SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 211, 231, and 241

[Release No. 33–7049; 34–33741; FR–42; FILE NO. S7–4–94]

Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others

AGENCY: Securities and Exchange Commission.

ACTION: Interpretation; Solicitation of comments.

SUMMARY: The Securities and Exchange Commission ("Commission") is publishing its views with respect to the disclosure obligations of participants in the municipal securities markets under the antifraud provisions of the federal securities laws, both in connection with primary offerings and on a continuing basis with respect to the secondary market. This interpretive guidance is intended to assist municipal securities issuers, brokers, dealers and municipal securities dealers in meeting their obligations under the antifraud provisions. The Commission is seeking comment on issues discussed in this release and possible future agency action.

DATES: This Interpretation is effective March 9, 1994.

Comments should be received on or before July 15, 1994.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Stop 6–9, Washington, DC 20549. Comment letters should refer to File No. S7–4–94. All comments received will be available for public inspection and copying at the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549.

FOR FURTHER INFORMATION CONTACT: Ann D. Wallace ((202) 272–7282), Amy Meltzer Starr ((202) 272–3654), Vincent W. Mathis ((202) 272–3968), Division of Corporation Finance; Janet W. Russell-Hunter (with respect to Sections III.C.6. and V.) ((202) 504–2418), Division of Market Regulation, U.S. Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549.

SUPPLEMENTARY INFORMATION: In a companion release, the Commission is proposing rule amendments that prohibit a broker, dealer or municipal securities dealer from underwriting a municipal issue unless the issuer agrees to disseminate information to the secondary market and from recommending the purchase of a municipal security without reviewing such information.

I. Executive Summary

The recent high volume of municipal securities offerings, as well as the growing ownership of municipal securities by individual investors, has highlighted the need for improved disclosure practices in the municipal securities market, particularly in the secondary market. To encourage and expedite the ongoing efforts by market participants to improve disclosure practices, and to assist market participants in meeting their obligations under the antifraud provisions, the Commission is publishing its views with respect to disclosures under the federal securities laws in the municipal market.

This interpretive release addresses the following:

(1) With respect to primary offering disclosure, despite the significant improvement in disclosure practices in recent years as a result of voluntary initiatives, increased attention needs to be directed at

- Disclosure of potential conflicts of interest and material financial relationships among issuers, advisers and underwriters, including those arising from political contributions;
- Disclosure regarding the terms and risks of securities being offered;
- Disclosure of the issuer's or obligor's financial condition, results of operations, and cash flows. This information should include audited financial statements (or disclosure that the financial statements were not subject to audit) and an explanation of the accounting principles followed in the preparation of the financial statements, unless the statements were prepared in accordance with generally accepted accounting principles ("GAAP") or accompanied by a quantified explanation of any deviation from GAAP;
- Disclosure of the issuer's plans regarding the provision of information to the secondary market; and
- Timely delivery of preliminary official statements to underwriters and potential investors.

(2) The Commission is renewing its recommendation for legislation to repeal the exemption for corporate obligations underlying certain conduit securities from the registration and reporting requirements of the federal securities laws.

(3) Particularly because of their public nature, issuers in the municipal market routinely make public statements and issue reports that can affect the market for their securities; without a mechanism for providing ongoing disclosures to investors, these disclosures may cause the issuer to violate the antifraud provisions.

Basic mechanisms to address potential antifraud liability include:

- Publication of financial information, including audited financial statements and other financial and operating information, on at least an annual basis;
- Timely reporting of material events reflecting upon the creditworthiness of the issuer or the obligor and the terms of its securities, including material defaults, draws on reserves, adverse rating changes and receipt of an adverse tax opinion; and
- Submission of such information to an information repository.

(4) Underwriters and municipal securities dealers are key players in maintaining the quality of disclosure in the municipal securities markets. The underwriter has a duty to review the issuer's disclosure documents before offering, selling or bidding for the securities and to have a reasonable basis for its belief as to the accuracy and completeness of the representations in the documents. Municipal dealers must have a reasonable basis for recommending the purchase of securities.

In a companion release,[1] the Commission is proposing for comment two related rule amendments, the first proposing to prohibit a broker, dealer or municipal securities dealer from underwriting a municipal issue unless the issuer makes a commitment to provide annual and event-related secondary market information to a designated repository; and the second proposing to prohibit a broker, dealer, or municipal securities dealer from recommending purchases of such issues in the secondary market if it does not review such information.

II. Introduction

A. The Municipal Securities Market

As detailed in the recent Staff Report on the Municipal Securities Market, the market for municipal securities is characterized by great diversity and high volume. Issuers, estimated to number approximately 50,000, include state governments, cities, towns, counties, and special subdivisions, such as special purpose districts and public authorities. It is estimated that there currently are 1.3 million municipal issues outstanding, representing approximately $1.2 trillion in securities.[2] In 1993, a record level of over $335 billion in municipal securities was sold, representing over 17,000 issues. This record financing was heavily influenced by refundings. Nevertheless, the level of long term new money financings, representing 49% of financings for the year, reflected continued growth. In 1993, there were $142 billion of new money long term

[1] Exchange Act Release No. 33742 (March 9, 1994) ("Companion Release").

[2] See Division of Market Regulation, Securities and Exchange Commission, *Staff Report on the Municipal Securities Market* ("Staff Report") (Sept. 1993) at 1.

financings, compared to $81 billion in 1988, a 75% increase.[3]

In recent years, the forms of securities used to meet the financing needs of these issuers have become increasingly diverse and complex. For example, conduit bonds, certificates of participation, and a variety of derivative products have joined traditional general obligation and revenue bonds as prevalent forms of municipal financing.[4]

In addition, there has been a change in the investor profile in the municipal securities market. By 1992, individual investors, including those holding through mutual funds, held 75% of the municipal debt outstanding, compared to 44% in 1983.[5]

Along with the changing investor profile, there has been a change in investor strategy. Traditionally, municipal bondholders have been buy and hold investors; however, this strategy has changed significantly with the growth and development of municipal bond funds. Many of these funds actively trade their portfolio securities to take advantage of market conditions or to meet redemption needs.

B. SEC Oversight of the Municipal Securities Market

As the agency charged with administering the federal securities laws and overseeing this nation's securities markets, the Commission has an obligation to protect investors in the municipal markets from fraud, including misleading disclosures. As the New York City report stated nearly two decades ago:

> By virtue of the large dollar volume of municipal securities issued and outstanding each year, such securities are a major factor in the Nation's economy and the national securities markets. In light of the national scope of the municipal securities markets, there is an overriding federal interest in assuring that there is adequate disclosure of all material information by issuers of municipal securities.
>
> Although municipalities have certain unique attributes by virtue of their political nature, insofar as they are issuers of securities, they are subject to the proscription against false and misleading disclosures.[6]

The burgeoning volume and complexity of municipal securities offerings, as well as the retail nature of the market, heighten the need for market participants to seek to prevent fraud through the timely provision of material information concerning municipal issuers and securities.

While Congress exempted offerings of municipal securities from the registration requirements and civil liability provisions of the Securities Act of 1933,[7] and a mandated system of periodic reporting under the Securities Exchange Act of 1934,[8] it did not exempt transactions in municipal securities from the coverage of the antifraud provisions of section 17(a) of the Securities Act,[9] section 10(b) of the Exchange Act, and Rule 10b–5 promulgated thereunder.[10] These antifraud provisions prohibit any person, including municipal issuers and brokers, dealers and municipal securities dealers, from making a false or misleading statement of material fact, or omitting any material facts necessary to make statements made by that person not misleading, in connection with the offer, purchase or sale of any security. In addition, brokers, dealers and municipal securities dealers are subject to regulations adopted by the Commission, including those regulations adopted to define and prevent fraud.[11] Municipal securities dealers are also subject to rules promulgated by the Municipal Securities Rulemaking Board ("MSRB").[12]

C. Disclosure Practices and Calls for Enhanced Disclosure

In the absence of a statutory scheme for municipal securities registration and reporting, disclosure by municipal issuers has been governed by the demands of market participants and antifraud strictures. Spurred by the New York City fiscal crisis in 1975 and the Washington Public Power Supply System defaults,[13] participants in the municipal securities market have developed extensive guidance to improve the level and quality of disclosure in primary offerings of municipal securities, and to a more limited extent, continuing disclosure in the secondary market.

In 1989, the Commission adopted Rule 15c2–12 under the Exchange Act[14] to enhance the quality and timeliness of disclosure to investors in municipal securities.[15] The rule requires that underwriters (both bank and non-bank) of primary offerings of municipal securities with an aggregate principal amount of $1,000,000 or more obtain and distribute to their customers the issuers' official statements for the offerings. This mechanism provides underwriters an opportunity to review the issuer's disclosure documents before commencing sales to investors.[16]

There is a consensus that, over the last two decades, these market and regulatory efforts have improved significantly the quality of primary offering disclosure in the municipal securities markets.[17] Nonetheless, there continue to be concerns with the adequacy of municipal offering disclosure, particularly with respect to offerings of non-general obligation bonds and smaller issues.[18]

Secondary market disclosure practices present greater concerns. Recent highly publicized defaults[19] and refundings,[20]

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[3] "A Decade of Municipal Finance," *The Bond Buyer* (Jan. 6, 1994) at 24.

[4] Staff Report at 1–2.

[5] *The Bond Buyer 1993 Yearbook* ("Bond Buyer 1993 Yearbook") at 61–63.

[6] *Staff Report on Transactions in Securities of the City of New York* ("NY City Report") (Aug. 1977) Chapter III, at 1–2.

[7] See section 3(a)(2) of the Securities Act (15 U.S.C. 77c(a)(2)).

[8] See section 3(a)(29) of the Exchange Act (15 U.S.C. 78c(a)(29)).

[9] 15 U.S.C. 77q(a).

[10] 15 U.S.C. 78j(b); 17 CFR 240.10b–5.

[11] Sections 15(c)(1) and (2) of the Exchange Act (15 U.S.C. 78o(c)(1) and (2)).

[12] See *MSRB Manual* (CCH).

[13] See Securities and Exchange Commission, *Report of the Securities and Exchange Commission on Regulation of Municipal Securities* (1988); Securities and Exchange Commission, *Staff Report on the Investigation in the Matter of Transactions in the Washington Public Power Supply System Securities* (1988); Securities Act Release No. 6021, *Final Report in the Matter of Transactions in the Securities of the City of New York* (Feb. 5, 1979); NY City Report.

[14] 17 CFR 240.15c2–12; see Municipal Securities Disclosure, Securities Exchange Act Release No. 26100 (Sept. 28, 1988), 53 FR 37778 ("Proposing Release"); Municipal Securities Disclosure, Securities Exchange Act Release No. 26985 (July 10, 1989), 54 FR 28799 ("Adopting Release").

[15] Proposing Release, 53 FR at 37779–37782; Staff Report at 25.

[16] Adopting Release, 54 FR at 28800.

[17] National Federation of Municipal Analysts, *Membership Survey Results Fall 1992 Disclosure Survey* ("NFMA Survey"); Public Securities Association, Municipal Securities Disclosure Task Force, *Report: Initial Analysis of Current Disclosure Practices in the Municipal Securities Market* (June 1988) ("PSA Survey") (content and completeness of primary disclosure documents and sufficiency of financial information rated satisfactory to excellent by 94% and 93% of firms responding, respectively).

[18] See Letter to Chairman Levitt from Charles Mires, Allstate Insurance Company (Nov. 4, 1993, as updated Jan. 19, 1994) ("Allstate Letter") (primary market disclosure by conduits found inadequate in 43.8% of rated issues reviewed); NFMA Survey (local housing, special district, hospitals, long term healthcare and industrial development issues were found to provide the least disclosure); PSA Survey (small issue industrial development bonds received a low rating; issues of $10 million or less received a low rating).

[19] Examples include the defaults engendered by the failures of Mutual Benefit Life, Executive Life and Tucson Electric Power, and the bankruptcies arising out of the Colorado Special Districts. See, *e.g.*, Hinden, "Mutual Benefit Life's Collapse Shows Fragility of Bond Guarantees," *The Washington Post* (Jul. 22, 1991) at F 27; Levinson, "No Coverage Against Junk," *Newsweek* (Apr. 22, 1991) at 46; Stamas, "Rep. Dingell Asks SEC to Investigate Defaults by Special Assessment Districts in Colorado," *The Bond Buyer* (Jan. 25, 1991) at 1.

[20] See Gasparino, "Balancing Budgets Through Lease Deals May Pose Credit Risks, Rating Agency Warns," *The Bond Buyer* (Jan. 25, 1993) at 1;

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as well as the tremendous level of issuances during the past two years, have heightened interest in municipal secondary market disclosure.[21] The PSA has testified that today "secondary market information is difficult to come by even for professional municipal credit analysts, to say nothing of retail investors."[22] Substantial issuer information, in the form of official statements, state-required reports, and other public documents, is available from the approximately 20% of municipal issuers that come to market frequently, accounting for 80% of the dollar volume of municipal securities issued.[23] However, the remaining issuers, representing 20% in dollar volume but 80% in number, which come to the market much less frequently, provide substantially less continuing information. Many of these issues are health care issues, housing issues, industrial development bonds, and other conduit financings,[24] financing sectors which have had the greatest incidence of defaults, both monetary and technical.[25] In addition, information often is unavailable for smaller issues of securities of general purpose units of government and the securities of special purpose districts and authorities.[26]

In response to a request by Commission Chairman Arthur Levitt for a recommended "market-participant sponsored solution" to the disclosure issues in the municipal securities market, on December 20, 1993, 12 groups and associations representing a broad range of market participants submitted to the Commission a Joint Statement on Improvements in Municipal Securities Market Disclosure (the "Joint Statement").[27] The Joint Statement sets forth "a framework for improving the availability of information in the marketplace" that calls for both continued market initiatives to improve issuer disclosure and "support from the SEC and the Municipal Securities Rulemaking Board (MSRB)."[28] Among other things, its participants recommend the adoption of a rule or interpretive guidance restricting underwriting of municipal issues unless continuing information covenants are provided by the issuer.

III. Primary Offering Disclosure

A. Application of the Antifraud Provisions

The antifraud provisions of the federal securities laws prohibit fraudulent or deceptive practices in the offer and sale of municipal securities.[29] Disclosure documents used by municipal issuers, such as official statements, are subject to the prohibition against false or misleading statements of material facts, including the omission of material facts necessary to make the statements made, in light of the circumstances in which they are made, not misleading. The adequacy of the disclosure provided in municipal security offering materials is tested against an objective standard: an omitted fact is material if there is a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable [investor]. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.[30]

B. Voluntary Guidelines

In the primary offering of municipal securities, the extensive voluntary guidelines issued by the Government Finance Officers Association ("GFOA") have received widespread acceptance and, among a number of larger issuers, have been viewed as "in essence obligatory rules."[31] Other groups, including the National Federation of Municipal Analysts ("NFMA"), have published voluntary disclosure guidelines covering industry specific sectors, including among others, housing, student loans, transportation and health care.[32] In connection with the offering of municipal securities, the GFOA Guidelines call for:[33]

Herman, "Municipal-Bond Holders: Watch Out for 'Call' Shock," *The Wall Street Journal* (Aug. 29, 1992) at C1; Hume, "Dealer Threatens Suit Over Proposed Call for Escrowed Bonds," *The Bond Buyer* (Nov. 6, 1993) at 4; Hume, "Issuer in Louisiana May Run Afoul of Law if Escrowed Bonds Are Called Next Month," *The Bond Buyer* (Apr. 22, 1993) at 1; Hume, "Rise in Re-Refundings of Escrowed Bonds Likely to Gain Attention at Treasury, SEC," *The Bond Buyer* (May 12, 1992) at 1.

[21] See generally, Testimony of Jeffrey S. Green, General Counsel, Port Authority of New York and New Jersey on behalf of Government Finance Officers Association, before the Subcommittee on Telecommunications and Finance, House Committee on Energy and Commerce, Oct. 7, 1993 ("GFOA Testimony") at 7–9; Remarks by C. Richard Lehmann, President, Bond Investors Association Before the U.S. House of Representatives Subcommittee on Telecommunications and Finance Concerning the Municipal Securities Market, Oct. 7, 1993 ("Lehmann Testimony") at 4–5; Testimony of Andrew R. Kintzinger, President-Elect, National Association of Bond Lawyers, Before the Subcommittee on Telecommunications and Finance, House Committee on Energy and Commerce, Oct. 7, 1993 ("NABL Testimony") at 8–23; Testimony of Harvey Eckert, Chairman of the Blue Ribbon Committee on Secondary Market Disclosure on Behalf of the National Association of State Auditors, Comptrollers and Treasurers Before the Subcommittee on Telecommunications and Finance, House Committee on Energy and Commerce, Oct. 7, 1993 ("NASACT Testimony") at 3–6; Testimony Relating to the Municipal Securities Market given by the National Federation of Municipal Analysts, Katherine Bateman, Chairperson, to the Subcommittee on Telecommunications and Finance, Oct. 7, 1993 ("NFMA Testimony") at 1–7; Statement of Gerald McBride, Chairman, Municipal Securities Division, Public Securities Association, Before the House Committee on Energy and Commerce, Telecommunications and Finance Subcommittee, Oct. 7, 1993 ("PSA Testimony") at 5–7; NASACT, *State and Local Government Securities Markets and Secondary Market Disclosure* (Oct. 1993) at 5; Stamas, "Issuers' Intentions on Secondary Market Disclosure are Starting to Appear in Official Statements," *The Bond Buyer* (Dec. 14, 1992) at 1; Standard & Poor's, "In Support of Secondary Market Disclosure," *CreditWeek Municipal* (Mar. 16, 1992).

[22] PSA Testimony at 5. See also Lehmann Testimony at 4; NASACT Testimony at 3; Nemes, "Investors' Service Steps in to Fill Void in Hospital Data Disclosure," *Modern Healthcare* (Feb. 3, 1992) at 46; Quint, "Credit Markets; Aiming for More Data About Municipal Bonds," *The New York Times* (June 28, 1993) at D5; Schifrin, "Hello, Sucker," *Forbes* (Feb. 1, 1993) at 40.

[23] NASACT, *Report of the Blue Ribbon Committee on Secondary Market Disclosure—Improving Secondary Market Disclosure* (Aug. 1993) ("NASACT Blue Ribbon Committee Report") at 1–2.

[24] See *id.* at 1. See also Allstate Letter.

[25] See Bond Buyer 1993 Yearbook at 3–5; *Municipal Bond Defaults—The 1980's; a Decade in Review* (J.J. Kenny Co., Inc. 1993)("Kenny Default Report"); Public Securities Association, *An Examination of Non-Rated Municipal Defaults 1986–1991* (Jan. 8, 1993)("PSA Default Report"); Staff Report, Appendix B.

