NASD NOTICE TO MEMBERS 94-45

SEC Approves Schedule E Conflict-Of-Interest Provisions

Suggested Routing

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Executive Summary

On May 10, 1994, the Securities and Exchange Commission (SEC) approved amendments to Schedule E to the NASD By-Laws (Schedule E) that require compliance with its provisions if a member participating in a distribution of a public offering of debt or equity securities has a conflict of interest with the issuer. A conflict of interest is deemed to exist if the member or its affiliates own an aggregate of 10 percent or more of the outstanding subordinated debt; 10 percent or more of the common equity or the preferred equity of a corporation; or 10 percent or more of the distributable profits or losses through a general, limited, or special partnership interest. The NASD also adopted an exception to the requirement that a qualified independent underwriter provide a pricing opinion where a member affiliated with the issuer or a member that has a conflict of interest with the issuer is participating as a financial advisor in a restructuring or recapitalization and does not provide a pricing opinion with respect to the transaction. The text of the amendments, which took effect May 10, 1994, follows the discussion below.

Background

On May 10, 1994, the SEC approved amendments to Schedule E to the By-Laws, which prohibit members and their associated persons from participating in the distribution of a public offering of debt or equity securities if the member and/or its associated persons, parent or affiliates have a conflict of interest with the company that arises as a result of ownership of the issuer's common equity, preferred equity, or subordinated debt or a partnership interest.[1]

[1]Securities Exchange Act Rel. No. 34041 (May 10, 1994); 59 F.R. 25510 (May 16, 1994).

Since 1972, Schedule E has regulated the potential conflicts of interest that exist with respect to the pricing of an offering and the conduct of due diligence when a member participates in the public distribution of its own securities, the securities of its parent, or the securities of an affiliate. The standards contained within Schedule E used to determine the presence of an affiliate relationship are either voting control through ownership of voting equity securities or common control of management through interlocking officerships or directorships.

Schedule E addresses the conflicts of interest with respect to pricing and due diligence raised when a member participates in an offering of its own securities or the securities of its parent or an affiliate by requiring a qualified independent underwriter to render an opinion on the price of the securities offered, conduct due diligence, and participate in the preparation of the registration statement, in the absence of an investment grade rating for debt securities or a bona fide independent market for equity securities. The qualified independent underwriter also assumes underwriter's liability for the offering. The NASD has relied on the objectivity and independence of the qualified independent underwriter to resolve the conflicts of interest present when a member distributes its own securities or those of its parent or affiliate.

In 1989, the NASD Board of Governors asked the Corporate Financing Committee to consider whether the ownership of debt of an issuer by an NASD member that participates in an offering of an issuer's securities creates a conflict of interest and, if so, whether the conflict should be regulated by the provisions of Schedule E. The NASD was concerned about such offerings because members and their affiliates often

become holders of risky, less-than-investment-grade debt securities as a result of their participation in leveraged buy-out transactions, which could influence the independence of members' pricing and due diligence functions in any subsequent related public offering. The Corporate Financing Committee concluded, after review of numerous leveraged buy-out offerings and discussions with several member firms, that a conflict of interest exists when a member owns subordinated debt, preferred equity, or nonvoting common equity of an issuer while engaged in an offering of the issuer's securities. In addition, as a result of its review, the Corporate Financing Committee recommended that Schedule E be amended to adopt an exception to the requirement that a qualified independent underwriter provide a pricing opinion where a member affiliated with the issuer or a member that has a conflict of interest with the issuer is participating as a financial advisor in a restructuring or recapitalization, so long as the member does not provide a recommendation or opinion with respect to the price, yield, or exchange value of the transaction. The Board of Governors approved the recommendations of the Corporate Financing Committee. The NASD submitted the amendments to the SEC for approval and published the amendments for vote in *Notice to Members 92-57* (November 1992).

