markup** is the amount a dealer adds to the wholesale offer price of the stock and a **markdown** is the amount it subtracts from the wholesale bid price of the stock as **compensation**. A markup/markdown usually serves the same role as a broker's commission on a trade. Most of the firms in the penny stock market will be dealers, not brokers.

- **The compensation received by the brokerage firm's salesperson for the trade**. The brokerage firm must disclose to you, as a total sum, the cash compensation of your salesperson for the trade that is known at the time of the trade. The firm must describe in the written confirmation the nature of any other compensation of your salesperson that is unknown at the time of the trade.

In addition to the items listed above, your brokerage firm must send to you:

- **Monthly account statements**. **In general, [effective January 1, 1993] your brokerage firm must send you a monthly statement** that gives an estimate of the value of each penny stock in your account, if there is enough information to make an estimate. If the firm has not bought or sold any penny stocks for your account for six months, it can provide these statements every three months.

- **A Written Statement of Your Financial Situation and Investment Goals**. In general, unless you have had an account with your brokerage firm for more than one year, or you have previously bought three different penny stocks from that firm, your brokerage firm must send you a written statement for you to sign that accurately describes your financial situation, your investment experience, and your investment goals, and that contains a statement of why your firm decided that penny stocks are a suitable investment for you. The firm also must get your written consent to buy the penny stock.

Legal remedies. If penny stocks are sold to you in violation of your rights listed above, or other federal or state securities laws, you may be able to cancel your purchase and get your money back. If the stocks are sold in a fraudulent manner, you may be able to sue the persons and firms that caused the fraud for damages. If you have signed an arbitration agreement, however, you may have to pursue your claim through arbitration. You may wish to contact an attorney. The SEC is not authorized to represent individuals in private litigation.

However, to protect yourself and other investors, you should report any violations of your brokerage firm's duties listed above and other securities laws to the SEC, the NASD, or your state securities administrator at the telephone numbers on the first page of this document. These bodies have the power to stop fraudulent and abusive activity of salespersons and firms engaged in the securities business. Or you can write to the SEC at 450 Fifth St., N.W., Washington, D.C. 20549; the NASD at 1735 K Street, N.W., Washington, D.C. 20006; or NASAA at 555 New Jersey Avenue, N.W., Suite 750, Washington, D.C. 20001. NASAA will give you the telephone number of your state's securities agency. If there is any disciplinary record of a person or firm, the NASD, NASAA, or your state securities regulator will send you this information if you ask for it.

MARKET INFORMATION

The market for penny stocks. Penny stocks usually are not listed on an exchange or quoted on the NASDAQ system. Instead, they are traded between dealers on the telephone in the "over-the-counter" market. The NASD's OTC Bulletin Board also will contain information on some penny stocks. At times, however, price information for these stocks is not publicly available.

Market domination. In some cases, only one or two dealers, acting as "market makers," may be buying and selling a given stock. You should first ask if a firm is acting as a **broker** (your agent) or as a dealer. A **dealer** buys stock itself to fill your order or already owns the stock. A **market maker** is a dealer who holds itself out as ready to buy and sell stock on a regular basis. If the firm is a market maker, ask how many other market makers are dealing in the stock to see if the firm (or group of firms) dominates the market. When there are only one or two market makers, there is a risk that the dealer or group of dealers may control the market in that stock and set prices that are not based on competitive forces. In recent years, some market makers have created fraudulent markets in certain penny stocks, so that stock prices rose suddenly, but collapsed just as quickly, at a loss to investors.

Mark-ups and mark-downs. The actual price that the customer pays usually includes the mark-up or mark-down. Markups and markdowns are direct profits for the firm and its salespeople, so you should be aware of such amounts to assess the overall value of the trade.

The "spread." The difference between the bid and offer price is the spread. Like a mark-up or mark-down, the spread is another source of profit for the brokerage firm and compensates the firm for the risk of owning the stock. A large spread can make a trade very expensive to an investor. For some penny stocks, the spread between the bid and offer may be a large part of the purchase price of the stock. Where the bid price is much lower than the offer price, the market value of the stock must rise substantially before the stock can be sold at a profit. Moreover, an investor may experience substantial losses if the stock must be sold immediately.