[26] See NASACT Blue Ribbon Committee Report at 1–2.

[27] Joint Statement on Improvements in Municipal Securities Market Disclosure ("Joint Statement") (Dec. 20, 1993) at 1. The Joint Statement was submitted by the American Bankers Association's Corporate Trust Committee, American Public Power Association, Association of Local Housing Finance Agencies, Council of Infrastructure Financing Authorities, Government Finance Officers Association, National Association of Bond Lawyers, National Association of Counties, National Association of State Auditors, Comptrollers and Treasurers, National Association of State Treasurers, National Council of State Housing Agencies, National Federation of Municipal Analysts, and Public Securities Association.

[28] Id.

[29] See *In re Washington Public Power Supply System Securities Litigation*, 623 F. Supp. 1466, 1478 (W.D. Wash. 1985). See also *Brown* v. *City of Covington*, 805 F 2d 1266, 1270 (6th Cir. 1986).

[30] *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976).

[31] Letter from Harlan E. Boyles, Treasurer of North Carolina to SEC Chairman Levitt, dated December 7, 1993. See Government Finance Officers Association, Disclosure Guidelines for State and Local Government Securities (Jan. 1991) ("GFOA Guidelines").

[32] See NFMA, *Disclosure Handbook for Municipal Securities 1992 Update* (Nov. 1992) ("NFMA Handbook"). See also Government Accounting Standards Board, *Codification of Government Accounting and Financial Reporting Standards* (2d ed. 1987); PSA, *Recommendations for a Consistent Presentation of Basic Bond Provisions in Official Statements* (Dec. 1989).

[33] GFOA Guidelines at xv–xix (summary).

- An introduction to serve as the guide to the official statement;
- A description of the securities being offered, including complete information regarding the purposes of the offering, the plan of financing, the security and sources of repayment, and the priority of the securities, as well as structural characteristics, such as call provisions, tender options, original issue or deep discount, variable rates, and lease purchase agreements;
- Information regarding the nature and extent of any credit enhancement and financial and business information about the issuer of the enhancement;
- A description of the government issuer or enterprise, including information about the issuer's range or level of service, capacity and demographic factors and, in the case of revenue supported offerings, information on the enterprise's organization, management, revenue structure, results of operations and operating plan;
- With respect to obligations of private profit making and nonprofit conduit issuers, information regarding the business or other activity, including the enterprise's form of organization and management, rate-making or pricing policies, and historical operations and plan of operation;
- A description of the issuer's outstanding debt, including the authority to incur debt, limitations on debt, and the prospective debt burden and rate of its retirement;
- A description of the basic documentation, such as indentures, trust agreements and resolutions authorizing the issuance and establishing the rights of the parties;
- Financial information, including summary information regarding the issuer's or obligor's financial practices and results of operations, and financial statements, prepared in conformity with generally accepted accounting principles and audited in accordance with generally accepted auditing standards;
- A discussion of legal matters, such as pending judicial, administrative, or regulatory proceedings that may significantly affect the securities offered, legal opinions, and tax considerations; and
- A discussion of miscellaneous matters, including ratings and their description and meanings, underwriting arrangements, arrangements with financial advisors, interests of named experts, pending legislation, and the availability of additional information and documentation.

The guidelines prepared by the GFOA and the NFMA provide a generally comprehensive roadmap for disclosure in offering statements for municipal securities offerings. There are, however, areas that need further improvement in both the context of negotiated and competitively bid underwritings. In addition, implementation of these guidelines needs to be extended to the whole market. For example, while large repeat general obligation issuers usually have comprehensive disclosure documents, small issuers and conduit issuers, particularly in the health care, housing and industrial development areas, do not always provide the same quality of disclosure.[34]

C. Areas Where Improvement Is Needed

1. Conflicts of Interest and Other Relationships or Practices

Information concerning financial and business relationships and arrangements among the parties involved in the issuance of municipal securities may be critical to an evaluation of an offering.[35] Recent revelations about practices used in the municipal securities offering process have highlighted the potential materiality of information concerning financial and business relationships, arrangements or practices, including political contributions, that could influence municipal securities offerings. For example, such information could indicate the existence of actual or potential conflicts of interest, breaches of duty, or less than arm's-length transactions. Similarly, these matters may reflect upon the qualifications, level of diligence, and disinterestedness of financial advisers, underwriters, experts and other participants in an offering. Failure to disclose material information concerning such relationships, arrangements or practices may render misleading statements made in connection with the process, including statements in the official statement about the use of proceeds, underwriters' compensation and other expenses of the offering. In addition, investors reasonably expect participants in municipal securities offerings to follow standards and procedures established by such participants, or other governing authorities, to safeguard the integrity of the offering process; accordingly, material deviations from those procedures warrant disclosure.

Existing rules and voluntary guidelines call for certain specific disclosures by offering participants. GFOA guidelines call for offering statement disclosure to investors of contingency fees to named experts, including counsel, and any other interest or connection those parties have with other transaction participants.[36] MSRB rules call for dealer disclosure to issuers and investors of any financial advisory relationship between an issuer and a broker, dealer, or municipal securities dealer, under certain circumstances.[37] MSRB rules also call for dealer disclosure to investors of, among other things, certain fees and expenses in negotiated transactions.[38]

Beyond existing specific disclosure requirements and guidelines, the range of financial and business relationships, arrangements and practices that need to be disclosed depends on the particular facts and circumstances of each case. If, for example, the issuer (or any person acting on its behalf) selects an underwriter, syndicate or selling group member, expert, counsel or other party who has a direct or indirect (for example, through a consultant) financial or business relationship or arrangement with persons connected with the offering process, that relationship or arrangement may be material.[39] Areas of particular concern are undisclosed payments to obtain underwriting assignments and undisclosed agreements or arrangements, including fee splitting, between financial advisers and underwriters.[40] If the adviser is hired to assist the issuer, such relationships, financial or otherwise, may divide loyalties. Similarly, affiliations between sellers of property to be used in a financed project and conduit borrowers raise questions regarding, among other things, the determination of fair market value of the property and self-dealing.

2. Terms and Risks of Securities

Evolution in the financial markets has led to increasingly complex and sophisticated derivative and other municipal products. While these new

[34] See NASACT Blue Ribbon Committee Report at 1–2; Staff Report at 26. Industry participants generally agreed in testimony before the House of Representatives Subcommittee on Telecommunications and Finance on October 7, 1993, that both the greatest disclosure problems and the greatest risk of default were with unrated hospital, housing, special district and industrial development revenue bonds.

[35] See *SEC* v. *Washington County Utility District*, 676 F.2d 218, 222 (6th Cir. 1982) ("Flagrant violations" of antifraud provisions arising from failure to disclose use of proceeds to purchase options on property held by issuer's manager and financial arrangements between the manager and the underwriter).

[36] Section XII.D. of the GFOA Guidelines.

[37] MSRB rule G–23.

[38] MSRB rule G–32. See Section 15B(c)(1) of the Exchange Act (15 U.S.C. 78o–4(c)(1)) (requiring compliance with MSRB rules); MSRB rule G–17.

[39] Gasparino, "The Trouble with Consultants" *The Bond Buyer* (Nov. 16, 1993) at 1. In his testimony before the Subcommittee on Telecommunications and Finance, Andrew Kintzinger, on behalf of the National Association of Bond Lawyers ("NABL"), stated: "[M]embers of the municipal finance bar should work with issuers to develop procurement procedures for state and local governments to ensure that all material financial arrangements between underwriters within the syndicate and between underwriters and financial advisors and possible conflicts of interest between issuers and members of the underwriting syndicate or other participants be accurately documented and disclosed or, if appropriate, prohibited." NABL Testimony at 28. See Joint Statement at 2.

[40] Gasparino, "Several Issuers Start to Scrutinize Ties Between Advisers, Bankers," *The Bond Buyer* (Dec. 27, 1993) at 1. *See* Section XII.C. of the GFOA Guidelines; rule G–23 of the MSRB.

products offer investors a wide range of investment alternatives, in choosing among the alternatives, investors need a clear understanding of the terms and the particular risks arising from the nature of the products.[41]

In particular, investors need to be informed about the nature and effects of each significant term of the debt, including credit enhancements and risk modifiers, such as inverse floaters and detachable call rights. Investors in these securities should be aware of their exposure to interest rate volatility, under all possible scenarios. In addition, any legal risk concerning the issuer's authority to issue securities with unconventional features needs to be disclosed. The PSA recently has identified disclosure that should be provided in connection with the offer of financial instruments that include such features as auction and swap-based inverse floaters and embedded cap bonds.[42]

Credit enhancements are used with increasing frequency in the municipal market. According to published information, over 37% of the dollar volume of new long term issues carry some form of credit enhancement.[43] The existence of bond insurance or other credit enhancement creates the need for disclosure concerning the provider of the credit enhancement and the terms of the enhancement[44] to avoid misleading investors concerning the value of the enhancements provided and the party's ability to fund the enhancement. The GFOA recommends that appropriate financial information about the assets, revenues, reserves and results of operations of credit enhancers be provided in the official statement. In determining the extent of disclosure, consideration should be given to the amount of the enhancement relative to the income and cash flows of the issuer or obligor, conditions precedent to application of the enhancement, duration of the enhancement, and other factors indicating a material relationship between the enhancement and the investor's anticipated return.

In a trend that has become increasingly common, municipal bond insurers are including in indentures provisions that appear to delegate to the bond insurer the ability to modify terms of the indenture, prior to default, without the consent of, or even prior notification to, bondholders.[45] There should be clear disclosure of any such provision that may have a material impact on the rights of bondholders or the obligations of the issuer, including the specific material rights of the bondholder that could be so altered.

3. Financial Information

a. *Financial Accounting.* Sound financial statements are critical to the integrity of the primary and secondary markets for municipal securities, just as they are for corporate securities.[46] The key to the reliability and relevancy of the information contained in the financial statements of a municipal issuer is the use of a comprehensive body of accounting principles consistently applied by the issuer.[47]

Although there continues to be some diversity in the financial reporting practices used in preparing financial statements of governmental issuers, practice in the municipal market is evolving rapidly to reliance on generally accepted accounting principles ("GAAP") as determined by the Government Accounting Standards Board ("GASB").[48] Only two years after GASB was founded in 1984, financial statements prepared in accordance with GAAP, as promulgated by GASB, were required by 75.2% of cities, 78.3% of counties and 69% of school districts responding to a research survey.[49] Forty-six states currently require, or are in the process of establishing a requirement, that state government financial statements be presented in accordance with GAAP.[50] In addition, local as well as state governments that receive significant amounts of federal aid must prepare financial statements in accordance with GAAP or provide information concerning variance from GAAP.[51]

The GFOA Guidelines call for financial statements that are either prepared in accordance with GAAP or accompanied by a quantified (if practicable) explanation of the differences.[52] To avoid misunderstanding, investors need to be informed of the basis for financial statement presentation. Accordingly, when a municipal issuer neither uses GAAP nor provides a quantified explanation of material deviations from GAAP, investors need a full explanation of the accounting principles followed.

b. *Audits.* Investors in the public securities markets have a reasonable expectation that annual financial statements contained in offering documents or periodic reports are subject to audit.[53] In the case of municipal issuers, these financial statement audits are typically conducted by either an independent certified public accountant or a state auditor. Although the frequency and timeliness of audits vary, every state requires some periodic audit verification of government financial statements.[54] A prudent investor needs to be able to evaluate the extent to which he or she can rely on the second look an auditor provides.

Accordingly, the offering statement should state whether the financial statements it contains were audited in accordance with generally accepted auditing standards ("GAAS"), as established by the American Institute of Certified Public Accountants.

c. *Other Financial and Operating Information.* Financial information beyond that contained in the financial statements—provided in tabular and

[41] As the NABL Testimony indicates: "Derivatives are sophisticated securities products designed for sophisticated investors and should not be sold to retail investors generally and certainly not without comprehensive disclosure. If issuers choose to undertake the financial benefits of these sophisticated and complicated transactions, they can assume the financial costs of providing * * * information." NABL Testimony at 22.

[42] PSA, *Recommendation on Dissemination of Product—Specific Terms For Municipal Derivative Products* (1993).

[43] PSA, *Municipal Market Developments* (Aug. 1993) at 5.

[44] *See* Revisions to Rules Regulating Money Market Funds, Securities Act Rel. No. 7038, 58 FR 68585, 68588 (footnote omitted) ("Money Market Fund Release"); Securities and Exchange Commission, *Report by the United States Securities and Exchange Commission on the Financial Guarantee Market: The Use of the Exemption in Section 3(a)(2) of the Securities Act of 1933 for Securities Guaranteed by Banks and the Use of Insurance Policies to Guarantee Debt Securities* (Aug. 28, 1987) ("SEC Financial Guarantee Report") at 82; Adopting Release, 54 FR at 28812.

[45] See Allstate Letter.

[46] See NY City Report at Ch. II p. 92.

[47] See GFOA Guidelines at 50.

[48] The financial statements of corporate obligors backing conduit securities should follow GAAP for such entities, as established by the Financial Accounting Standards Board and other bodies.

[49] Ingram & Robbins, *Financial Reporting Practices of Local Governments*, Government Accounting Standards Board (1987) at 12 (The survey results were based on information received from 567 respondents to a survey questionnaire mailed to 1161 government units).

[50] *State Comptrollers: Technical Activities and Functions* (1992 Edition).

[51] Where state and local governments programs that are subject to the federal "Single Audit Act of 1984," Public Law 98–502 *et seq.* prepare financial statements on a basis other than GAAP, "the audit report should state the nature of the variances therefrom and follow professional guidance for reporting on financial statements which have not been prepared in accordance with GAAP." Office of Management and Budget, "Questions and Answers on the Single Audit Process of OMB Circular A–128, 'Single Audits of State and Local Governments,' " 52 FR at 43716 (Nov. 13, 1987). question 35.

[52] GFOA Guidelines at 45.

[53] See Gauthier, *An Elected Official's Guide to Auditing* (1992) at vii and xi.

[54] State Comptrollers: Technical Activities and Functions: NASACT, *Municipal Task Force Report* (1990) ("NASACT 1990 Task Force Report") at 12.

narrative format, footnotes, supplemental tables, schedules and discussions of operations and financial position—is essential to the fair presentation of an issuer's financial performance and position. As reflected in industry guidelines,[55] the type of information needed (*e.g.*, tax revenue base, budget, demographics, project revenues and operations) varies depending on the type of issuer, the type of security sold, and the sources for repayment of the bond obligations.

There are a number of areas in which greater care needs to be taken to provide investors with adequate information. In a pooled financing structure, such as that used by bond banks, in addition to providing financial information concerning the issuing authority or program in the aggregate, it may be necessary to provide information on participating obligors. This will depend on diversification and risk concentration factors, such as the significance of any single obligor to the overall financing.

Conduit bond issuers need to provide operational information concerning the activities of the private enterprise that will provide the cash flows to service the debt—for example, financial reporting, legal proceedings, changes in indebtedness, defaults and other significant developments relating to the underlying corporate obligor. Where the issuing authority in a conduit financing has no remaining obligation for the repayment of the indebtedness, in providing financial information about the issuing entity (as compared to the obligor on the bonds), care must be taken to avoid misleading investors regarding the sources of repayment.[56]

Municipal issuers also must consider disclosure issues arising from their activities as end users of derivative products. For example, the use of non-exchange traded derivatives to alter interest rate risk exposes the issuer to counterparty credit risk. Disclosure documents need to discuss the market risks to which issuers are exposed, the strategies used to alter such risks and the exposure to both market risk and credit risk resulting from risk alteration strategies. The NFMA has published sector specific secondary market disclosure guidelines calling for a discussion of the issuer's use of derivative products, especially interest rate swaps.[57]

[55] See generally, GFOA Guidelines; NFMA Handbook. *See also infra* n. 84.

[56] See Letter of John Murphy, Executive Director of Association of Local Housing Finance Agencies to Chairman Levitt (Dec. 20, 1993).

[57] NFMA Handbook.

Moreover, in addition to financial and operating data, the official statement may need to include a narrative explanation to avoid misunderstanding and assist the reader in understanding the financial presentation. A numerical presentation alone may not be sufficient to permit an investor to judge financial and operating condition of the issuer or obligor.[58] For example, it may be necessary to explain the presentation of budget information and the relationship of the budget figures to the financial statements.

In addition, issuers must assess whether the future impact of currently known facts mandate disclosure. The GFOA Guidelines call for a description of known facts that would significantly affect the financial information presented or future financial operation of the issuer, as well as a discussion of its projected operations.[59] For example, in a hospital financing, a steadily declining population in the surrounding community that, in the future, would not support the size of facility to be built would be important to investors. Disclosure of such currently known conditions and their future impact is critical to informed decisionmaking.

d. *Timeliness of Financial Statements.* The timeliness of financial information is a major factor in its usefulness. To avoid providing investors with a stale, and therefore potentially misleading, picture of financial condition and results of operations, issuers and obligors need to release their annual financial statements as soon as practical. After extensive discussion with market participants, it appears that, for the most part, audited financial statements of municipal issuers for the most recently completed fiscal year are available within six months after fiscal year end. The six month time period is consistent with the recommendations of NASACT's Blue Ribbon Committee Report.[60] Unaudited financial statements should be provided when available prior to the completion of the audit.

[58] See Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Securities Act Release No. 6835 (May 24, 1989), 54 FR 22427; Securities Act Release No. 6711 (April 24, 1987), 52 FR 13715.

[59] GFOA Guidelines at 55.

[60] See NASACT Blue Ribbon Committee Report at 17. While due dates for audited financial statements of government units differ, a significant majority of states currently require audited financial statements for government units to be filed within six months after the fiscal year end. NASACT 1990 Task Force Report at 12–22.

4. Availability of Continuing Information

An investor's ability to monitor future developments affecting the issuer, as well as the likely liquidity of a security, are important to an investor's evaluation of an offering. The official statement should state clearly whether ongoing disclosure concerning the issuer or obligor will be provided, including the type, timing, and method of providing such information.[61] In deciding whether to purchase the securities or to continue to hold them, investors need to know whether the issuer has committed to provide information on an ongoing basis.[62] The absence of such a commitment can adversely affect the secondary market for the securities and increases the risks of the investment.

As discussed above, the Joint Statement recommends that the Commission adopt a rule prohibiting a municipal securities dealer from underwriting securities absent a commitment to provide ongoing information. In the Companion Release, the Commission is proposing such a rule for comment. In order to fully inform investors, an issuer needs to include in the official statement a description of the scope of its continuing disclosure commitment, the type of information that would be provided, the repositories to which the information would be sent, when annual and other periodic information would be available, and the consequences of the issuer's failure to abide by the requirements of the covenant.