In response to the publication of the proposed amendments by the SEC, one commenter noted that concerns about conflicts arising from an underwriter's ownership of issuers' debt and nonvoting equity arose as a result of the prevalence of leveraged buy-outs and bridge loans in the late 1980s and early 1990s. The commenter pointed out that these transactions are no longer prevalent and argued that the rule change should be postponed until these transactions again become prevalent. The NASD responded that a member's debt or nonvoting equity interest in an issuer can present a conflict regardless of the structure of the transaction and that, recently, companies once subject to leveraged buy-outs are now deleveraging by issuing equity. In these situations, the member, who served as financial advisor and acquired subordinated debt in the buy-out, may now serve as lead manager of the equity offering. The NASD believes that these situations raise conflicts that warrant the protections of Schedule E.

Description of Amendments

Section 1—General
The NASD is adding a new introductory paragraph to Schedule E that permits members and their associated persons to participate in the distribution of a public offering of debt or equity securities if the member and/or its associated persons, parent or affiliates have a conflict of interest with the company, provided that the member complies with, and the distribution conforms to, the applicable provisions of Schedule E.

Section 2 — Definitions
Four new definitions are added to the definitions section and one definition is being amended.

Common Equity A new definition of "common equity" includes the total number of shares of common stock outstanding without regard to class, voting rights, or other distinguishing characteristics as reflected on the consolidated financial statements of the company.[2]

Conflict of Interest The principal new definition is that of "conflict of interest." A conflict of interest will be deemed to exist if the member and/or its associated persons, parent or affiliates in the aggregate beneficially own 10 percent or more of the:

(1) outstanding subordinated debt of a company;

(2) common equity of a company that is a corporation; or

(3) preferred equity of a company.

In addition, a conflict of interest will be deemed to exist if the member and/or its associated persons, parent or affiliates beneficially own a general, limited, or special partnership interest in 10 percent or more of the distributable profits or losses of a company. The term "conflict of interest" does not, by its terms, include ownership by a member, its associated persons, parent or affiliates of the common equity, preferred stock, or debt of the parent of the issuer.

The calculation of the 10 percent threshold will be based on all securities of the issuer beneficially owned by the member at the time of the filing of the offering documents, including proprietary trading accounts and other fluctuating positions, regardless of whether any of the securities are sold prior to effectiveness of the offering. If a member meets the 10 percent threshold at the time of filing the offering documents for review, the NASD will presume that the member who has a conflict of interest has conducted due diligence and participated in the preparation of the disclosures in the offering document. Therefore, the member's sale of sufficient securities to decrease its ownership below the 10 percent threshold after the filing of an offering will not cure the conflicts present when due diligence was conducted and the offering document prepared.

[2] The NASD believes that the term "common equity" also includes warrants or rights for common equity that are exercisable within the 60-day period following the offering.

With respect to the ownership of subordinated debt, the calculation of the 10 percent threshold will be based on the issuer's entire subordinated debt outstanding, not just the class or series of subordinated debt owned by the member.

This provision sets forth exclusions from the definition of "conflict of interest" for offerings by not-for-profit and charitable organizations; investment companies registered under the Investment Company Act; "separate accounts" as defined in the Investment Company Act of 1940; real estate investment trusts; direct participation programs; financing-instrument-backed securities rated investment grade; equity securities for which a bona fide independent market exists; and debt securities rated investment grade.[3]

Preferred Equity The term "preferred equity" includes the aggregate capital invested by all persons in the preferred securities outstanding without regard to class, voting rights, or other distinguishing characteristics as reflected on the consolidated financial statements of the company.

Subordinated Debt The NASD is also adopting a definition of "subordinated debt" to include debt of an issuer that is expressly subordinate in right of payment to, or with a claim on assets subordinate to, any existing or future debt of such issuer and all debt that is specified as subordinated at the time of issuance. All senior debt, whether secured or unsecured, and all short-term obligations with a maturity at issuance of less than one year are expressly excluded from the definition. The calculation of the 10 percent threshold would be applicable to an issuer's entire subordinated debt outstanding—not just to the specific class of subordinated debt owned by the member. Senior and short-term debt would, therefore, be excluded when calculating the percentage of debt that would trigger application of Schedule E.