Example: If the bid is $0.04 per share and the offer is $0.10 per share, the spread (difference) is $0.06, which appears to be a small amount. But you would lose $0.06 on every share that you bought for $0.10 if you had to sell that stock immediately to the same firm. If you had invested $5,000 at the $0.10 offer price, the market maker's repurchase price, at $0.04 bid, would be only $2,000; thus you would lose $3,000, or more than half of your investment, if you decided to sell the stock. In addition, you would have to pay compensation (a "mark-up," "mark-down," or commission) to buy and sell the stock.

In addition to the amount of the spread, the price of your stock must rise enough to make up for the compensation that the dealer charged you when it first sold you the stock. Then, when you want to resell the stock, a dealer again will charge compensation, in the form of a markdown. The dealer subtracts the markdown from the price of the stock when it buys the stock from you. Thus, to make a profit, the bid price of your stock must rise above the amount of the original spread, the markup, and the markdown.

Primary offerings. Most penny stocks are sold to the public on an ongoing basis. However, dealers sometimes sell these stocks in initial public offerings. You should pay special attention to stocks of companies that have never been offered to the public before, because the market for these stocks is untested. Because the offering is on a first-time basis, there is generally no market information about the stock to help determine its value. The federal securities laws generally require broker-dealers to give investors a "prospectus," which contains information about the objectives, management, and financial condition of the issuer. In the absence of market information, investors should read the company's prospectus with special care to find out if the stocks are a good investment. However, the prospectus is only a description of the current condition of the company. The outlook of the start-up companies described in a prospectus often is very uncertain.

For more information about penny stocks, contact the Office of Filings, Information, and Consumer Services of the U.S. Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549, (202) 272-7440.

NASD

Notice To Members

National Association of Securities Dealers, Inc. August 1992

Number 92-43

Suggested Routing:*

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

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

Subject: Labor Day — Trade Date-Settlement Date Schedule

Securities exchanges and The Nasdaq Stock Market[SM] will be closed on Monday, September 7, 1992, in observance of Labor Day. "Regular way" transactions made on the business days immediately preceding that day will be subject to the settlement date schedule listed below.

Trade Date		Settlement Date		Reg. T Date*	
August	28	Sept.	4	Sept.	9
	31		8		10
Sept.	1		9		11
	2		10		14
	3		11		15
	4		14		16
	7	Markets Closed			—
	8		15		17

Brokers, dealers, and municipal securities dealers should use these settlement dates for purposes of clearing and settling transactions pursuant to the NASD Uniform Practice Code and Municipal Securities Rulemaking Board Rule G-12 on Uniform Practice.

Questions regarding the application of these settlement dates to a particular situation may be directed to the NASD Uniform Practice Department at (212) 858-4341.

*Pursuant to Sections 220.8(b)(1) and (4) of Regulation T of the Federal Reserve Board, a broker/dealer must promptly cancel or otherwise liquidate a customer purchase transaction in a cash account if full payment is not received within seven (7) business days of the date of purchase or, pursuant to Section 220.8(d)(1), make application to extend the time period specified. The date by which members must take such action is shown in the column entitled "Reg. T Date."

NASD

Notice To Members

National Association of Securities Dealers, Inc. August 1992

Number 92-44

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: Appointment of a SIPC Trustee for Two Firms

On July 6, 1992, the Securities Investor Protection Corporation (SIPC) instituted a Direct Payment Procedure for:

Alison Baer Securities, Inc.
P.O. Box 811025
Boca Raton, FL 33481-1015.

Questions regarding the firm should be directed to SIPC:

Securities Investor Protection Corporation
805 15th Street, NW, Suite 800
Washington, DC 20005-2207
(202) 371-8300.

On July 9, 1992, the United States District Court for the Southern District of New York appointed Lee S. Richards, III, Esquire, Richards Spears Kibbe & Orbe Trustee for:

W.H. Farr & Co., Inc.
20 Exchange Place
New York, NY 10005.

Questions regarding the firm should be directed to SIPC Trustee:

Lee S. Richards, III, Esquire
Richards Spears Kibbe & Orbe
140 Broadway
New York, NY 10005
(212) 514-9000.

Members may use the "immediate close-out" procedures as provided in Section 59(i) of the NASD's Uniform Practice Code to close out open over-the-counter contracts. Also, Municipal Securities Rulemaking Board Rule G-12(h) provides that members may use above procedures to close out transactions in municipal securities.