5. Clarity and Conciseness

Like other disclosure documents, official statements need to be clear and concise to avoid misleading investors through confusion and obfuscation. The expanded level of disclosure in official statements and increased sophistication of municipal securities instruments have, in many cases, resulted in longer

[61] See Fall 1992 NFMA Survey. See also American Bankers Association, Corporate Trust Committee, Four Point Public 1991 Disclosure Guidelines for Corporate Trustees ("ABA 1991 Guidelines") at 2; Stamas, "Issuers' Intentions on Secondary Disclosure are Starting to Appear in Official Statements," *The Bond Buyer* (Dec. 14, 1992) at 1.

[62] See MSRB, *Report of the Municipal Securities Rulemaking Board on Regulation of the Municipal Securities Market* (Sept. 1993) at 6–7 (Board announced plan that would include requiring underwriters to recommend to issuers that they provide continuing disclosure to the market and requiring municipal securities dealers to disclose to their customers the negative impact that the lack of secondary market information may have on the value and liquidity of the securities and whether the issuer has agreed to voluntarily provide such disclosures).

and more complex disclosure documents, with the corresponding danger of overly detailed, legalistic, and possibly obtuse disclosure.[63]

The location, emphasis, and context of the disclosure can affect the ability of a reasonable investor to understand the relationship between, and cumulative effect of, the disclosure.[64] As the U.S. Court of Appeals for the Second Circuit has stated:

> [D]isclosures in a prospectus must steer a middle course, neither submerging a material fact in a flood of collateral data, nor slighting its importance through seemingly cavalier treatment. The import of the information conveyed must be neither oversubtle nor overplayed, its meaning accurate, yet accessible.[65]

Appropriate disclosure "is measured not by literal truth, but by the ability of the material to accurately inform rather than mislead" investors.[66] As the Commission has indicated in other contexts, legalistic, overly complex presentations and inattention to understandability can render the disclosure incomprehensible and consequently misleading.[67]

6. Delivery of Official Statements

One of the concerns leading to the adoption of Rule 15c2–12 was that underwriters were not receiving official statements within time periods that would allow them to examine the accuracy of the disclosure.[68] The Commission noted in proposing the rule that a thorough, professional review by underwriters of municipal offering documents could encourage appropriate disclosure of foreseeable risks and accurate descriptions of complex put and call features, as well as novel financing structures now employed in many municipal offerings. In addition, with the increase in novel or complex financings, there may be greater value in having investors receive disclosure documents describing fundamental aspects of their investment. Yet, underwriters are unable to perform this function effectively when offering statements are not provided to them on a timely basis.[69]

To address this concern, the rule requires any underwriter, including lead underwriters, syndicate members, and selling group members that receive in excess of the usual seller's commission, to obtain and review an official statement that is deemed final as of its date by the issuer, except for the omission of certain information, before bidding for, purchasing, offering, or selling municipal securities in a primary offering.

Since the adoption of Rule 15c2–12, however, there have been continued problems with the timeliness of receipt by underwriters of the "near final" official statement required by the Rule.[70] In addition to compromising the ability of an underwriter to make a reasonable investigation of the issuer, this problem also may limit the ability of potential customers to make informed investment decisions. In a recent NFMA survey, 59% of those responding rated the delivery of preliminary official statements in competitive sales as either not very good or poor, and 50% rated the delivery of preliminary official statements in negotiated sales as either not very good or poor.[71]

One cause of delay has been confusion as to the point at which the underwriter must have obtained and reviewed the near final official statement in a negotiated offering. The term "offer" traditionally has been defined broadly under the federal securities laws and, for purposes of Rule 15c2–12, encompasses the distribution of a preliminary official statement by the underwriter, as well as oral solicitations of indications of interest. Thus, prior to the time that the underwriter distributes the preliminary official statement to potential investors, or otherwise begins orally soliciting investors, the rule requires it to have obtained and reviewed a near final official statement. If no offers are made, the underwriter is required to obtain and review a near final official statement by the earlier of the time the underwriter agrees (whether in principle or by signing the bond purchase agreement) to purchase the bonds, or the first sale of bonds to investors.[72]

The Commission has acknowledged that the rule would require greater planning and discipline by some issuers.[73] The Commission anticipated that, in order to allow underwriters to meet their obligation to have a reasonable basis for recommending any municipal securities, issuers would have to begin drafting disclosure documents earlier, and perhaps with greater care than in the past.[74] This result enables underwriters to receive, and if necessary influence the content of, the final official statement before committing themselves to an offering.[75] Moreover, placing an obligation on the issuer to prepare the official statement at an earlier stage is appropriate, because it is the issuer's obligation to ensure that there is timely dissemination of disclosure documents in connection with the offer and sale of the issuer's securities.[76]

D. Conduit Financings

When financing involves a third party as the source of repayment, investors need information on that underlying borrower. The GFOA Guidelines call for description of conduit obligors, which are defined by the GFOA Guidelines to include both private profit-making and nonprofit entities.[77] The suggested

[63] See GFOA Testimony at 6. *See also* Allstate Letter.

[64] *Isquith* v. *Middle South Utilities*, 847 F.2d 186, 201 (5th Cir.), *cert. denied*, 488 U.S. 926 (1988); *Kas* v. *Financial General Bankshares, Inc., et al.*, 796 F.2d 508, 516 (D.C. Cir. 1986); *Kennedy* v. *Tallant*, 710 F.2d 711, 720 (11th Cir. 1983).

[65] *Isquith*, 847 F.2d at 202.

[66] *McMahan & Company, et. al.* v. *Wherehouse Entertainment, Inc.*, 900 F.2d 576, 579 (2d Cir. 1990).

[67] See, *e.g.*, Limited Partnership Reorganizations and Public Offerings of Limited Partnership Interests, Securities Act Release No. 6900 (June 25, 1991) 56 FR 28979, 28980 ("Limited Partnership Release").

[68] Proposing Release, 53 FR at 37781.

[69] Proposing Release, 53 FR at 37782.

[70] As a practical matter, near final official statements distributed to underwriters to satisfy Rule 15c2–12(b)(1) are often the same document as the preliminary official statement distributed to potential customers pursuant to Rule 15c2–12(b)(2). See Mudge Rose Guthrie Alexander & Ferndon (April 4, 1990) ("Mudge Rose") (rejecting the argument that in a negotiated offering, the identification of a credit enhancer and related information about the credit enhancer may be omitted on the assumption that the information depends on pricing). See also Fippinger & Pittman, *Disclosure Obligations of Underwriters of Municipal Securities*, 47 Business Lawyer 127, 140 (Nov. 1991). In addition, underwriters are required to deliver to potential customers, upon request, copies of the final official statement for a specified time period. Rule 15c2–12(b)(4).

[71] NFMA Survey. See also Letter from Jeffrey M. Baker, Chairperson, NFMA Industry Practices and Procedures Committee and Richard A. Ciccarone, Past Chairperson, NFMA Industry Practices and Procedures Committee to Arthur Levitt, Chairman, Securities and Exchange Commission, Christopher A. Taylor, Executive Director, MSRB and Joseph R. Hardiman, President and Chief Executive Officer, National Association of Securities Dealers, Inc. (Oct. 19, 1993) (regarding the timeliness of receipt of near final and preliminary official statements).

[72] See Mudge Rose.

[73] Adopting Release, 54 FR at 28804. The Commission also noted that the requirements of Rule 15c2–12(b)(1) could be met through the use of multiple documents. For example, a frequent issuer might be able to supply a recent official statement, together with supplementary information containing the terms of the current offering, as well as any material changes from the previous offering materials.

[74] Proposing Release, 53 FR at 37790.

[75] *Id.*

[76] See Adopting Release, 54 FR at 28811 N. 84 (official statement is issuer's document).

[77] GFOA Guidelines at 26. In a recent policy statement, the GFOA referred to "conduit bonds" as "municipal securities issued by a state or local government for the benefit of a private corporation or other entity that is ultimately obligated to pay such bonds * * *." GFOA, Committee on Governmental Debt and Fiscal Policy, Improvements in Municipal Securities' Market

information includes the nature and development of the business or other activity to be undertaken by the conduit obligor (including its form of organization and management), location of principal facilities and service area, ratemaking or pricing policies and historical operations and plan of operations.

To address disclosure issues involving conduit financings in a comprehensive fashion, however, legislation addressing the exempt status of conduit securities under the federal securities laws is necessary. Bonds used to finance a project to be used in the trade or business of a private corporation are, from an investment standpoint, equivalent to corporate debt securities issued directly by the underlying corporate obligor.[78] Payments on these types of conduit securities are derived solely from revenues received by the governmental entity under the terms of a contractual agreement, typically a lease or a note, from a private enterprise, rather than from the general credit and taxing power of the governmental issuer. The tax-exempt status of interest payments does not alter the fundamental analysis that these are private obligations, in which the investor looks, and can look, only to a private entity for repayment.

The private nature of many conduit enterprises distinguishes them from traditional municipal financings. The incidence of bond default appears to be inversely related to the degree a financed project represents an essential public service.[79] A study conducted by the PSA on non-rated issues that defaulted found that 75% were issued by local authorities in the areas of health care and industrial related sectors such as energy, chemical, pollution control and industrial development.[80]

Given the essentially private nature of non-governmental industrial development financings, investors need the same disclosure regarding the underlying non-municipal corporate obligor as they would receive regarding any corporate obligor, and the same regulatory and liability scheme should apply. Accordingly, the Commission has consistently supported legislative proposals to amend Section 3(a)(2) of the Securities Act[81] and Section 3(a)(29)[82] of the Exchange Act to remove the registration exemption for the corporate credit underlying municipal conduit securities involving non-governmental industrial development (private activity) financings.[83] The Commission today renews that legislative recommendation.

Pending amendment to the securities laws to eliminate the registration exemption, the disclosure provided by such non-governmental conduit borrowers should be substantially the same as if such conduit borrower were subject to the information requirements of the federal securities laws applicable to the particular conduit borrower. For example, financial statements prepared in accordance with generally accepted accounting principles prescribed by the Financial Accounting Standards Board should be provided.

IV. Disclosure in the Secondary Market for Municipal Securities

While significant progress has been made in primary market disclosure practices in recent years, the same development has not taken place with respect to secondary market disclosure. The GFOA issued separate secondary market disclosure guidelines in 1979, but they have not yet achieved the broad acceptance accorded its primary offering guidance. In the last five years, the NFMA, the National Council of State Housing Agencies, and the Association of Local Housing Authorities have published sector specific guidelines for secondary market disclosure; the National Advisory Council of the National Association of State Auditors, Comptrollers and Treasurers ("NASACT") is in the process of preparing such guidelines for adoption by the states.[84] The GFOA's longstanding Certificate of Achievement program recognizes issuers that have prepared comprehensive annual financial reports meeting its guidelines. The NFMA's Award of Recognition Program likewise recognizes issuers that have committed to provide continuous disclosure.

A. Application of Antifraud Provisions

Participants in the municipal securities market do not dispute the need for ongoing disclosure following an offering of securities, but municipal issuers reportedly resist developing a routine of ongoing disclosure to the investing market because of concerns about the costs of generating and disseminating that information and about potential liability relating to such disclosure. These issuers and obligors are at times advised by their professional advisors that there is no duty under the federal securities laws to make disclosure following the completion of the distribution.[85] At least some municipal issuers thus appear to believe that silence shields them from liability for what may later be found to be false or misleading information. As a practical matter, however, municipal issuers do not have the option of remaining silent. Given the wide range of information routinely released to the public, formally and informally, by these issuers in their day-to-day operations, the stream of information on which the market relies does not cease with the close of a municipal offering. In light of the public nature of these issuers and their accountability and

Disclosure (Feb. 1, 1994) ("GFOA Disclosure Policy Statement").

[78] See Money Market Fund Release, 58 FR at 68588 (proposal to subject tax exempt money market fund investments in conduit securities to restrictions similar to those applicable to securities of comparable obligors offered to taxable funds).

[79] Kenny Default Report at 2.

[80] PSA Default Report at 12.

[81] 15 U.S.C. 77c(a)(2).

[82] 15 U.S.C. 78c(a)(29).

[83] See Remarks of David S. Ruder, Chairman, SEC, "Disclosure in the Municipal Securities Markets," Before the Public Securities Association (Oct. 23, 1987) at 17–18; Letter from John S.R. Shad, Chairman, SEC to Representative Timothy E. Wirth, Chairman, House Subcommittee on Telecommunications, Consumer Protection, and Finance (March 12, 1985); 124 Cong. Rec. 21, 639 (1978) (letter from SEC Chairman Harold M. Williams to Senator Harrison A. Williams). There were two bills introduced, one in 1975 and one in 1978, that would have repealed the exemption from the registration requirements of the Securities Act of 1933. The 1978 bill would have subjected certain industrial development bonds to the registration requirements of the Securities Act of 1933, the filing and qualification provisions of the Trust Indenture Act and the periodic reporting requirements of the Securities Exchange Act of 1934. Neither bill was enacted. *See also* "Municipal Securities Full Disclosure Act of 1976," S. 2969, 94th Cong., 2d. Sess. (Feb. 17, 1976).

Governmental industrial development financings, which would have retained their exempt status under prior proposals, include those financings in which the bonds are repaid from the general revenues of the governmental unit or the project or facility is a public facility (or part of a public facility) and owned and operated by or on behalf of the governmental unit. The prior proposals to register conduit financings would not have affected the separate exemption for securities issued by non-profit charitable organizations in Section 3(a)(4) of the Securities Act (15 U.S.C. 77c(a)(4)).

[84] See Association of Local Housing Finance Agencies, *Guidelines for Information Disclosure to the Secondary Market* (1992) ("Local Housing Guidelines"); National Council of State Housing Agencies, *Quarterly Reporting Format for State Housing Finance Agency Single Family Housing Bonds* (1989) and *Multi-family Disclosure Format* (1991) collectively ("State Housing Guidelines"); NFMA Handbook. *See also* Healthcare Financial Management Association, *Statement of Principles of Public Disclosure of Financial and Operating Information by Healthcare Providers* (Exposure Draft dated Aug. 1, 1993) ("Healthcare Disclosure Principles").

[85] See Stamas, "Issuers' Intentions on Secondary Market Disclosure Are Starting to Appear in Official Statements," *The Bond Buyer* (Dec. 14, 1992) at 1; Stamas, "Why the Issue of Secondary-Market Disclosure Remains on the Back Burner: It Can Be Risky," *The Bond Buyer* (Sept. 20, 1991) at 1; Stamas, "Analysts Warn Issuers About Some Lawyers' Disclosure Advice," *The Bond Buyer* (Jan. 15, 1991) at 1.

governmental functions, a variety of information about issuers of municipal securities is collected by state and local governmental bodies, and routinely made publicly available.[86] Municipal officials also make frequent public statements and issue press releases concerning the entity's fiscal affairs.

A municipal issuer may not be subject to the mandated continuous reporting requirements of the Exchange Act, but when it releases information to the public that is reasonably expected to reach investors and the trading markets, those disclosures are subject to the antifraud provisions.[87] The fact that they are not published for purposes of informing the securities markets does not alter the mandate that they not violate antifraud proscriptions.[88] Those statements are a principal source of significant, current information about the issuer of the security, and thus reasonably can be expected to reach investors and the trading market. As the U.S. Court of Appeals for the Second Circuit has said: "The securities markets are highly sensitive to press releases and to information contained in all sorts of publicly released . . . documents, and the investor is foolish who would ignore such releases."[89] Since investors obtain information concerning the fiscal health of a municipal issuer from its public statements concerning financial and other matters, "[t]he nature of these statements and the assumptions upon which they are based must be carefully and accurately communicated to the public, so that potential investors may be fully informed of all material facts relevant to their investment decision."[90]

The current process by which municipal issuers and their officials release information to market participants does not address the risk of misleading investors, because there is no mechanism for disseminating information about the municipal issuer to the market as a whole. To the contrary, in the municipal market, information released publicly frequently is disseminated only to a narrow segment of the marketplace. For example, market participants who request current information from indenture trustees are often turned away on the grounds that they are not current holders of the securities.[91] As a result, investors purchasing municipal securities in the secondary market risk doing so on the basis of incomplete and outdated information.

Since access by market participants to current and reliable information is uneven and inefficient, municipal issuers presently face a risk of misleading investors through public statements that may not be intended to be the basis of investment decisions, but nevertheless may reasonably be expected to reach the securities markets. As market participants have urged,[92] in order to minimize the risk of misleading investors, municipal issuers should establish practices and procedures to identify and timely disclose, in a manner designed to inform the trading market, material information reflecting on the creditworthiness of the issuer and obligor and the terms of the security.[93]

B. Secondary Market Disclosure

There is general recognition of the need for disseminating comprehensive information on an annual basis and, on a more timely basis, information about material events that reflect on the credit quality of the security.[94]

1. Annual Information

Investors need updated comprehensive information sufficient to enable them to evaluate the financial condition, results of operations and cash flows of the issuer or underlying borrower. Although the issuance of comprehensive annual information has not yet become prevailing practice, it is recommended by industry disclosure guidelines, including those published by the GFOA in connection with its Comprehensive Annual Financial Reports ("CAFRs") award program, NFMA, and the other industry specific guidelines,[95] and is an effective means of providing the market updated information about the issuer and the issue. The GFOA Guidelines for Continuing Disclosure call for, either in an official statement or comprehensive annual report, a description of:

- The issuer and its structure, management, assets and operations;
- The issuer's debt structure (including changes in indebtedness);
- The issuer's finances (including financial condition and results of operations and financial practices of the issuer or the enterprise);
- Legal matters affecting the issuer; including litigation and legislation;
- Ratings; and
- Interests of certain persons.

The GFOA Guidelines also specify additional information to be provided by conduit borrowers. The eligibility criteria for a Certificate of Achievement from GFOA include audited financial statements prepared in accordance with GAAP, reported upon by an independent public auditor. The guidelines for CAFRs include both a financial section and a statistical section.[96]

[86] See NASACT Blue Ribbon Committee Report at 2, 24; NASACT 1990 Task Force Report at 21.

[87] See Public Statements by Corporate Representatives, Securities Act Release No. 6504 (Jan. 20, 1984) 49 FR 2468, 2469; *In re Ames Dept. Stores Inc. Stock Litigation*, 991 F.2d 953, 965–67 (2d Cir. 1993) (with respect to corporate information).