Qualified Independent Underwriter A conforming amendment has been made to subparagraph (6) of the definition of "qualified independent underwriter" currently included in Subsection 2(l) to Schedule E, which is redesignated Subsection 2(o). Subsection 2(o) sets forth the requirement that a qualified independent underwriter not be an affiliate of the issuer and not beneficially own 5 percent or more of the outstanding voting securities of the issuer. The provision is modified to also prohibit ownership of 5 percent or more of the common equity, preferred equity, or subordinated debt of the issuer.

Section 3—Participation in Distribution Of Securities Of Member Or Affiliate

Subsection 3(a) Section 3 is retitled "Participation in Distribution of Securities." Subsection 3(a) has been amended to require compliance with Subsections 3(b) and (c) where a member underwrites or participates as a member of the underwriting syndicate or selling group or otherwise assists in the distribution of a public offering of securities of a company with which the member or its associated persons, parent or affiliates have a conflict of interest.

Subsection 3(b) The NASD is not changing Subsection 3(b). This subsection requires that the majority of the Board of Directors of the member that is deemed to have a conflict with the issuer must have been actively engaged in the investment banking or securities business for at least five years.

Subsection 3(c) The NASD is amending Subsection 3(c) to require that if a member proposes to underwrite, participate as a member of the underwriting syndicate or selling group, or otherwise assist in the distribution of a public offering of securities of a company with which it or its associated persons, parent or affiliates have a conflict, the offering must be made in compliance with paragraph 3(c)(1). Paragraph 3(c)(1) requires a qualified independent underwriter to participate in the preparation of the offering document, exercising the usual standards of due diligence with respect thereto, and issue an opinion that the price at which an equity issue or the yield at which a debt issue is to be distributed to the public is established at a price no higher or yield no lower than the qualified independent underwriter would recommend. As stated above, the definition of "conflict of interest" would specifically exclude the application of Schedule E to conflict-of-interest situations where the offering comports with the alternative forms of Schedule E compliance set forth in paragraphs 3(c)(2) and (3), which require either a bona fide independent market (in the case of an equity offering) or an investment grade rating (in the case of a debt offering).

The NASD is also amending paragraph 3(c)(1) to adopt an exception from the requirement that a qualified independent underwriter provide a pricing opinion where a member affiliated with the issuer or a member that has a conflict of interest is participating solely as a financial advisor in a restructuring or recapitalization and therefore the member is not obligated to and does not provide an opinion with respect to the price, yield, or exchange value of the transaction. The exception is not avail-

[3]For offerings subject to Schedule E on the basis that the securities are being issued by a member or an affiliate of a member, the offering is subject to the filing requirements of Schedule E regardless of whether the offering is of equity securities for which a bona fide independent market exists or of debt securities that are rated investment grade.

able for transactions involving an offering by a member of its own securities or those of a member's parent.[4]

Sections 4, 11, and 12

The NASD is also amending Sections 4, 11, and 12 of Schedule E to provide that the requirements with respect to disclosure, suitability, and discretionary accounts, respectively, apply to offerings by a company in which a member has a conflict of interest.

Corporate Financing Filing Requirements

The filing requirements of the Corporate Financing Rule are contained in Section (b) to Article III, Section 44 of the NASD Rules of Fair Practice (Corporate Financing Rule). Paragraph (b)(6)(C) requires that members filing an offering subject to the filing requirements of the Rule or Schedule E[5] submit a statement that is intended to elicit information on whether any member or person associated with a member has acquired any debt or equity securities of the issuer. The provision currently requires a statement of the association or affiliation with any member of any debt or equity securityholder of an issuer in an initial public offering. Where the offering is not an initial public offering, the same information is requested with respect to any securityholder of 5 percent or more of any class of the issuer's securities. The provision sets forth the details of the information regrading such securityholdings that must be submitted in the statement.