[88] See Fippinger, *The Securities Law of Public Finance* (2d ed. 1993) at 291 ("[P]ress releases, conversations with analysts, information meetings, official comments on budget negotiations, and even angry reactions by public officials to rating agency downgrades" are subject to antifraud provisions).

[89] *Ames*, 991 F.2d at 963 (corporate information).

[90] NY City Report at Ch. III at 2. The report found that public statements by City officials were misleading, since they were characterized by unwarranted reassurances as to the soundness and attractiveness of the City's securities, including statements that the City's budget problems, no matter how serious, had nothing to do with the City's ability to pay its debts. *Id.* at 110–111.

Municipal issuers should also be sensitive to whether their official statements contain forward-looking statements, such as projections of revenues, that remain alive in the market and may require updating in light of subsequent events. Guides for Disclosure of Projections of Future Economic Performance, Exchange Act Rel. No. 5992 (Nov. 7, 1978), 43 FR 53246. To the extent that the official statement in many cases remains the principal (or perhaps even the sole) source of information concerning an outstanding security, the potential for an obligation to update is of particular importance.

[91] Under notice provisions of indentures, the issuer and trustee generally are required to provide notice to existing bondholders of events of default and other significant matters, such as a draw on reserves, a failure to renew a letter of credit, or a substitution of collateral. ABA 1991 Guidelines at 10. Indeed, trustees often deny requests by market participants for information out of concern for liability arising from exceeding the authority set forth in the indenture. Fippinger at 325. This situation led the American Bankers Association Corporate Trust Committee, in cooperation with the National Association of Bond Lawyers, to develop agreed upon guidelines for indenture provisions permitting the trustee to provide public notice of specified events. See ABA 1991 Guidelines.

[92] See GFOA Guidelines at 91–97; Joint Statement.

[93] National Association of Bond Lawyers and Section of Urban, State and Local Government Law, American Bar Association, *Disclosure Roles of Counsel in State and Local Government Securities Offerings* at 135 (forthcoming 1994) (Pre-publication Draft) ("ABA Disclosure Roles") (noting that many municipal issuers have concluded that post-issuance disclosure in accordance with GFOA guidelines can be more efficient and expose them to less potential liability than ad hoc disclosures).

[94] See GFOA Testimony; Mires, "An Investor's Framework for Examining Disclosure Issues and Possible Solutions," *The Bond Buyer* (Feb. 7, 1994) at 24; NASACT Blue Ribbon Committee Report at 7. *See also* PSA Testimony at 6, supporting annual financial statement filing requirements and submission of information regarding any material fact for issuers who borrow $1 million or more annually.

[95] See ABA Disclosure Roles at 134–136; ABA 1991 Guidelines; Association of Local Housing Guidelines; Healthcare Disclosure Principles. The Disclosure Task Force of the National Council of State Housing Agencies is developing standards for the issuance of audited financial and annual reports.

[96] See GFOA Certificate of Achievement for Excellence in Financial Reporting Program; GFOA Guidelines at 64.

For frequent issuers, current information can be disseminated in official statements for new offerings, and thus is readily available without the preparation of a separate annual financial report. Regardless of the form of document relied upon to provide the marketplace with information concerning the financial condition of the issuer or obligor, to minimize risk of misleading investors, issuers or obligors should provide, as discussed above with respect to primary offerings:

- Financial statements that are audited in accordance with GAAS (or disclosure of the absence of such an audit) and that are either prepared in accordance with GAAP, or accompanied by a quantified explanation of material deviations from GAAP or a full explanation of the accounting principles used;
- Other pertinent financial and operating information (depending on the type of issuer and security sold), as well as the sources for repayment—of course, a variety of information may be appropriate for an issuer with a range of outstanding securities with differing characteristics, from general obligation to revenue and conduit bonds; and
- A narrative discussion that analyzes the issuer's or obligor's financial condition, and results of operations, as well as facts likely to have a material impact on the issuer or obligor.

Clarity and conciseness are equally relevant concerns with respect to ongoing disclosures, as with official statements.

As discussed above with respect to offering statements, as a general matter, the annual financial information may reasonably be expected to be made available within six months of the issuer's fiscal year end.[97] For some conduit entities, annual information may not be sufficient and investors may need more frequent periodic financial information. Under guidelines developed by the National Council of State Housing Agencies, for example, current information on loan portfolio status is compiled and disseminated to information repositories on a quarterly basis.[98] Similar ongoing disclosure on a periodic basis appears appropriate for analogous conduit municipal financings such as structured student loan programs, housing and health care financings.

2. Event Disclosure

In addition to periodic information, to assure that participants in the secondary market base their investment decisions on current information, commentators have called for timely disclosure of events that materially reflect on the creditworthiness of municipal securities issuers and obligors and the terms of their securities. There is a general consensus among participants in the municipal securities market that investors need information about the following events, among others, where material:[99]

a. Principal and interest payment delinquencies
b. Nonpayment-related defaults
c. Unscheduled draws on reserves
d. Unscheduled draws on credit enhancements
e. Substitution of credit or liquidity providers, or their failure to perform
f. Adverse tax opinions or events affecting the tax-exempt status of the security
g. Modifications to rights of security holders
h. Bond calls
i. Defeasances
j. Matters affecting collateral
k. Rating changes

3. Dissemination

As discussed above, the municipal market today lacks an effective mechanism for dissemination of material information to investors and the marketplace. To be effective in minimizing the issuer's risk under the antifraud provisions, the annual financial information and event disclosure should be disseminated in a manner reasonably designed to inform the holders of the issuer's securities and the market for those securities.

Trustees can serve as cost effective disseminators of information to the market due to the capacity and duties of trustees under the terms of the indentures, which positions them to have knowledge of the events requiring disclosure, and the ability and authority to communicate with bondholders.[100] The Commission encourages the inclusion of provisions in trust indentures that authorize trustees to transmit information to the market, particularly in structured financings where the issuer's obligations generally are delegated to various participants. Trustees also may provide a service to other small issuers, by enabling them to notify the market in a timely manner and at a lower cost.

The common denominator for current proposals to improve secondary market disclosure for municipal securities is the establishment and designation of one or more information repositories to serve as a collection and access point for annual and current information.[101] Such repositories would serve as predetermined sources for information concerning a particular issuer, allowing participants to verify that they have the latest available information concerning the issuer before recommending, purchasing, or bidding for a security. The repositories would supplement, not substitute for, the existing access bondholders may have to issuers to obtain current information.[102]

In the Companion Release, the Commission is proposing an amendment to Rule 15c2-12 to prohibit, as suggested by the Joint Statement, underwriting of a municipal securities issue unless the issuer of the municipal security has covenanted to provide annual and ongoing disclosure to a repository.

V. Interpretive Guidance With Respect to Obligations of Municipal Securities Dealers

In the Proposing and Adopting Releases for Rule 15c2-12, the

[97] See Section III.C.3.d. above.

[98] State Housing Guidelines.

[99] In 1990, the American Bankers Association Corporate Trust Committee drafted a proposal identifying 16 factors that it believed were important for issuers to disclose to bondholders and the marketplace. American Bankers Association Corporate Trust Committee, *Proposed Disclosure Guidelines for Corporate Trustees* (ABA Draft for Discussion Purposes) (June 12, 1990) ("ABA 1990 Guidelines"). As published in final form in September of 1991 ("ABA 1991 Guidelines"), the Guidelines contained a nonexclusive list of five types of events that could be disclosed by notice to a repository. Numerous market participants have referenced the ABA draft proposal, or variations of that proposal, as a starting point for identifying straightforward, nonjudgmental, categories of events that call for prompt disclosure. An addendum to the Joint Statement provided four examples of "significant information" that the participants considered appropriate for disclosure. The nonexclusive examples were (1) nontechnical defaults, (2) draws from a debt service reserve fund, (3) failure to make a regularly scheduled payment, and (4) any draws on any credit enhancement. Joint Statement, Addendum. The list set forth above is drawn from these proposals.

[100] See ABA 1991 Guidelines at 3.

[101] Consistent with the recent recommendation of the Joint Statement, the GFOA Guidelines call for lodging secondary market disclosure with a repository, as did the ABA guidelines published in 1991. GFOA Guidelines, Procedural Statement No. 8; ABA 1991 Guidelines at 3.

[102] The American Bankers Association Corporate Trust Committee and the National Association of Bond Lawyers, as well as the Joint Statement, have expressed concern that securities depositories and their participants do not retransmit notices they receive from trustees and issuers to the beneficial owners of the issuer's securities. The ABA Corporate Trust Committee sought to address the problem by calling for simultaneous dissemination of the information to the marketplace through an information repository. The National Association of Bond Lawyers has suggested that the Commission promulgate a rule mandating that all depositories and their direct and indirect participants promptly retransmit notices received from the issuer or indenture trustee. While the establishment of information repositories may address the problem to some extent, the Commission staff intends to work with the relevant organizations to assure that steps are taken to provide for consistent retransmission of the information.

Commission set forth its interpretation of the obligation of municipal underwriters under the antifraud provisions of the federal securities laws. The interpretation discussed the duty of underwriters to the investing public to have a reasonable basis for recommending any municipal securities, and their responsibility, in fulfilling that obligation, to review in a professional manner the accuracy of statements made in connection with the offering. The interpretation was set out in the Proposing Release, and modified slightly in the Adopting Release. The Commission reaffirms its Interpretation with respect to underwriters' responsibilities under the antifraud provisions of the federal securities laws.[103]

Furthermore, the Commission believes that it is also appropriate to emphasize the responsibilities of brokers and dealers in trading municipal securities in the secondary market. The Commission historically has taken the position that a broker-dealer recommending securities to investors implies by its recommendation that it has an adequate basis for the recommendation.[104] A dealer, unlike an underwriter, ordinarily is not obligated to contact the issuer to verify information. A dealer must, however, have a reasonable basis for its recommendation.[105] If, based on publicly available information, a dealer discovers any factors that indicate the disclosure is inaccurate or incomplete, or signal the need for further inquiry, a municipal securities dealer may need to obtain additional information, or seek to verify existing information.[106]

One of the rules proposed simultaneously with the issuance of this release would require a broker, dealer or municipal securities dealer to review current information provided by the issuer prior to recommending a transaction in a municipal security. In the absence of such current information, the dealer could not recommend a transaction in the issuer's securities. That rule, which would be applicable to municipal securities issued subsequent to the effective date of the proposed rule, would reinforce the obligations of dealers under the antifraud provisions of the federal securities laws to have a reasonable basis for recommendations of outstanding municipal securities.

The Joint Statement also called for a strengthening of the suitability rules to require disclosure of ratings and whether the issuer has committed to provide annual financial reports. Today, the Commission is proposing amendments to its confirmation rules to require disclosure of the absence of a rating in confirmations. The MSRB has indicated it has under consideration a plan requiring municipal securities dealers to disclose to their customers the importance of secondary market information and whether the issuer has agreed to voluntarily provide such disclosures.[107] The Commission will defer to the MSRB's reexamination of its suitability rules in implementing those aspects of the Joint Statement.

VI. Request for Comments

The Commission intends to continue to monitor developments in municipal securities disclosure practices. Comment is requested regarding the disclosure items discussed in this release, and in particular, items warranting event disclosure. Comment also is requested regarding additional action that should be taken with respect to disclosure in the municipal securities market by the Commission, the MSRB, or Congress.

List of Subjects in 17 CFR Parts 211, 231 and 241

Securities.

Amendment of the Code of Federal Regulations

For the reasons set out in the preamble, title 17 chapter II of the Code of Federal Regulations is amended as set forth below:

PART 211—INTERPRETATIONS RELATING TO FINANCIAL REPORTING MATTERS

1. Part 211, Subpart A, is amended by adding Release No. FR–42 and the release date of March 9, 1994, to the list of interpretive releases.

PART 231—INTERPRETATIVE RELEASES RELATING TO THE SECURITIES ACT OF 1933 AND GENERAL RULES AND REGULATIONS THEREUNDER

2. Part 231 is amended by adding Release No. 33–7049 and the release date of March 9, 1994, to the list of interpretive releases.

PART 241—INTERPRETATIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER

3. Part 241 is amended by adding Release No. 34–33741 and the release date of March 9, 1994, to the list of interpretive releases.

By the Commission.

Dated: March 9, 1994.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 94–5922 Filed 3–16–94; 8:45 am]

BILLING CODE 8010–01–P

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[103] In light of the underwriter's obligation, as discussed in the prior releases, to review the official statement and to have a reasonable basis for its belief in the accuracy and completeness of the official statement's key representations, disclaimers by underwriters of responsibility for the information provided by the issuer or other parties, without further clarification regarding the underwriter's belief as to accuracy, and the basis therefor, are misleading and should not be included in official statements.

[104] See *Donald T. Sheldon*, Securities Exchange Act Release No. 31475 (Nov. 18, 1992); *Elizabeth Bamberg*, Securities Exchange Act Release No. 27672 (Feb. 5, 1990); *Feeney* v. *SEC*, 564 F.2d 260 (8th Cir. 1977); *Nassar & Co.*, Securities Exchange Act Release No. 15347 (Nov. 22, 1978). *See also* Proposing Release, 53 FR at 37787, n.72–73.

[105] *Richard J. Buck & Co.*, 43 SEC 998 (1968), *aff'd sub nom. Hanley* v. *SEC*, 416 F.2d 589 (2d Cir. 1969). *See also* The Obligations of Underwriters, Brokers and Dealers in Distributing and Trading Securities, Particularly of New High Risk Ventures, Securities Act Release No. 5275 (Aug. 9, 1972) 37 FR 16011, 16012–13; *In Re Blumenfeld*, Securities Exchange Act Release No. 16437 (Dec. 19, 1979) (broker-dealer charged unfair mark-ups and recommended transactions in municipal securities without a reasonable basis); *J.A. Winston & Co., Inc.*, 42 S.E.C. 62 (1964) (broker-dealer recommended transactions without a reasonable basis, and made representations that were false and misleading).

[106] *See Merrill, Lynch, Pierce, Fenner & Smith*, Securities Exchange Act Release No. 14149 (Nov. 9, 1977) ("A recommendation by a broker-dealer is perceived by a customer as (and in fact it should be) the product of an objective analysis [which] can only be achieved when the scope of an investigation is extended beyond the company's management); *John R. Brick*, Securities Exchange Act Release No. 11763 (Oct. 24, 1975) ("the professional...is not an issuer. But he is under a duty to investigate and see that his recommendations have a reasonable basis"); *M.G. Davis & Co.*, 44 SEC 153, 157–58 (1970) (broker-dealer registration revoked because "representations and predictions" made and market letter relied on by registrant "were without reasonable basis," and "registrant could not reasonably accept all of the statements in the [market letter] without further investigation"), *aff'd sub nom. Levine* v. *SEC*, 436 F.2d 88 (2d Cir. 1971). *See also Merrill, Lynch, Pierce, Fenner & Smith*, Securities Exchange Act Release No. 14149 (Nov. 9, 1977) (noting that if a broker-dealer lacks sufficient information to make a recommendation, the lack of information is material and should be disclosed).

[107] *See supra* n. 62.

NASD NOTICE TO MEMBERS 94-38

SEC Seeks Comment On Rule 10b-10 Changes And New Rule 15c2-13

Suggested Routing

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

Executive Summary

The Securities and Exchange Commission (SEC) recently published for comment amendments to Rule 10b-10 and a proposed new rule, Rule 15c2-13, under the Securities Exchange Act of 1934. The proposed amendments to Rule 10b-10 specify additional information to be disclosed on customer confirmations. In particular, the changes affect transactions in debt securities. Rule 15c2-13 provides municipal securities customers with disclosure concerning markup/markdown information in riskless principal transactions and whether the security is unrated by a nationally recognized statistical rating organization. Comments are due on or before June 15, 1994.

Background

SEC Rule 10b-10 requires a broker/dealer that effects transactions for customers in securities, other than U.S. savings bonds or municipal securities, to provide a written confirmation to the customer at or before completion of the transaction. The rule also requires disclosure of specified transaction details on the confirmation. Providing written confirmation of a securities transaction forms a basis for customer protection under the federal securities laws.

Description Of Proposals

The proposed amendments and rule would strengthen investor protection by providing customers with additional details about their securities transactions. The SEC took action due to changes in the securities markets and the development of new securities products. The principal amendments address the following:

Disclosure In Riskless Principal Transactions

The SEC would amend Rule 10b-10 to require the disclosure of markup/markdown information for riskless principal trades in debt securities, other than U.S. savings bonds and municipal securities.

Similarly, proposed Rule 15c2-13 would require disclosure of markup/markdown information in riskless principal trades in municipal securities. Unlike current disclosure requirements for riskless principal transactions in equity securities, the proposed amendment and new Rule 15c2-13 do not include an exclusion for market makers. The SEC notes that it omitted this exclusion because market makers have a much more limited function in the debt markets.

Unrated Status Disclosure

Both Rule 10b-10 and new Rule 15c2-13 would require broker/dealers to disclose on customer confirmations whenever a debt security, or a municipal security, has not been rated by a nationally recognized statistical rating organization. The proposal requires only that customers must be informed when the security is not rated. U.S. Treasury securities are excluded from this requirement.

Disclosure In Principal Transactions

Since 1985, Rule 10b-10 has required broker/dealers acting as principals in transactions in Reported Securities to disclose on customer confirmations the reported trade price, the price to the customer, and the difference between the two prices. With the extension of last-sale reporting to additional securities, the SEC now is proposing to require similar disclosure in principal transactions in Nasdaq SmallCap Market℠ securities and regional exchange-listed securities. Members should note that the NASD already

requires that customer confirmations for Nasdaq SmallCap Market securities contain the same disclosures as are required under Rule 10b-10 for Nasdaq/NMS securities.

Disclosure Of SIPC Coverage
The changes to Rule 10b-10 to require broker/dealers not belonging to the Securities Investor Protection Corporation (SIPC) to affirmatively state on the customer confirmation that they are not SIPC members. In addition, the amendment would require disclosure if the account is carried by a broker/dealer that is not a SIPC member.

The SEC notes that this change will reduce the potential for confusion, especially regarding whether SIPC coverage exists for accounts with government securities broker/dealers. This proposed requirement is consistent with the authority granted to the SEC under the Government Securities Act Amendments of 1993.

Asset-Backed Securities Disclosure
In another amendment to Rule 10b-10, the SEC would revise the yield disclosure requirements for asset-backed securities. This amendment would require broker/dealers to disclose yield information for debt instruments that are insulated from prepayment risk or that are subject to predictable yield forecasts.

However, the proposed amendments treat collateralized mortgage obligations (CMOs) differently. A broker/dealer effecting transactions in CMOs would be required to disclose the estimated yield, the weighted average life, and the prepayment assumptions underlying the yield.