The NASD believes that this provision is sufficiently broad to require the submission of information regarding the beneficial ownership by a member, its associated persons, parent or affiliates of any equity, preferred stock, or subordinated debt of an issuer and the submission of supplemental information after the offering is filed if the ownership level changes during the registration period.

Questions regarding this Notice may be directed to the Corporate Financing Department, at (202) 728-8258.

Text Of Amendments To Schedule E Of The By-Laws

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

Schedule E

Distribution of Securities of Members and Affiliates— Conflicts of Interest

Section 1 - General

(a) No member or person associated with a member shall participate in the distribution of a public offering of debt or equity securities issued or to be issued by the member, the parent of the member, or an affiliate of the member and no member or parent of a member shall issue securities except in accordance with this Schedule.

(b) No member or person associated with a member shall participate in the distribution of a public offering of debt or equity securities issued or to be issued by a company if the member and/or its associated persons, parent or affiliates have a conflict of interest with the company, as defined herein, except in accordance with this Schedule.

Section 2 - Definitions

(a) - (d) No change.

(e) **Common Equity** — the total number of shares of common stock outstanding without regard to class, whether voting or non-voting, convertible or non-convertible, exchangeable or non-exchangeable, redeemable or non-redeemable, as reflected on the consolidated financial statements of the company.

[(e)] (f) No change.

(g) **Conflict of Interest** — shall be presumed to exist when:

(1) a member and/or its associated persons, parent or affiliates in the aggregate beneficially own 10% or more of the outstanding subordinated debt of a company;

[4]The modifications to Section 3(c) also include deletion of the words "subject to this Section without limitation as to the amount of securities to be distributed by the member," which were erroneously retained after a prior amendment deleted provisions that provided for two levels of participation in an offering by a member offering its own securities or those of a parent or affiliate, depending on whether one or two qualified independent underwriters participated in pricing and due diligence. Section 3(c) does not currently limit the percentage of a member's participation in an offering by the member subject to Schedule E. In addition, the reorganization of Subsection 3(c)(1) results in increased clarity with respect to the current requirement that the qualified independent underwriter must act as managing underwriter of an offering in which the member that is offering its own securities or those of a parent or affiliate or is subject to a conflict of interest has not been actively engaged in the investment banking or securities business for at least the five years immediately preceding the filing of the offering.

[5]The filing requirements of Schedule E take precedence over the filing requirements of the Corporate Financing Rule pursuant to Section 15 of Schedule E. Therefore, offerings that are exempt from the filing requirements of the Rule are nonetheless subject to filing with the Corporate Financing Department for review if subject to the provisions of Schedule E. *See* subparagraph (7) to Section (b) to the Corporate Financing Rule.

(2) a member and/or its associated persons, parent or affiliates in the aggregate beneficially own 10% or more of the common equity of a company which is a corporation, or beneficially own a general limited or special partnership interest in 10% or more of the distributable profits or losses of a company; or

(3) a member and/or its associated persons, parent or affiliates in the aggregate beneficially own 10% or more of the preferred equity of a company.

(4) The provisions of paragraphs (1), (2) and (3) hereof notwithstanding, the conflict of interest provisions of this Schedule E shall not apply to:

(a) an offering of securities exempt from registration with the Securities and Exchange Commission under Section 3(a)(4) of the Securities Act of 1933;

(b) an investment company registered with the Securities and Exchange Commission pursuant to the Investment Company Act of 1940, as amended;

(c) a "separate account" as defined in Section 2(a)(37) of the Investment Company Act of 1940, as amended;

(d) a "real estate investment trust" as defined in Section 856 of the Internal Revenue Code;

(e) a "direct participation program" as defined in Article III, Section 34 of the Rules of Fair Practice;

(f) an offering of financing instrument-backed securities which are rated by a nationally recognized statistical rating organization in one of its four (4) highest generic rating categories;

(g) an offering of a class of equity securities for which a bona fide independent market as defined in Section 2(c) exists as of the date of the filing of the registration statement and as of the effective date thereof; and

(h) an offering of a class of securities rated in one of the four highest generic rating categories by a nationally recognized statistical rating organization.