Introductory Note
The SEC is proposing to add a brief preliminary note to Rule 10b-10, making explicit the SEC's longstanding position that the rule was not intended to codify all the disclosure that may be needed for a particular transaction. Additional disclosures may be required to satisfy anti-fraud provisions of the federal securities laws. Finally, the SEC is proposing a variety of non-substantive changes to Rule 10b-10 to improve its clarity.

* * * * *

In seeking comment on these changes, the SEC also requested comment on the impact of three-day settlement (T+3) on the confirmation process. Although T+3 does not create compliance problems with regard to Rule 10b-10, the SEC is concerned that accelerated settlement could diminish the confirmation's role as a safeguard against errors, misunderstandings, or other problems associated with a transaction. Should this happen, the SEC questions whether certain information should then be required on customers' periodic account statements.

The SEC request for comments appeared in the March 17, 1994, Federal Register. Members wishing to comment on these proposals have until June 15, 1994, to do so. Comment letters should refer to File No. S7-6-94 and should be sent, in triplicate, to:

Jonathan G. Katz
Secretary
SEC
450 Fifth Street, N.W.
Mail Stop 6-9
Washington, D.C. 20549

Members are requested to send copies of their comment letters to:

Joan Conley
Corporate Secretary
NASD
1735 K Street, N.W.
Washington, D.C. 20006-1500

Questions concerning this Notice may be directed to Janet Marsh, District Coordinator, Compliance Department, (202) 728-8228.

NASD NOTICE TO MEMBERS 94-39

Treasury Implements Buy-In Requirements For Government Securities

Suggested Routing

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

Executive Summary

Effective April 29, 1994, the Department of the Treasury (Treasury) issued regulations under the Government Securities Act of 1986 (GSA) to require broker/dealers to initiate buy-in procedures for mortgage-backed securities that are in a fail-to-receive status for more than 60 calendar days. The amendments also implement buy-in requirements to complete a customer sell order if the government securities have not been received from the customer within 30 calendar days after settlement date. For mortgage-backed securities this time frame is 60 calendar days.

Background

Before these amendments, mortgage-backed securities were not subject to GSA's buy-in requirements. In addition, GSA regulations did not impose a buy-in requirement for customer sell orders where the broker/dealer had not obtained the securities from its customers.

In 1991, Treasury proposed rule changes to subject mortgage-backed securities in a fail-to-receive status to a buy-in requirement. The proposed time frame was 60 calendar days, rather than the existing 30 calendar days applicable to other government securities. Treasury proposed the longer time frame due to the unique nature of the mortgage-backed market, particularly the lengthy settlement cycle. The proposed rulemaking also included buy-in rules for customer sell orders that would apply to all government securities broker/dealers.

Treasury waited to finalize the proposed rules until its rulemaking authority under the GSA was permanently reauthorized on December 17, 1993.

Fail-To-Receive Buy-Ins

Treasury is now adopting without significant changes amendments to paragraphs 403.1, 403.4(g), and 403.5(c)(1)(iii) that were proposed in 1991. These provisions require all government securities broker/dealers that are required to register or file notice pursuant to 15C(a)(1) of the Securities Exchange Act of 1934 to take prompt steps to obtain possession or control of mortgage-backed securities that are in a fail-to-receive status for more than 60 calendar days through a buy-in procedure or otherwise.

To avoid abnormal settlements, Treasury is advising that any buy-in accomplished pursuant to these rules would be allowed to settle on the next regularly scheduled settlement date for that particular class or pool of mortgage-backed securities.

Sell Order Buy-Ins

Treasury also is adding paragraphs 403.4(1) and 403.5(g) to the GSA regulations to require that government securities broker/dealers buy-in customer sell orders in cases where the broker/dealers have not obtained the government securities from the customer within 30 calendar days after settlement date. The 30-calendar-day requirement applies to all government securities, except mortgage-backed securities that must be bought-in within 60 calendar days.

The adopted rules permit the use of alternatives other than purchasing securities (e.g., securities may be borrowed, substituted, or bought back) in closing out orders. Also, the new rules provide an exemption for short sales.

Similar to buy-ins of mortgage-backed securities that are in a fail-to-receive status, broker/dealers will be

allowed to effect buy-ins for customer sell orders of mortgage-backed securities at the next regularly scheduled settlement cycle.

* * * * *

Questions concerning this Notice may be directed to Janet Marsh, District Coordinator, Compliance Department, (202) 728-8228.

NASD NOTICE TO MEMBERS 94-40

NASD Solicits Member Comment On Trading Activity In Advance Of Research Reports; **Comment Period Expires June 15, 1994**

Suggested Routing

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

Executive Summary

The Board of Governors of the NASD is soliciting member comment on a proposed Interpretation under Article III, Section 1 of the NASD Rules of Fair Practice whereby it would be considered a violation of just and equitable principles of trade for members to purposefully establish, increase, or liquidate a position in a security listed on The Nasdaq Stock Market prior to the members' issuance of a research report on that stock. The Board is also soliciting comment on a policy to recommend that member firms develop and implement "Chinese Wall" restrictions to isolate information within individual departments of the firm.

Background And Description Of Policy

In 1991, a New York Stock Exchange (NYSE) memorandum on stock accumulation in advance of issuing research reports was issued to NYSE member firms. That notice stated that where an NYSE member organization intended to purposefully acquire a position in an NYSE-listed security in contemplation of its issuance of a favorable research report, the exchange would find that conduct inconsistent with just and equitable principles of trade. The NYSE interpretation only applied to NYSE-listed securities, and the NASD did not at that time take a formal position on the practice of stock accumulation in advance of research on Nasdaq-listed issues or on third market trading of exchange-listed issues.

Since that time, the NASD has received inquiries from member firms concerning NASD policy with regard to the practice of accumulating inventory positions in Nasdaq-listed securities in contemplation of the issuance of research reports recommending purchase of those securities. For example, a firm's research department might prepare research reports recommending certain Nasdaq-listed securities to its customer base. Before publication of the research reports, however, the trading department of the member firm might accumulate a position in those securities to meet anticipated customer demand for the stocks. Once the stock accumulation had taken place, the firm would issue the recommendations and commence solicitation of orders for the stocks, expecting to fill customer orders from the member firm's inventory position.

In response to these inquiries requesting guidance on the NASD's position relative to Nasdaq-listed companies, the NASD's Market Surveillance Committee (MSC) and Trading Committee reviewed the recommendation of a task force appointed by the MSC to study and develop proposals to address this issue. Both Committees formulated a proposal that the NASD Board of Governors considered and approved. Accordingly, the Board authorized the issuance of this Notice to solicit comment from members on adoption of a new policy that in concept is consistent with the NYSE position.

The proposed NASD Board policy is as follows (the Interpretation follows this Notice):

> Trading activity purposefully establishing, increasing or liquidating a position in a Nasdaq security prior to the issuance of a research report in that security is inconsistent with just and equitable principles of trade in violation of Article III, Section 1 of the Rules of Fair Practice.

In addition, the Board recommended that firms be encouraged to establish

Chinese Wall procedures to control the flow of information between their research and trading departments. Chinese Wall procedures are risk management controls adopted by securities firms that include physical and informational barriers between different departments of firms so that knowledge of upcoming events will be isolated within a single group and not disclosed to other groups that might trade on or otherwise benefit from the information. Because many firms today already use Chinese Wall restrictions between the research and trading departments of their firms, the Board approved a policy to encourage use of Chinese Walls as the preferred method of complying with the Board's new policy.

While the Board's action would not require a member to develop Chinese Wall procedures, the Board noted that Chinese Wall restrictions are the most effective means for a member firm to demonstrate that any trading activity before its issuance of a research report had not been in violation of the policy. Accordingly, if a member decides not to implement Chinese Wall restrictions, it would carry the significantly greater burden of proving that stock accumulations or liquidations had not been purposeful if an NASD investigation into the firm's buying or selling activity were initiated. This approach would make Chinese Walls the recommended and preferred choice, but would allow members to analyze their own environments and choose whether Chinese Wall procedures were appropriate for their firm. The Board believed that although a Chinese Wall would be the preferable method for firms to comply with the standard, they did not believe it appropriate to adopt a mandatory requirement for such procedures.

The Board is soliciting comment from member firms on adoption of the new policy. The Board anticipates that the policy would be an Interpretation of Article III, Section 1 of the Rules of Fair Practice governing just and equitable principles of trade. The Board is also requesting comment on these collateral issues: (1) whether the policy should also apply to third market trading of exchange-listed securities (i.e., apply the policy to non-NYSE member firms trading exchange-listed securities); and (2) whether the policy should apply to non-Nasdaq securities (i.e., issues quoted on the OTC Bulletin Board or in the pink sheets).

Comments should be sent to Joan C. Conley, Secretary, NASD, 1935 K Street, NW, Washington, DC 20006, and should be postmarked **no later than June 15, 1994.** Questions regarding this Notice may be directed to the Market Surveillance Department at (301) 590-6410.

Interpretation Of The Board Of Governors On Member Firm Trading Activity In Securities Prior To Issuance Of Research Reports

(**Note:** New language is underlined.)

The Board of Governors of the NASD is concerned with activities of member firms that purposefully establish or change inventory positions in Nasdaq-listed securities in contemplation of the issuance of research reports recommending purchase or sale of those securities. For example, a firm's research department might prepare research reports recommending certain Nasdaq-listed securities. Prior to publication and dissemination of the research reports, however, the trading department of the member firm might accumulate a position in those securities in order to meet anticipated customer demand for the stocks. Once the stock accumulation had taken place, the firm would issue the recommendations, expecting to fill customer orders from the member firm's inventory position.

Because such trading practices disadvantage the contra parties to the transactions who are unaware of the pending research report, the NASD is issuing this Interpretation and adopting a policy position that would find purposeful trading activity in advance of research reports a violation of just and equitable principles of trade:

> Trading activity purposefully establishing, increasing or liquidating a position in a Nasdaq security prior to the issuance of a research report in that security is inconsistent with just and equitable principles of trade in violation of Article III, Section 1 of the Rules of Fair Practice.

For purposes of this Interpretation, the phrase "purposefully establishing, increasing or liquidating a position" means any trading activity undertaken with the intent of materially altering a firm's position in a security for the purpose of either profiting from or accommodating trading interest subsequent to the publication of the research report.

Hence the policy would not apply to stock accumulations or liquidations from unsolicited order flow from a firm's retail or broker/dealer client base or to research done solely for in-house trading and not intended for external publication.

In addition, the Board is recommending that firms establish effective Chinese Wall policies and procedures to control the flow of

information between their research and trading departments. Chinese Wall procedures are risk management controls adopted by securities firms that include physical and informational barriers between different departments of firms so that knowledge of upcoming transactions will be isolated within a single group and not disclosed to other groups that might trade on or otherwise benefit from the information.

Where the firm has implemented one or a combination of Chinese Wall policies and procedures which are, taking into consideration the nature of the firm's business, reasonably designed to ensure that the individuals responsible for making trading decisions for the firm do not have access to information regarding the intention to release or timing of release of any firm research report and those procedures operated effectively with respect to the research report in question, then neither the firm nor its associated persons will be deemed to have violated thisInterpretation.

While the NASD does not require members to develop Chinese Wall procedures, these restrictions are the most effective means for a member firm to safeguard against the inappropriate flow of sensitive information between research and trading departments and in demonstrating that trading activity had not been purposeful. Accordingly, if the member decides not to implement Chinese Wall restrictions, it bears the significantly greater burden of proving that stock accumulations or liquidations have not been purposeful.

NASD NOTICE TO MEMBERS 94-41

NASD Clarifies Compensation Disclosure Requirements For Mutual Funds

Suggested Routing

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

Executive Summary

In *Notice to Members 94-14*, the NASD provided guidance on compliance with Article III, Section 26 of the Rules of Fair Practice, which requires members to disclose in the fund prospectus any compensation received in the sale of mutual fund securities. This Notice clarifies that the guidance provided in *Notice to Members 94-14* applies to *current* disclosure obligations of members in the sale of mutual fund securities.

Discussion

In March 1994, the NASD issued *Notice to Members 94-14* to help members comply with the disclosure requirements of Article III, Section 26 (l)(1)(C) of the Rules of Fair Practice, which prohibits members from accepting compensation from an underwriter when selling its mutual fund unless such compensation is disclosed in the fund prospectus. The NASD Investment Companies Regulation Department has received a number of inquiries as to whether the guidance provided in the Notice applies to members' current disclosure obligations under Section 26. This question has arisen because many members are aware that the NASD has had pending at the SEC since 1992 a rule filing that would amend the provisions of Section 26 (1). It appears that many members believe the guidance provided in *Notice to Members 94-14* would apply only upon SEC approval of the rule filing.

The NASD is hereby clarifying that the guidance provided in *Notice to Members 94-14* applies now to the current disclosure obligations of members in the sale of mutual fund securities. In publishing *Notice to Members 94-14*, the NASD was addressing its concern that the current level of disclosure in many cases does not meet the requirements of Section 26 (l)(1)(C). The NASD determined to remind members of their obligations under that provision and provide clear guidance to assist members in reviewing and, where necessary, modifying current disclosure in the fund prospectus.

Further, members have asked for clarification of their disclosure obligations under Section 26 when a mutual fund modifies its compensation arrangements to establish a "special" short-term compensation arrangement that is available to all participating members. The NASD agrees with members that this arrangement is not a "special compensation arrangement" that requires detailed disclosure because it is available to all participating members. However, because the special short-term compensation arrangement modifies the compensation provided to participating members, the fund prospectus is required to provide a clear statement of the new maximum cash compensation and/or a generic statement of the type of non-cash compensation to be provided under the short-term arrangement. Therefore, if the prospectus does not contain this disclosure, it should be amended or stickered to provide this information.

Any questions regarding this Notice should be directed to R. Clark Hooper, Vice President, Investment Companies Regulation Department (202) 728-8325.

NASD NOTICE TO MEMBERS 94-42

Nasdaq National Market Additions, Changes, And Deletions As Of April 27, 1994

Suggested Routing

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

As of April 27, 1994, the following 66 issues joined the Nasdaq National Market®, bringing the total number of issues to 3,610:

Symbol	Company	Entry Date	SOES℠ Execution Level
ADAX	Applied Digital Access, Inc.	3/29/94	500
CMSH	Cameron Ashley Inc.	3/29/94	500
CHPP	Champps Entertainment, Inc.	3/29/94	500
ALRT	First Alert, Inc.	3/29/94	200
PCSS	PC Service Source, Inc.	3/29/94	500
PSON	Paul-Son Gaming Corporation	3/29/94	500
REPT	Reptron Electronics, Inc.	3/29/94	1000
AKST	AK Steel Holding Corporation	3/30/94	500
CONE	Conestoga Bancorp, Inc.	3/30/94	500
FKBC	First-Knox Banc Corp.	3/30/94	200
OPPCF	Optima Petroleum Corporation	3/30/94	500
GTFN	Great Financial Corporation	3/31/94	200
MFCX	Marshalltown Financial Corporation	3/31/94	200
PMFI	Perpetual Midwest Financial, Inc.	3/31/94	200
RELY	Reliance Bancorp, Inc.	3/31/94	500
LFSB	LFS Bancorp, Inc.	4/4/94	500
MEGO	Mego Financial Corp.	4/4/94	200
PERM	Permanent Bancorp, Inc.	4/4/94	200
QSII	Quality Systems, Inc.	4/4/94	500
AEIC	Air Express International Corporation	4/5/94	200
AGVS	NDC Automation, Inc.	4/5/94	500
BRBC	Bay Ridge Bancorp, Inc.	4/6/94	500
RARE	Bugaboo Creek Steak House, Inc.	4/6/94	500
HMSR	HemaSure Inc.	4/7/94	500
MTIC	MTI Technology Corporation	4/7/94	500
RCRE	Retirement Care Associates, Inc.	4/7/94	200
SERV	Serving Software, Inc.	4/7/94	500
VVUS	Vivus, Inc.	4/7/94	500
CELL	Wholesale Cellular USA, Inc.	4/7/94	500
CNXS	CNS, Inc.	4/8/94	200
HTPI	Home Theater Products International, Inc.	4/8/94	200
HTPIW	Home Theater Products International, Inc. (Wts 8/14/94)	4/8/94	200
BOOT	LaCrosse Footwear, Inc.	4/8/94	200
REDF	REDFED Bancorp Inc.	4/8/94	500
RMTR	Ramtron International Corporation	4/8/94	200
CPLX	Cerplex Group, Inc. (The)	4/8/94	500
WGTI	Wandel & Goltermann Technologies, Inc.	4/8/94	500
DLGC	Dialogic Corporation	4/12/94	500
SMBC	Southern Missouri Bancorp, Inc.	4/13/94	500
ABTE	Able Telcom Holding Corp.	4/14/94	200
AEOS	American Eagle Outfitters, Inc.	4/14/94	200
HIFI	Cambridge SoundWorks, Inc.	4/14/94	500
LISB	Long Island Bancorp, Inc.	4/14/94	500
NUMR	NUMAR Corporation	4/14/94	500

Symbol	Company	Entry Date	SOES℠ Execution Level
RCHY	Richey Electronics, Inc.	4/14/94	200
XNET	XcelleNet, Inc.	4/14/94	500
DTII	DT Industries, Inc.	4/15/94	500
EDIN	Educational Insights, Inc.	4/15/94	1000
PRHB	Pacific Rehabilitation & Sports Medicine, Inc.	4/15/94	1000
QTXXF	Quartex Corporation (The)	4/15/94	200
GDMIV	Gardner Denver Machinery Inc. (WI)	4/18/94	200
SFTW	Software Professionals, Inc.	4/20/94	1000
CUBE	C-Cube Microsystems Inc.	4/21/94	500
MKFCF	Mackenzie Financial Corporation	4/21/94	500
PSDI	Project Software & Development Inc.	4/21/94	500
QTRN	Quintiles Transnational Corp.	4/21/94	1000
SABR	Saber Software Corporation	4/21/94	500
HART	Heartland Wireless Communications, Inc.	4/22/94	200
MPIX	Microelectronic Packaging, Inc.	4/22/94	500
TNSI	Transaction Network Services, Inc.	4/22/94	1000
HUMCF	Hummingbird Communications, Ltd.	4/25/94	500
SLIQ	Scott's Liquid Gold, Inc.	4/25/94	200
EMLTF	EMCO Limited	4/26/94	200
MKRL	MK Rail Corporation	4/26/94	200
SPPR	Supertel Hospitality, Inc.	4/26/94	500
WABC	Westamerica Bancorporation	4/26/94	500