(f) - (i) are redesignated (h) - (k) No change.

(l) **Preferred Equity** — the aggregate capital invested by all persons in the preferred securities outstanding without regard to class, whether voting or non-voting, convertible or non-convertible, exchangeable or non-exchangeable, redeemable or non-redeemable, as reflected on the consolidated financial statements of the company.

(j) and (k) are redesignated (m) and (n) No change.

[l](0) **Qualified independent underwriter***— a member which:

(1) - (5) No change.

(6) is not an affiliate of the entity issuing securities pursuant to Section 3 of this Schedule and does not beneficially own five percent or more of the outstanding voting securities, common equity, preferred equity or subordinated debt of such entity which is a corporation or beneficially own a partnership interest in five percent or more of the distributable profits or losses of such entity which is a partnership; and

(7) No change.

(m) and (n) are redesignated (p) and (q) No change.

(r) **Subordinated Debt** — includes (1) debt of an issuer which is expressly subordinate in right of payment to, or with a claim on assets subordinate to, any existing or future debt of such issuer; or (2) all debt that is specified as subordinated at the time of issuance. Subordinated debt shall not include short-term debt with maturity at issuance of less than one year and secured debt and bank debt not specified as subordinated debt at the time of issuance.

Section 3 - Participation in Distribution of Securities [of Member or Affiliate]

(a) No member shall underwrite, participate as a member of the underwriting syndicate or selling group, or otherwise assist in the distribution of a public offering of an issue of debt or equity securities issued or to be issued by the member or an affiliate of the member, or of a company with which the member or its associated persons, parent or affiliates have a conflict of interest, unless the member is in compliance with subsection 3(b) and subsection 3(c) below.

(b) In the case of a member which is a corporation, the majority of the board of directors, or in the case of a member which is a partnership, a majority of the general partners or, in the case of a member which is a sole proprietorship, the proprietor as of the date of the filing of the registration statement and as of the effective date of the offering shall have been actively engaged in the investment banking or securities business for the five-year period immediately preceding the filing of the registration statement.

*In the opinion of the National Association of Securities Dealers, Inc. and the Securities and Exchange Commission the full responsibilities and liabilities of an underwriter under the Securities Act of 1933 attach to a "qualified independent underwriter" performing the functions called for by the provisions of Section 3 hereof.

(c) If a member proposes to underwrite, participate as a member of the underwriting syndicate or selling group, or otherwise assist in the distribution of a public offering of its own, or an affiliate's securities, or of securities of a company with which it or its associated persons, parent or affiliates have a conflict of interest, [subject to this Section without limitation as to the amount of securities to be distributed by the member,] one or more of the following three criteria shall be met:

(1) the price at which an equity issue or the yield at which a debt issue is to be distributed to the public is established at a price no higher or yield no lower than that recommended by a qualified independent underwriter which shall also participate in the preparation of the registration statement and the prospectus, offering circular, or similar document and which shall exercise the usual standards of "due diligence" in respect thereto; provided, however, that:

(i) an offering of securities by a member which has not been actively engaged in the investment banking or securities business, in its present form or as a predecessor broker/dealer, for at least the five years immediately preceding the filing of the registration statement shall be managed by a qualified independent underwriter; [or] and

(ii) the provision of this paragraph which requires that the price or yield of the securities be established based on the recommendation of a qualified independent underwriter shall not apply to an offering of equity or debt securities if:

a. the securities (except for the securities of a broker/dealer or its parent) are issued in an exchange offer or other transaction relating to a recapitalization or restructuring of a company; and

b. the member that is affiliated with the issuer or with which the member or its associated persons, parent or affiliates have a conflict of interest is not obligated to and does not provide a recommendation with respect to the price, yield, or exchange value of the transaction;

(2) and (3) No change.