Nasdaq National Market Symbol And/Or Name Changes

The following changes to the list of Nasdaq National Market securities occurred since March 29, 1994:

New/Old Symbol	New/Old Security	Date Of Change
BSEP/BSPR	BioSepra Inc./BioSepra Inc.	3/29/94
RATL/VRDX	Rational Software Corporation/Verdix Corp.	4/4/94
ASHW/CGOL	Ashworth Inc./Charter Golf Inc.	4/6/94
NOVI/CLDA	Novitron International, Inc./Clinical Data Inc.	4/13/94
HEALW/HEALW	HealthWatch, Inc. (Cl A Wts exp 10/31/94)/ HealthWatch Inc. (Cl A Wts exp 4/30/94)	4/21/94
HEALZ/HEALZ	HealthWatch, Inc. (Cl B Wts exp 10/31/94)/ HealthWatch Inc. (Cl B Wts exp 4/30/94)	4/21/94
GDMI/GDMIV	Gardner Denver Machinery Inc.(S/D 4/29/94)/ Gardner Denver Machinery Inc. (WI)	4/25/94
MMAN/HAKO	Minuteman International Inc./Hako Minuteman Inc.	4/25/94
UMBF/UMSB	UMB Financial Corp./United Missouri Bancshares Inc.	4/26/94

Nasdaq National Market Deletions

Symbol	Security	Date
TRLS	Thousand Trails, Inc.	3/30/94
FBRX	Fibronics International Inc.	3/31/94
FMSI	Fidelity Medical, Inc.	4/4/94
ISLH	International Holding Capital Corp.	4/4/94
TOCRZ	Tocor II, Inc. (Uts exp '96)	4/4/94
VMXI	VMX, Inc.	4/4/94
CREI	Care Enterprises, Inc.	4/5/94
CNCN	Citizen's National Corporation	4/5/94
AGCO	AGCO Corporation	4/6/94
AGCOZ	AGCO Corporation (Depository Shs)	4/6/94
MMGI	Medical Marketing Group, Inc.	4/6/94
CWTR	California Water Service Company	4/8/94
CHOL	Central Holding Company	4/11/94
HBSI	Hamptons Bancshares, Inc.	4/11/94
LAWR	CMS/DATA Corporation	4/14/94
CINNA	Citizens, Inc. (Cl A)	4/14/94
NWOR	Neworld Bancorp, Inc.	4/15/94
SBRNQ	SANBORN INC.	4/15/94
SYMKE	Sym-Tek Systems, Inc.	4/15/94
GRND	Grand Casinos, Inc.	4/20/94
RCOME	Regal Communications Corporation	4/20/94
SUMH	Summit Health Ltd.	4/20/94
CDCC	ChemDesign Corporation	4/22/94
GWCC	GWC Corporation	4/22/94
CARL	Carl Karcher Enterprises, Inc.	4/25/94
HFMO	Home Federal Bancorp	4/25/94
KSRCE	Kendall Square Research Corporation	4/26/94

Questions regarding this Notice should be directed to Mark A. Esposito, Supervisor, Market Listing Qualifications, at (202) 728-8002. Questions pertaining to trade reporting rules should be directed to Bernard Thompson, Assistant Director, NASD Market Surveillance, at (301) 590-6436.

NASD NOTICE TO MEMBERS 94-43

Fixed Income Pricing System Additions, Changes, And Deletions As Of April 29, 1994

Suggested Routing

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

As of April 29, 1994, the following bonds were added to the Fixed Income Pricing System℠:

Symbol	Name	Coupon	Maturity
BYX.GA	Bayou Steel Corp La Place	10.250	3/1/01
BRRY.GA	Berry Plastics	12.250	4/15/04
CALL.GB	NEXTEL Communications Inc.	9.750	8/15/04
REVL.GD	Revlon Consumer Prod.	10.500	2/15/03
USAR.GC	US Air Inc.	9.625	2/1/01

FIPS Symbol And/Or Name Changes

The following changes to the list of FIPS bonds occurred since April 11, 1994:

New/Old Symbol	New/Old Name	Coupon	Maturity
SCTG.GA/SCOT.GA	Scotsman Grp/Scotsman Grp	9.500	12/15/00
TTRR.GA/TTRA.GA	Tracor/Tracor	14.000	8/1/98
TTRR.GB/TTRA.GB	Tracor/Tracor	16.000	8/1/00
TTRR.GC/TTRA.GC	Tracor/Tracor	10.875	8/15/01

All of the bonds listed above are subject to trade-reporting requirements. Questions pertaining to trade-reporting rules should be directed to Bernard Thompson, Assistant Director, NASD Market Surveillance, at (301) 590-6436.

NASD DISCIPLINARY ACTIONS

Disciplinary Actions Reported For May

The NASD® has taken disciplinary actions against the following firms and individuals for violations of the NASD Rules of Fair Practice; securities laws, rules, and regulations; and the rules of the Municipal Securities Rulemaking Board. Unless otherwise indicated, suspensions will begin with the opening of business on Monday, May 16, 1994. The information relating to matters contained in this Notice is current as of the fifth of this month. Information received subsequent to the fifth is not reflected in this edition.

Firms Expelled, Individuals Sanctioned

Brighton Financial Corporation (Houston, Texas) and Harrell Ray Blacklock, Jr. (Registered Principal, Houston, Texas) were fined $50,000, jointly and severally. The firm was expelled from NASD membership and Blacklock was barred from association with any NASD member in any capacity. The sanctions were based on findings that in a contingent offering, the firm, acting through Blacklock, failed to establish and maintain an escrow account for the deposit and retention of customer and investor funds, and failed to return funds to the investors when the contingency was not met. The firm and Blacklock also failed to establish a reserve bank account, to compute reserve requirements, and to obtain a bank notification letter, in violation of Securities and Exchange Commission (SEC) Rule 15c3-3.

In addition, the firm, acting through Blacklock, failed to maintain its required minimum net capital, to give telegraphic notice of its net capital deficiencies, and to abide by its restrictive letter agreement with the NASD. The firm, acting through Blacklock, also made improper use of customer funds by withdrawing $146,700 and converting the funds to a use not intended by customers.

The NASD also determined that the firm, acting through Blacklock, failed to file its FOCUS Part I report.

Omni Securities, Inc. (Dallas, Texas) and Michael Timothy Churchill (Registered Representative, Plano, Texas) were fined $25,000, jointly and severally. The firm was expelled from NASD membership and Churchill was barred from association with any NASD member in any capacity. The sanctions were based on findings that the firm, acting through Churchill, conducted a securities business while failing to maintain its minimum required net capital and failed to file its FOCUS Part IIA reports. In addition, the firm, acting through Churchill, failed to file its annual audited financial report with the NASD.

Brooks Securities, Inc. (Cleveland, Ohio), Cleveland Clifford Brooks (Registered Principal, Shaker Heights, Ohio), and **Eric L. Small (Registered Representative, Shaker Heights, Ohio)** submitted an Offer of Settlement pursuant to which the firm was fined $15,000 and suspended from underwriting for 30 days. Brooks was barred from association with any NASD member in a principal capacity and Small was suspended from association with any NASD member in any capacity for one business day. In addition, the firm and Small were fined $5,000, jointly and severally and the firm and Brooks were fined $25,000, jointly and severally. Without admitting or denying the allegations, the respondents consented to the described sanctions

and to the entry of findings that the firm and Brooks failed to supervise representatives of the firm adequately and filed a false *Uniform Termination Notice for Securities Industry Registration (Form U-5)* concerning the termination of a registered representative. In addition, the NASD found that the firm, acting through Brooks and Small, conducted a securities business while failing to maintain sufficient net capital.

Barrett Day Securities, Inc. (New York, New York), David Berger (Registered Principal, Roslyn, New York), Barry Leonard Schwartz (Registered Principal, Huntington, New York), and **Phillip Edwin Bredow (Registered Principal, Ozone Park, New York)** submitted an Offer of Settlement pursuant to which the firm was fined $10,000 and ordered to disgorge $82,419.01 to public customers. Berger and Schwartz were each fined $10,000 and suspended from association with any NASD member as general securities principals for 10 business days. Bredow was fined $2,500 and suspended from association with any NASD member as a general securities principal for three business days.

Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Berger and Schwartz, dominated and controlled the market for a common stock by charging prices to public customers that were unfair and included excessive and fraudulent markups ranging from 81 to 100.5 percent over the prevailing market price. The NASD also found that the firm, acting through Berger, Bredow, and Schwartz, failed to establish and maintain a supervisory system that was reasonably designed to achieve compliance with applicable securities laws and regulations and the NASD Rules of Fair Practice. In addition, the findings stated that the firm, acting through Berger, Bredow, and Schwartz, failed to reasonably supervise an individual to ensure that the prices charged to public customers on principal transactions were fair.

Firms And Individuals Fined

Dickinson & Co. (Des Moines, Iowa) and **Albert Thomas Ayala (Registered Principal, Colts Neck, New Jersey)** submitted an Offer of Settlement pursuant to which they were fined $10,000, jointly and severally. The firm was also ordered to pay $51,988.54 in restitution to public customers. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that in violation of the NASD Mark-Up Policy, the firm, acting through Ayala, effected corporate securities transactions as principal at prices that were not fair and reasonable with markups or markdowns ranging from 6.25 to 37.931 percent. The NASD also found that, in a private best efforts, minimum-maximum contingency offering, the firm failed to terminate the offering when the contingency was not met and failed to refund monies promptly to investors as represented. In addition, the findings stated that the firm failed to supervise an individual properly to ensure compliance with SEC Rules 15c2-4 and 10b-9.

Thomas F. White & Co., Inc. (San Francisco, California) and **John Warren Boudinot (Registered Representative, San Francisco, California).** The firm and Boudinot were fined $10,000, jointly and severally. In addition, the firm was ordered to refund $17,207 to the purchasers of securities with markups that exceeded 5 percent and to include with its refund to investors a letter acceptable to the NASD San Francisco staff disclosing that the refunds have been ordered by the NASD. The SEC modified the sanctions following appeal of a November 1992 National Business Conduct Committee (NBCC) decision. The sanctions were based on findings that the firm, acting through Boudinot, failed to comply with the NASD Mark-Up Policy in that it effected 32 corporate securities transactions as principal at prices that were unfair and unreasonable with markups ranging from 7.03 to 14.17 percent above the contemporaneous cost.

This action has been appealed to a United States Court of Appeals and the sanctions are not in effect pending consideration of the appeal.

Firms Fined

Marsh, Block & Co., Inc. (New York, New York) submitted a Letter of Acceptance, Waiver and Consent pursuant to which the firm was fined $10,000 and required to undertake to revise its supervisory procedures to ensure timely, complete, and accurate responses to NASD requests for information. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to respond timely to NASD requests for information concerning trades in an over-the-counter (OTC) security.

Securities Service Network, Inc. (Knoxville, Tennessee) submitted a Letter of Acceptance, Waiver and Consent pursuant to which the firm was fined $10,000 and agreed to hire one additional compliance officer as well as to have all off-site

registered representatives qualified as branch Offices of Supervisory Jurisdiction (OSJ) or assigned to already-established OSJ branch offices according to a schedule satisfactory to the NASD. In addition, the firm will immediately institute new policies requiring newly hired registered representatives to be qualified as an OSJ or assigned to already-established OSJ branch offices within 90 days of their effective registration with the firm, and the firm agrees to update its correspondence review procedures.

Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed and neglected to exercise reasonable and proper supervision over a registered general securities principal. Specifically, the NASD found that the firm failed to establish, maintain, and enforce proper supervisory procedures governing the suitability of investments in limited partnership programs and monitoring correspondence sent by employees.

Shearson Lehman Brothers Inc. (New York, New York) submitted a Letter of Acceptance, Waiver and Consent pursuant to which the firm was fined $10,000. Without admitting or denying the allegations, the firm consented to the described sanction and to the entry of findings that it failed and neglected to exercise reasonable and proper supervision over a registered representative of the firm in connection with the firm's policy for check disbursement. Specifically, the NASD found that the firm failed adequately to follow and enforce the supervisory procedures in place for the disbursement of checks out of client accounts by personnel in its Tulsa, Oklahoma branch office.

Individuals Barred Or Suspended

Jorge I. Acosta (Registered Representative, Tampa, Florida) was fined $75,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Acosta effected the purchase of shares of common stocks in the accounts of public customers without their knowledge or authorization. Acosta also made material misrepresentations to public customers without having a factual basis for such representations and engaged in fraudulent activity by changing the address of record for a customer's account to prevent him from discovering unauthorized trades. In addition, Acosta failed to respond to an NASD request for information.

Wayne W. Bevis (Registered Representative, Salt Lake City, Utah) was fined $35,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Bevis solicited and sold shares of a common stock to a public customer outside the scope of his regular employment with his member firm without giving prior written notice to or receiving written approval from his member firm. In addition, Bevis failed to respond to an NASD request for information.

Marven O. Bowman, Jr. (Registered Principal, Pittsburgh, Pennsylvania) was fined $50,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Bowman caused a member firm to conduct a securities business while it failed to maintain its minimum required net capital. Moreover, Bowman caused the firm to operate without a financial principal and used the personal identification number of a former financial principal to electronically file its FOCUS reports with the NASD. Bowman also failed to respond to NASD requests for information.

Philip S. Chase (Registered Representative, Paducah, Kentucky) submitted an Offer of Settlement pursuant to which he was fined $100,000, barred from association with any NASD member in any capacity, and ordered to pay restitution to his member firm. Without admitting or denying the allegations, Chase consented to the described sanctions and to the entry of findings that he caused $310,670.30 to be drawn on and transferred from 19 public customer accounts and converted $274,740.70 of the funds to his own use and benefit without the knowledge or consent of the customers. In addition, Chase failed to respond timely to NASD requests for information.

Jeanneane Denise Crabb (Registered Representative, Sacramento, California) was fined $50,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Crabb forged the signature of an assistant branch manager to seven option client information forms and agreements. Crabb also failed to respond to NASD requests for information.

Jose A. Dancel, Jr. (Registered Representative, Dover, Delaware) was fined $20,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Dancel failed to respond to NASD requests for information regarding several customer complaints.

Peter Daniel DaValle (Registered Representative, Chino, California) was fined $208,787.09.

The fine may be reduced by any amount paid to a member firm for its reimbursement to customers of the converted amounts (such reduction not to exceed $88,787.09). In addition, DaValle was barred from association with any NASD member in any capacity.

The sanctions were based on findings that DaValle caused $24,466.87 to be wired from a trust account to an individual third-party account at a broker/dealer other than his member firm without the knowledge or consent of the trustee or the beneficiaries of the trust account. After the trustee complained about the unauthorized withdrawal, DaValle reimbursed the account by causing $24,466.87 to be transferred from another securities account maintained at his member firm. However, DaValle subsequently converted approximately $80,782.25 from that account, and $32,308 from two additional customer accounts. DaValle also failed to respond to NASD requests for information.

David Lee Davis (Registered Representative, St. Paul, Minnesota) was fined $20,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Davis failed to respond to NASD requests for information concerning his termination from a member firm.

Cesar J. DeLeon (Associated Person, Louisville, Colorado) was barred from association with any NASD member in any capacity. The sanction was based on findings that while taking the Series 7 examination, DeLeon was found to be in possession of unauthorized materials containing information pertaining to the subject matter of the examination.

Ronald Edward DiZinno (Registered Principal, LaQuinta, California) submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined $700 and suspended from association with any NASD member in any capacity for three business days. Without admitting or denying the allegations, DiZinno consented to the described sanctions and to the entry of findings that, in violation of the Board of Governors Free-Riding and Withholding Interpretation, he purchased shares of new issues that traded at a premium in the immediate aftermarket.

Jeffrey H. Dunlap (Registered Representative, Taylors, South Carolina) submitted an Offer of Settlement pursuant to which he was fined $5,000 and suspended from association with any NASD member in any capacity for six months. Without admitting or denying the allegations, Dunlap consented to the described sanctions and to the entry of findings that he participated in two private securities transactions outside the scope of his regular employment with his member firm without providing prior written notice to his member firm.

Ralph J. Eiseman (Registered Representative, Parlin, New Jersey) was fined $75,000 and barred from association with any NASD member in any capacity. The sanctions based on findings that Eiseman misappropriated commission checks totaling $742 that belonged to fellow agents of his member firm by forging the agents' signatures and cashing the checks at a store, thereby converting the funds to his own use and benefit without the agents' knowledge or consent. In addition, Eiseman failed to respond to NASD requests for information.

Jay Michael Fertman (Registered Principal, Englewood, Colorado) was fined $1,902,075 and barred from association with any NASD member in any capacity. However, Fertman's fine may be reduced by any amount of restitution he makes to customers. The SEC affirmed the sanctions following appeal of a April 1992 NBCC decision. The sanctions were based on findings that Fertman implemented and directed a fraudulent scheme to manipulate stock prices. Pursuant to this scheme, he sold shares of stock between accounts he controlled to give the appearance of an active trading market in the securities. This way he could disguise arbitrary price increases and induce investors to purchase the stock, thereby raising the price of the securities. As a result, the stock, owned and controlled by Fertman at nominal cost, could be sold at substantial profits.

In addition, to facilitate the aforementioned manipulation, Fertman used advertisements, "scripts," and other sales literature that contained exaggerated, unwarranted, and promissory claims, but failed to disclose the risks involved in the recommended investments and omitted material facts. Fertman also maintained securities accounts at two broker/dealers other than his member firm without first notifying such broker/dealers of his association with a member firm.

Robert Edward Gillespie (Registered Principal, Dallas, Texas) and **James P. Brennan (Registered Principal, Prosper, Texas)**. Gillespie was fined $10,000 and suspended from association with any NASD member as a principal for five years. Brennan was fined $10,000 and required to pay $100,000 in restitution to a public customer. The sanctions were based on findings that a member firm, acting through Gillespie, failed to

comply with the provisions of its restriction agreement with the NASD limiting the firm to clearing securities transactions on a fully disclosed basis. Furthermore, the firm, acting through Gillespie, failed to comply with SEC Rule 15c3-3 by failing to introduce transactions on a fully disclosed basis while purporting to operate pursuant to the (k)(2)(ii) exemption of that Rule.

Also, Gillespie, acting for the firm, effected transactions in securities while failing to maintain the firm's required minimum net capital. In addition, Brennan recommended the purchase of securities to a public customer without having reasonable grounds for believing the recommendation was suitable for the customer. The firm, acting through Brennan, also fraudulently recommended and induced the same customer to purchase securities while misstating and omitting material facts. Furthermore, the firm, acting through Gillespie, failed to supervise Brennan adequately, and employed an individual as a general securities principal without proper registration.

David Mark Gold (Registered Representative, Commack, New York) submitted an Offer of Settlement pursuant to which he was fined $15,000, suspended from association with any NASD member in any capacity for 10 business days, and required to requalify by examination as a general securities representative. Without admitting or denying the allegations, Gold consented to the described sanctions and to the entry of findings that he failed to advise his member firm in writing that he was opening accounts with other member firms and failed to advise the other firms in writing that he was associated with his member firm. In addition, in violation of the Board of Governors Free-Riding and Withholding Interpretation, Gold purchased shares of a new issue that traded at a premium in the immediate aftermarket.

Scott A. Gould (Registered Representative, Mesa, Arizona) submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined $1,000 and suspended from association with any NASD member in any capacity for one year. Without admitting or denying the allegations, Gould consented to the described sanctions and to the entry of findings that he participated in private securities transactions without his member firm's written approval or authorization. The findings also stated that Gould completed four customer new account forms with falsified addresses reflecting his personal residence as the customers' home addresses to avoid state registration requirements.

Lawrence Milton Greenberg (Registered Representative, Tulsa, Oklahoma) was fined $35,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Greenberg prepared and presented to a public customer a written agreement to effect securities transactions in the customer's account to restore the value of the account to a predetermined amount, thereby guaranteeing against loss in a customer account. In addition, Greenberg failed to respond to NASD requests for information and failed to amend a *Uniform Application for Securities Industry Registration or Transfer (Form U-4)* to reflect his current address.

Duane I. Hackman (Registered Representative, Lynwood, Illinois) was fined $30,000, barred from association with any NASD member in any capacity, and required to pay $200 in restitution to a member firm. The sanctions were based on findings that Hackman received from a public customer $600 in checks and cash with instructions to use such funds for insurance payments. Hackman failed to follow said instructions by using only $400 as instructed, and used $200 for some purpose other than to benefit the customer. Hackman also failed to respond to NASD requests for information.

Philip M. Hiestand (Associated Person, Villanova, Pennsylvania) was fined $30,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Hiestand, while taking the Series 6 examination, retained in his possession notes relating to the subject matter of the examination. Hiestand also failed to respond to NASD requests for information.

Robert E. Hutchinson (Registered Representative, Newport News, Virginia) was fined $150,000 (to be reduced by the amount of restitution made to the aggrieved parties) and barred from association with any NASD member in any capacity. The sanctions were based on findings that Hutchinson participated in private securities transactions while failing to provide prior written notice to his member firm. Hutchinson also failed to respond to NASD requests for information.

Robert K. Incaprera (Registered Representative, Metairie, Louisiana) submitted an Offer of Settlement pursuant to which he was fined $14,500, suspended from association with any NASD member in any capacity for two weeks, and required to requalify by examination as a general securities representative. Without admitting or

denying the allegations, Incaprera consented to the described sanctions and to the entry of findings that he exercised discretion pursuant to oral authority in the joint account of public customers without having obtained prior written authorization from the customers and prior written acceptance of the account as discretionary by his member firm.

The NASD also found that Incaprera recommended and engaged in transactions involving the use of margin in the joint account of public customers without having reasonable grounds for believing that such recommendations and resultant transactions were suitable for the customers. In addition, the NASD determined that Incaprera prepared and submitted to his member firm an active account information report with inaccurate information about a public customer and failed to obtain approval from a principal of his member firm on two items of undated correspondence sent to a public customer.

Michael J. Janik (Registered Representative, Cherry Hill, New Jersey) was fined $30,000 and barred from association with any NASD member in any capacity. The fine shall be reduced by the amount of any restitution paid to customers.

The sanctions were based on findings that Janik received from one public customer a $1,000 loan and a $3,000 loan from another customer by misrepresenting to them that he owned valuable stock options that he wanted to exercise and sell. In return, Janik gave each customer a promissory note agreeing to repay them $2,000 and $6,500, respectively, by a certain date. Janik has not repaid the first customer the full amount due under the note, nor has he paid the second customer any of the amount due under the note. Janik also failed to respond to NASD requests for information.

Dinesh V. Kamath (Registered Representative, Princeton, New Jersey) was fined $100,000, barred from association with any NASD member in any capacity, and required to pay $91,185 plus interest in restitution to customers. The sanctions were based on findings that Kamath received from an insurance customer four checks totaling $38,318.21 intended as payments on policy loans. Kamath negotiated the checks, retained the proceeds, and failed to apply such funds to their intended purpose.

In addition, Kamath received from two public customers three checks totaling $33,323.24 intended for the purchase of a bond fund. Kamath negotiated the checks, retained the proceeds thereof, and failed to apply them to their intended purpose. Furthermore, Kamath received corporate checks drawn to the order of his member firm representing contributions to its profit sharing plan, and induced the clerical staff to issue "exchange checks" to his own order in the amount of $19,543.17. He thereafter negotiated the checks and retained the proceeds.

John J. Kelleher, Jr. (Registered Representative, Allentown, Pennsylvania) was fined $35,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Kelleher received from public customers two checks totaling $7,000 drawn to the order of his member firm and, without authorization, endorsed and deposited the checks in his personal bank account.

Matthew Edward Kelly (Registered Representative, Syosset, New York) was fined $30,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Kelly failed to pay a $1,575 NASD arbitration award. In addition, Kelly failed to respond to NASD requests for information.

Gerald Thomas Kieffer (Registered Representative, Buffalo, New York) submitted an Offer of Settlement pursuant to which he was fined $5,000 and barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Kieffer consented to the described sanctions and to the entry of findings that he recommended the implementation of a trading strategy in the accounts of public customers involving securities and options that was unsuitable given the customers' financial situations, investment objectives, and experience.

Gregory W. Laubach (Registered Representative, Lancaster, Pennsylvania) submitted an Offer of Settlement pursuant to which he was fined $2,500 and suspended from association with any NASD member in any capacity for six months. Without admitting or denying the allegations, Laubach consented to the described sanctions and to the entry of findings that he forged the signature of an insurance policyholder to requests to withdraw policy dividends and thereafter submitted such requests to his member firm as genuine.

Patricia Ann Lewis (Registered Representative, St. Petersburg, Florida) submitted an Offer of Settlement pursuant to which she was fined $150,000 and barred from association with any NASD member in any capacity. Without admitting or denying the allega-

tions, Lewis consented to the described sanctions and to the entry of findings that she received from a public customer $49,326.28 intended for investment purposes and, instead, converted the funds to her own use and benefit without the customer's knowledge or authorization. The NASD also found that Lewis received $1,000 from a public customer for services rendered outside the scope of her relationship with her member firm without providing prompt written notice to her member firm. In addition, Lewis failed to respond to an NASD request for information.

Edwin R. Lyon (Registered Representative, Charleston, South Carolina) was fined $20,000 and ordered to offer rescission to three public customers. In addition, he was suspended from association with any NASD member in any capacity for 30 days and thereafter until he provides proof that either he reimbursed those investors who requested rescission, or that none of the investors requested a rescission. Lyon is also required to requalify by examination. The NBCC imposed the sanctions following appeal of an Atlanta District Business Conduct Committee (DBCC) decision. The sanctions were based on findings that Lyon engaged in private securities transactions outside the scope of his employment with his member firm without prior written approval from his member firm.

Joseph H. Miller, Jr. (Registered Representative, New Canaan, Connecticut) submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined $175,000 and barred from association with any NASD member in any principal or supervisory capacity. Without admitting or denying the allegations, Miller consented to the described sanctions and to the entry of findings that he engaged in private securities transactions and allowed various agents/registered representatives under his control and supervision to also engage in private securities transactions that were neither sponsored nor approved by his member firm.

Frank F. Millsaps (Registered Principal, Mobile, Alabama) submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined $21,000, barred from association with any NASD member in any capacity, and must demonstrate that full restitution has been made. Without admitting or denying the allegations, Millsaps consented to the described sanctions and to the entry of findings that he received payroll checks totaling $4,150.58 from his member firm for distribution to fellow employees. The NASD found that Millsaps failed to distribute the checks and, instead, deposited the funds into checking accounts under his control, thereby converting the funds to his own use and benefit without the knowledge or consent of the designated payees or his member firm.

Derrick E. Morales (Registered Representative, Philadelphia, Pennsylvania) was fined $25,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Morales received from a public customer a $395 check intended for the purchase of insurance. Morales negotiated the check, but failed to remit the funds for their intended purpose. Morales also failed to respond to NASD requests for information.

William J. Moriarty (Registered Representative, Snowmass Village, Colorado) submitted an Offer of Settlement pursuant to which he was fined $25,000 and barred from association with any NASD member in any capacity. In addition, Moriarty must pay $175,808.17 in restitution to customers. Without admitting or denying the allegations, Moriarty consented to the described sanctions and to the entry of findings that he provided a false and misleading document to a public customer concerning the purchase of a security when, in fact, no such security existed. The findings also stated that Moriarty made false and misleading representations to three public customers without having a reasonable basis for making these representations and knew, or should have known, that the representations were false and misleading.

Richard L. Novosel (Registered Representative, Pittsburgh, Pennsylvania) submitted an Offer of Settlement pursuant to which he was fined $14,000 and suspended from association with any NASD member in any capacity for 25 days. Without admitting or denying the allegations, Novosel consented to the described sanctions and to the entry of findings that as custodian of a lapsed securities account, he received from his member firm a check in the amount of $2,710.12. Novosel negotiated the check and retained the proceeds of the custodian account for his own use and benefit.

James S. Oates (Registered Representative, Tampa, Florida) was fined $50,000, barred from association with any NASD member in any capacity, and ordered to pay $6,393.37 in restitution to public customers. The sanctions were based on findings that Oates effected transactions for the securities accounts of public customers without their knowledge or consent. In addition, Oates failed to respond to an NASD request for information.

Michael D. Pullon (Registered Representative, Rome, Georgia) was fined $120,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Pullon received from public customers checks totaling $52,362.18 intended for the purchase of shares of mutual funds and, instead, converted the funds to his own use and benefit, without the knowledge or authorization of the customers. In addition, Pullon failed to respond to NASD requests for information.

Daniel M. Ross (Registered Representative, Boca Raton, Florida) submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined $320,000 and suspended from association with any NASD member in any capacity for 15 months (deemed served). Without admitting or denying the allegations, Ross consented to the described sanctions and to the entry of findings that he engaged in private securities transactions without giving prior written notice to his member firm.

Charles A. Roth (Registered Representative, Denver, Colorado) was fined $105,000, suspended from association with any NASD member in any capacity for six months, and required to requalify by examination as a registered representative. The United States Court of Appeals for the District of Columbia Circuit affirmed the SEC sanctions following appeal of a February 1990 NBCC decision. The sanctions were based on findings that Roth conducted business as a broker/dealer without being registered as required, and effected private securities transactions without properly notifying his member firm. The NASD also found that, in these transactions, Roth accepted fees and expenses from seven insurance companies for his participation in securities transactions involving these companies.

Roth has filed a Petition for Rehearing with the U.S. Court of Appeals.

David W. Rothenbusch (Associated Person, Phoenix, Arizona) was barred from association with any NASD member in any capacity. The sanction was based on findings that while taking the Series 7 examination, Rothenbusch possessed unauthorized materials containing information pertaining to the subject matter of the examination.

Erika Safran a/k/a Erika Salamon (Registered Representative, New York, New York) submitted a Letter of Acceptance, Waiver and Consent pursuant to which she was fined $2,500 and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the allegations, Safran consented to the described sanctions and to the entry of findings that she purchased, or caused to be purchased, shares of a fund in the account of a public customer without the customer's prior knowledge, authorization, or consent. In addition, the NASD determined that Safran failed to take advantage of a breakpoint to reduce the sales charge available to the same customer in the aforementioned transaction.

Arthur H. Salas (Registered Representative, Fort Collins, Colorado) submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined $7,500 and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the allegations, Salas consented to the described sanctions and to the entry of findings that he engaged in private securities transactions and outside business activities without providing written notice to his member firm of such activities.

Peter J. Scanlan (Registered Representative, Nyack, New York) was barred from association with any NASD member in any capacity. The sanction was based on findings that during the course of a Series 7 examination, Scanlan possessed and used printed information that contained material relevant to the subject matter of the examination.

Donald Schaefer (Registered Representative, Roselle Park, New Jersey) was fined $77,500 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Schaefer received money orders from a public customer totaling $1,500 for investment purposes and that he endorsed and deposited the money orders into his personal bank account, thereby converting the funds to his own use and benefit. In addition, Schaefer failed to respond to NASD requests for information.

Daryl Wilfred Schliem (Registered Representative, Janesville, Wisconsin) was fined $120,000, barred from association with any NASD member in any capacity, and required to pay $48,447.87 in restitution to a member firm. The sanctions were based on findings that Schliem received from a public customer checks for $35,000 and $7,039.44 intended to be used for payment of premiums on a variable life insurance policy. Contrary to the customer's instruction, and without her knowledge and consent, Schliem deposited the funds in a bank account he controlled or had an interest in, and

retained the funds for his own use and benefit. Schliem also failed to respond to NASD requests for information.

Stephen J. Sciambra (Associated Person, Metairie, Louisiana) submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined $8,000 and barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Sciambra consented to the described sanctions and to the entry of findings that he received a $1,500 check from a public customer for the purchase of an annuity but he failed to submit the funds to his member firm. Instead, the NASD found that Sciambra converted the money to his own use and benefit without the customer's knowledge or consent. In addition, the NASD found that Sciambra cashed a $150 check drawn against his personal bank account that had been closed and used the bank checking account of a public customer as security, without the customer's knowledge or consent, eventually causing the customer's account to be charged for that amount.

Catherine Ann Seiwert a/k/a Catherine Ann Jensen (Registered Representative, Omaha, Nebraska) was fined $70,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Seiwert exercised effective control over the account of a public customer. Specifically, she recommended the purchase and sale of securities including options without having reasonable grounds for believing that such recommendations were suitable for the customer in view of the size and frequency of the recommended transactions and the customer's financial situation and needs. In addition, Seiwert forged the same customer's signature to an option client information form and agreement.

Edwin D. Simmons (Registered Principal, Greensboro, North Carolina) was fined $5,000 and barred from association with any NASD member in any capacity. The NBCC affirmed the sanctions following appeal of an Atlanta DBCC decision. The sanctions were based on findings that, without the knowledge or authorization of a subordinate, Simmons forged and converted to his own use and benefit four insurance commission checks totaling $605.60 that were payable to the individual.

Anna W. Smith (Associated Person, Fayetteville, Arkansas) submitted an Offer of Settlement pursuant to which she was fined $12,500, barred from association with any NASD member in any capacity, and ordered to pay $2,500 in restitution to a member firm. Without admitting or denying the allegations, Smith consented to the described sanctions and to the entry of findings that she caused funds totaling $3,000 to be disbursed from her firm's payroll department to herself in the form of a bonus when she knew that she had only received proper authorization for $500 of that amount, thereby, misappropriating $2,500 from her member firm.

Michael K. Stevens (Registered Principal, Jackson, Mississippi) submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined $17,000, suspended from association with any NASD member in any capacity for two weeks, and required to requalify by examination as a general securities representative. Without admitting or denying the allegations, Stevens consented to the described sanctions and to the entry of findings that he entered into a written agreement with a public customer whereby he guaranteed the customer against losses incurred in the customer's IRA account. In addition, the findings stated that Stevens engaged in private securities transactions without giving prior written notice to his member firm.

David Thomas Stover (Registered Representative, Seattle, Washington) submitted an Offer of Settlement pursuant to which he was fined $15,000 and suspended from association with any NASD member in any capacity for 10 business days. In addition, Stover must pay $9,700 in restitution to a customer. Without admitting or denying the allegations, Stover consented to the described sanctions and to the entry of findings that he executed securities transactions in the margin account of a public customer on the order of an individual who was not an owner of the account and did not have third-party trading authorization for effecting these transactions.

The findings also stated that Stover recommended to the same customer the purchase of securities without having reasonable grounds for believing such transactions, including the use of margin, were suitable for the customer considering the customer's financial situation and needs. In addition, the NASD found that Stover sent a $21,000 check to another individual to repay a portion of a $40,000 loan the individual had taken to meet a margin call on the aforementioned customer's account. The findings further stated that Stover wired $7,000 to this individual's bank account to assist in the payment of another margin call in the aforementioned customer's account, without the knowledge or prior authorization of

his member firms.

Darrell D. Svenby (Registered Representative, Colorado Springs, Colorado) submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined $100,000 and barred from association with any NASD member in any capacity. In addition, Svenby must pay $16,569.93 in restitution to a member firm.

Without admitting or denying the allegations, Svenby consented to the described sanctions and to the entry of findings that he forged signatures of 12 customers on checks made payable to the customers without their authorization. Further, the NASD found that Svenby endorsed the checks to himself and deposited the funds into accounts he controlled thereby misappropriating and/or misusing customer funds. In addition, the findings stated that Svenby falsified firm books and records by submitting false change of address forms reflecting his own address for the purpose of controlling the disbursement of funds from customer accounts.

Michael Edward Svenson (Registered Representative, Lake Elmo, Minnesota) was fined $20,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Svenson failed to respond to NASD requests for information.

Michael Gregory Sweeney (Registered Representative, Spokane, Washington) was fined $90,520 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Sweeney executed unauthorized transactions in customer accounts and made material misrepresentations and unsuitable recommendations. In addition, Sweeney used discretion in the account of a customer without obtaining prior written discretionary authorization from the customer and without acceptance of such account by his member firm.

George F. Tully (Registered Principal, Jessup, Georgia) and **Michael D. Beck (Registered Representative, Petersburg, Virginia)**. Tully and Beck were both barred from association with any NASD member in any capacity. The sanctions were based on findings that, on several occasions, Tully and Beck misappropriated customer funds, forged customer signatures, engaged in unauthorized transactions in customer accounts including municipal securities, and, failed to respond to NASD requests for information.

In addition, Tully prepared an inaccurate confirmation in a customer's account, and diverted monthly statements, confirmations, and other official mail by submitting fictitious address change requests for various customer accounts. Furthermore, Tully made unsuitable recommendations and misrepresentations to public customers.

Michael Richard Waldman (Registered Representative, Henderson, Nevada) was fined $25,000 and barred from association with any NASD member in any capacity. Waldman executed for the account of a public customer the purchase of securities without the customer's knowledge or consent. Waldman also failed to respond to NASD requests for information.

Cleveland Maynard Welsh, II (Registered Representative, St. Louis, Missouri) was fined $75,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Welsh executed nine transactions in eight customer accounts and opened accounts in the names of two public customers without their prior knowledge, authorization, or consent. In addition, Welsh failed to respond to NASD requests for information.

Gregory A. Williams (Registered Representative, Sykesville, Maryland) was fined $25,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Williams received from an insurance customer two money orders totaling $125 intended for the purchase of a health insurance policy. Williams never purchased any policy but, instead, negotiated the instruments and converted the proceeds to his own use and benefit. Williams also failed to respond to NASD requests for information.

Michael John Wyrostek (Registered Representative, Naperville, Illinois) submitted an Offer of Settlement pursuant to which he was fined $2,500 and suspended from association with any NASD member in any capacity for five business days. Without admitting or denying the allegations, Wyrostek consented to the described sanctions and to the entry of findings that he participated in outside business activities while failing to give prompt written notice to his member firm of such activities.

Darrell Murray Zimmerman (Registered Representative, Chicago, Illinois) was fined $120,000 and barred from association with any NASD member in any capacity. The sanctions were based on findings that Zimmerman filed a *Form U-4* with the NASD that failed to disclose his previous employment as a floor trader at the

Chicago Board of Trade and the fact that he was previously suspended by the Board. Zimmerman also failed to respond to NASD requests for information.

Agostino Joseph Zolezzi (Registered Principal, San Diego, California) was fined $7,500, jointly and severally with a member firm, fined an additional $500, jointly and severally with other respondents, and suspended from association with any NASD member in any capacity for three days. The SEC affirmed the sanctions following appeal of a December 1992 NBCC decision.

The sanctions were based on findings that a member firm, acting through Zolezzi, effected securities transactions and/or induced the purchase or sale of securities when the firm failed to maintain sufficient net capital. In addition, the firm, acting through Zolezzi, failed to give telegraphic notice to the SEC and the NASD of its net capital deficiency in a timely manner and failed to file a report detailing steps taken to correct the situation. Furthermore, the firm, acting through Zolezzi, sold shares of an initial public offering to a public customer without a final registration statement in effect and without the benefit of an exemption from registration, in violation of Section 5 of the Securities Act of 1933.

Individuals Fined

Richard L. Hansen (Registered Representative, Battle Creek, Michigan) was fined $20,000, that can be reduced by demonstrating that restitution has been paid to customers (reduction not to exceed $10,000), and required to requalify by examination as a general securities representative. The sanctions were based on findings that Hansen engaged in private securities transactions while failing and neglecting to give written notice of his intention to engage in such activities to his member firm.

John Thomas Mason (Registered Representative, Tacoma, Washington) was fined $7,500, and required to pay $4,575.17 plus interest in restitution to customers. The sanctions were based on findings that Mason deposited in a non-securities related business account $579,548, comprising monies from four different customers intended for investment in mutual funds. These deposits commingled customer securities funds with other non-securities funds thereby denying these customers' funds the protection afforded by the applicable securities rules, regulations, and laws.

Mason also recommended that two customers redeem their investment in four mutual funds and re-invest the proceeds into another mutual fund while allowing the customers to believe that there would be no sales charge for the investments. Based on this understanding, the customers agreed to invest in a mutual fund and two IRA accounts. However, without notice to the customers, Mason canceled these purchases at net asset value and had them rebilled at the public offering price, thereby imposing sales charges on the customers.

Charles C. Ramsey (Registered Representative, Houston, Texas) submitted a Letter of Acceptance, Waiver and Consent pursuant to which he was fined $25,000. Without admitting or denying the allegations, Ramsey consented to the described sanction and to the entry of findings that he engaged in activities requiring registration as either a general securities principal or government securities principal but failed to register with the NASD.

Charles Felix Tummino (Registered Representative, Rogue River, Oregon) was fined $39,139 and required to requalify by examination before registering with any NASD member. The sanctions were based on findings that Tummino distributed to customers and to the public a sales brochure that failed to disclose material facts, made exaggerated, unwarranted, or misleading statements or claims, and made promises of specific results and forecasts of future events. Moreover, Tummino distributed the aforementioned material when it was not approved by a registered principal of his member firm.

Firms Suspended

The following firms were suspended from NASD membership for failure to comply with formal written requests to submit financial information to the NASD. The actions were based on the provisions of Article IV, Section 5 of the NASD Rules of Fair Practice and Article VII, Section 2 of the NASD By-Laws. The date the suspension commenced is listed after each entry. If the firm has complied with the requests for information, the listing also includes the date the suspension concluded.

Anvil Securities Corp., Fairmont, West Virginia (March 28, 1994)

Burnett, Grey & Co., Inc., Atlanta, Georgia (March 28, 1994)

Carolina Barnes Capital, Inc., New York, New York (April 11, 1994)

Dolphin Private Offerings, South San Francisco, California (March

28, 1994)

Dupont, White & Stone, Inc., New York, New York (April 11, 1994)

Enterprise Financial Group, Inc., East Providence, Rhode Island (April 11, 1994)

GEB Securities, Inc., Clearwater, Florida (March 24, 1994)

Harold Pastron - Funded Investments, Northbrook, Illinois (March 28, 1994-March 31, 1994)

Interacciones Global, Inc., New York, New York (March 28, 1994-March 31, 1994)

Johnston Kent Securities, Inc., Denver, Colorado (April 11, 1994-April 19, 1994)

Kitef Investments Co., Inglewood, California (April 11, 1994-April 15, 1994)

Lone Cypress Capital Corporation, Phoenix, Arizona (April 11, 1994)

Main Street Capital Corporation, Dallas, Texas (April 11, 1994)

Melbourne GSI Corp., New York, New York (March 24, 1994)

Mesa Financial Group, Inc., Santa Ana Heights, California (March 28, 1994)

New London Capital, Inc., Decatur, Georgia (March 24, 1994)

PCA Capital Corporation, Boston, Massachusetts (April 11, 1994)

Pond Equities, Inc., Brooklyn, New York (March 24, 1994)

Schwarm & Co., Hamilton, Ohio (March 24, 1994)

Trinity Group Securities, Inc., Berkeley Heights, New Jersey (March 28, 1994)

Waller Capital Corporation, New York, New York (March 28, 1994-April 11, 1994)

Worthington & Dunn Securities, Dallas, Texas (March 24, 1994)

Suspension Lifted

The NASD has lifted the suspension from membership on the date shown for the following firm, because it has complied with formal written requests to submit financial information.

Gold Securities Corp., Pomona, California (March 16, 1994)

Individuals Whose Registrations Were Revoked For Failure To Pay Fines, Costs, And/Or Provide Proof Of Restitution In Connection With Violations

Alfred Abdo, Jr., Winston Salem, North Carolina

Brian D. Carpenter, Stockton, California

John K. Dennee, Fairport, New York

Cary W. DePriest, Phoenix, Arizona

Richard F. Duell, Buffalo Grove, Illinois

David J. Eckert, Rochester, New York

Mark R. Elston, Shawnee, Kansas

Steve A. Goddard, Haleyville, Alabama

Kevin C. Grom, Chicago, Illinois

Stephen C. Harrison, Merriam, Kansas

Robert E. Holbert, Phoenix, Arizona

Larry W. Kennaugh, Mount Vernon, Washington

Donald L. Poindexter, San Diego, California

John B. Rosenow, Phoenix, Arizona

Carlos M. Sera, Bowie, Maryland

Marshall W. Smalling, Grand Prairie, Texas

John D. Wilshere, Jr., St. Albans, West Virginia

Retraction

The NASD is retracting a disciplinary action reported in the August 1993 NASD Notice to Members and the December 1993 NASD Regulatory & Compliance Alert in connection with **Ellen Lapin Margaretten (Registered Principal, North Miami, Florida)** due to the fact that the NASD subsequently dismissed the proceeding.

FOR YOUR INFORMATION

Credit Division Schedules Prime Brokerage Meeting

The Credit Division of the Securities Industry Association (SIA) has scheduled a special meeting on *Prime Brokerage*, Wednesday, June 22, 1994, at Salomon Brothers Inc., Executive Center, 39th Floor, Seven World Trade Center, New York, New York. Registration is at 8:30 a.m. For more information, please contact Arthur Quartermaine, President, SIA Credit Division, (212) 902-7891.

SPECIAL NASD NOTICE TO MEMBERS 94-44

Board Approves Clarification On Applicability Of Article III, Section 40 Of Rules Of Fair Practice To Investment Advisory Activities Of Registered Representatives

Suggested Routing

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

Executive Summary

The Board of Governors, acting on the recommendation of a special Ad Hoc Committee, is clarifying the applicability of Article III, Section 40 of the NASD Rules of Fair Practice to the investment advisory activities of registered representatives. This Notice describes those investment advisory activities that constitute private securities transactions within the scope of Article III, Section 40.

Summary Of Article III, Section 40

Article III, Section 40 provides that any person associated with a member who participates in a private securities transaction must, prior to participating in the transaction, provide written notice to the member with which he or she is associated. The required notice must describe the transaction, the associated person's role, and state whether the associated person has received or may receive selling compensation. The member must respond to the notice in writing indicating whether it approves or disapproves the proposed transaction. Where the registered person has received or may receive selling compensation, the member approving the transaction must record the transaction in its books and records and must supervise the registered person's participation in the transaction as if it was the member's own under Article III, Section 27 of the Rules of Fair Practice.

Section 40 defines "private securities transaction" as any securities transaction outside the regular course or scope of an associated person's employment with a member, including, though not limited to, new offerings of securities which are not registered with the U.S. Securities and Exchange Commission (SEC). "Selling compensation" is defined as any compensation paid directly or indirectly from whatever source in connection with or as a result of the purchase or sale of a security, including, though not limited to, commissions; finder's fees; securities or rights to acquire securities; rights of participation in profits, tax benefits, or dissolution proceeds, as a general partner or otherwise; or expense reimbursements.

Notice to Members 85-84, which announced the approval of Article III, Section 40, broadly defined the scope of selling compensation and deliberately meant to include the receipt of any item of value received or to be received, directly or indirectly, from the execution of any such securities transaction. The Notice also discussed that Article III, Section 40 was specifically designed to apply to situations where the registered person was acting as a salesperson or in some other capacity.

Background Of The Application Of Section 40 To RR/RIAs

The National Business Conduct Committee (NBCC), at its May 1991 meeting, considered the issue of the applicability of Article III, Section 40 of the Rules of Fair Practice to certain activities of individuals who are registered both as representatives of an NASD member firm and with the SEC as a Registered Investment Adviser ("dually registered person" or "RR/RIA"), and who conduct their investment advisory activities "away from" their NASD member employer. The issue was considered by the NBCC as a result of a number of requests for interpretations relating to programs under which registered representatives directed securities transactions for their investment advisory clients to a broker/dealer

other than the firm with which they are registered.

The NBCC concluded that Article III, Section 40, consistent with the policy announced when the section was adopted, applied in such a manner as to cover certain activities of individuals who are registered both as a representative of an NASD member and with the SEC as an investment adviser. The NBCC stated that Section 40 should apply to all investment advisory activities conducted by these dually registered persons that result in the purchase or sale of securities by the associated person's advisory clients, with the exception of their activities on behalf of the member. The NBCC also determined that the receipt of compensation as a result of investment advisory activities constituted the receipt of selling compensation as defined in Section 40.

The NBCC then issued *Notice to Members 91-32*, explaining its position and soliciting comments on other advisory compensation arrangements, including "wrap" fees, that had not been before the Committee. In response to *Notice to Members 91-32*, the NASD received over 150 comment letters. Few of the letters addressed the NBCC's request for information on other compensation arrangements but rather sought to clarify the NBCC's view on the application of Section 40 to various factual scenarios involving the activities of dually registered persons. After reviewing the comments, the NBCC and the Board appointed an Ad Hoc Committee of the Board to examine this entire area. This special committee met numerous times to review the comment letters, the history and intent of Section 40, and to receive input from various segments of the securities industry, including those most affected by the NBCC's position.

Following extensive discussions and deliberations, the Ad Hoc Committee formulated a clarification which the Board considered and adopted. The following discussion explains the Board's clarification of its position on the scope of transactions that would be deemed to be "for compensation" under Article III, Section 40 with respect to registered representatives/registered investment advisers.

Clarification

In clarifying its previous position in *Notice to Members 91-32*, the Board focused primarily upon the RR/RIA's participation in the execution of the transaction—meaning participation that goes beyond a mere recommendation. Article III, Section 40, therefore, applies to any transaction in which the dually registered person participated in the execution of the trade.

An example of a RR/RIA clearly participating in the execution of trades is where he or she enters an order on behalf of the customer for particular securities transactions either with a brokerage firm other than the member they are registered with, directly with a mutual fund, or with any other entity, including another adviser, and receives any compensation for the overall advisory services. As a result, the "for compensation" provisions of Article III, Section 40 would apply, thereby requiring the RR/RIA adviser to provide notice to his or her firm and requiring that firm, if it approved the activities, to record the transactions and supervise the conduct of the RR/RIA. The Board has determined to exclude from Section 40 coverage arrangements under which the account is "handed off" to unaffiliated third-party advisers that make all investment decisions. This, and most other advisory activities, would fall under and be subject to the requirements of Article III, Section 43 of the Rules of Fair Practice.

Activities that would fall under either Sections 40 or 43 of the Rules of Fair Practice can be generally categorized as follows:

1. Transactions executed on behalf of the customer in which the RR/RIA participated in the execution would be subject to the full "for compensation" provisions of Section 40, thereby requiring the member to record and supervise the transactions. This would be the case whether the RR/RIA received transactionally related, commission-type compensation, asset-based management fees, wrap fees, hourly, yearly, or per-plan fees, as long as fees paid include execution services by the RR/RIA. Also included are situations where the dually registered person has an arrangement with a third-party money manager to handle the customer's account and the RR/RIA makes individual investment decisions for the client, based on recommendations or alternatives provided by the third-party manager.

2. Only transactions executed on the customer's behalf without any form of compensation would be subject to the "non-compensation" provisions of Section 40. It is unlikely that activity of this sort would exist to any substantial degree outside of a familial type relationship.

3. All other investment advisory activities that do not include the RR/RIA's participation in the execution would be subject to the notification provisions of Article III, Section 43. These activities would include securities transactions executed by customers independently through another broker/dealer or directly with a fund or other entity based on specific recommendations of the dually registered person, tim-

ing services where the service makes the investment decision, the utilization of unaffiliated third-party advisers where the RR/RIA does not participate in investment decisions for the client, financial plan creation and other such activities.

Analysis Of Various Scenarios Under The Clarification

The following are issues raised in correspondence from members and the results under this interpretation.

1. A service offered by many discount brokerage firms includes the firm providing "back office" services for the dually registered person which include collection of the asset-based advisory fee. Here, the RR/RIA has opened an account on behalf of a customer and has discretionary authority to execute transactions on the customer's behalf. Under these facts, the "for compensation" of Section 40 would apply.

2. Some RR/RIAs engage in activities limited to the writing of financial plans for a fee which do not include specific securities purchase recommendations or executions. Under this approach, such activities would be governed by Section 43.

3. Some asset management firms offer "wrap fee" programs to registered investment advisers. The "wrap fee" includes a fee for management, accounting, and reporting. This fee is shared with the investment adviser who is also a registered representative. Portfolio transactions are handled through a broker/dealer firm at substantial discounts and are not known to or handled by the RR/RIA. Investment advisers receive a part of the asset management fee only and receive no part of any transaction fee. The adviser is registered with the SEC and any states as necessary. This activity would be subject to Section 43 rather than Section 40 of the Rules of Fair Practice.

4. There are firms offering market timing services where the firm, operating as an independent investment adviser, directs the switches within a family of mutual funds, either load or no-load. There are no transaction charges and the investment adviser, also a registered representative, is not involved in handling switches among funds. The dually registered person does receive some part/percentage of the market timing fee. If the customer or timing firm effects the switches with no involvement by the RR/RIA, this fact pattern would be considered as falling under Section 43.

5. Investment advisers who are also registered representatives often charge an advisory fee to "time" a group of load or no-load mutual funds for clients. This process could also be described as asset allocation or a monitoring service. The exchange of funds is handled directly by the investment adviser with the fund group. This pattern differs from number 4 in that the adviser effects the transactions. These are "for compensation" transactions pursuant to Section 40.

6. There are several firms which provide asset allocation models, software, computer hardware, and direct linkup and execute the transactions as necessary. Each adviser can produce statements for clients based on downloaded information. The RR/RIA receives a portion of the asset-based fee for his or her monitoring of the account. The firm to which the account is referred actually handles all implementation, and the dually registered person has no part in the actual transactions. These third-party arrangements are covered by Section 43.

7. Institutional advisers offer services to individual investment advisers which include permitting the adviser to implement, via computer, purchases and sales in institutional funds. Assets are held at banks and the RR/RIA produces statements and confirms for a client. The RR/RIA also handles the allocation of assets and places transactions. The client can pay one combined fee or two separate fees. One is paid to the mutual fund (internal fee) and the second is paid separately to the dually registered person for handling the account. To the degree that the RR/RIA participates in the execution of the transactions, this would produce a "for compensation" Section 40 result.

8. Investment advisers may advise clients on assets held and transacted at another broker/dealer without being involved in implementation or execution. The RR/RIA may receive copies of statements and charges an advisory fee which is for investment advice and monitoring not related to any transactions in the account. This scenario does not involve either the recommendation or execution of transactions. Since the service is solely advice and monitoring "not related to any transactions in the account," the activities would fall under Section 43.

9. Varying situation number 8, such that the adviser calls the representative of the other broker/dealer to implement or execute transactions but receives no fee or commission for the handling thereof, results in "for compensation" transactions under Section 40.

Members and RR/RIAs are expected to be in compliance with the Board's Interpretation as clarified in this Notice. Those firms and RR/RIAs who have not been operating in accordance with the provi-

sions of *Notice to Members 91-32* must immediately conform their activities in order to ensure compliance with the concepts and requirements that have been clarified in this Notice. NASD district examiners will be closely reviewing for compliance with this Interpretation during the course of their field examinations, and violations will be reviewed by DBCCs for consideration of disciplinary action. This clarification should enhance members' abilities to design internal policies and procedures to protect customers who deal with dually registered persons and to prevent potential violations of NASD rules and regulations, particularly Article III, Section 40 of the Rules of Fair Practice.

Any questions or inquiries concerning the applicability of Article III, Section 40 to the activities of RR/RIAs may be directed to Craig Landauer, Associate General Counsel at (202) 728-8291.

Questions relating to members' general compliance and record-keeping responsibilities under Article III, Section 40 may be directed to Daniel Sibears, Director, Regulatory Policy at (202) 728-6911.