Section 4 - Disclosure

(a) Any member offering its securities pursuant to this schedule shall disclose in the registration statement, offering circular, or similar document a date by which the offering is reasonably expected to be completed and the terms upon which the proceeds will be released from the escrow account described in subsection 5(a).

(b) All offerings included within the scope of this Schedule shall disclose in the underwriting section of the registration statement, offering circular or similar document that the offering is being made pursuant to the provisions of this Schedule, that the offering is either being made by a member of its own securities or those of an affiliate, or those of a company in which the member or its associated persons, parent or affiliates own the common stock, preferred stock or subordinated debt of the company, the name of the member acting as qualified independent underwriter, if any, and that such member is assuming the responsibilities of acting as a qualified independent underwriter in pricing the offering and conducting due diligence.

* * * *

Section 11 - Suitability

Every member underwriting an issue of its securities, or securities of an affiliate, or the securities of a company with which it has a conflict of interest, pursuant to the provisions of Section 3 hereof, who recommends to a customer the purchase of a security of such an issue shall have reasonable grounds to believe that the recommendation is suitable for such customer on the basis of information furnished by such customer concerning the customer's investment objectives, financial situation, and needs, and any other information known by such member. In connection with all such determinations, the member must maintain in its files the basis for its determination.

Section 12 - Discretionary Accounts

Notwithstanding the provisions of Article III, Section 15 of the Corporation's Rules of Fair Practice, or any other provisions of law, a transaction in securities issued by a member or an affiliate of a member, or by a company with which a member has a conflict of interest shall not be executed by any member in a discretionary account without the prior specific written approval of the customer.

NASD NOTICE TO MEMBERS 94-46

NASD Reminds Members Of Their Obligations When Trading Options

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

Given the growing market for over-the-counter (OTC) derivatives, such as OTC options on individual equity securities and stock indexes, and the Securities and Exchange Commission's (SEC) recent approval of increases in option position and exercise limits, the NASD reminds members of their obligations to comply with NASD rules governing options position limits, exercise limits, and position-reporting requirements. To clarify the application and operation of these rules, a description of the rules and a question and answer section follow. In addition, a reprint of the applicable rules follows this Notice.

Background

Section 33 of the NASD Rules of Fair Practice governs members' activities in standardized and conventional options. Standardized options are exchange-traded options issued by the Options Clearing Corporation (OCC) that have standard terms for strike prices, expiration dates, and the amount of the underlying security. Presently, there are standardized options overlying individual equity securities, stock indexes, foreign currencies, American Depositary Receipts, exchange-listed closed-end country funds, Treasury instruments, and yields based on Treasury instruments. A conventional option is any other option contract not issued, or subject to issuance, by the OCC. Section 33(a), however, provides that the term "option" shall "not include any tender offer, registered warrant, right, convertible security, or any other option with respect to which the writer is the issuer of the security which may be purchased or sold upon the exercise of the option."

Pursuant to Section 33(b)(1)(A) of the Rules of Fair Practice the position limits, exercise limits, and reporting requirements described below apply to standardized and conventional stock and stock-index options in the following manner:

(1) The position and exercise limits contained in Sections 33(b)(3) and 33(b)(4) of the Rules of Fair Practice apply only to standardized and conventional equity options.

(2) Standardized options on stock indexes are subject to the position and exercise limits established by the exchange on which the index option trades.

(3) Conventional options on stock indexes are not subject to any position or exercise limits.

(4) The position-reporting requirements contained in Section 33(b)(5) of the Rules of Fair Practice apply to all conventional and standardized-options positions established by member firms that are "access" firms.[1]

Options Position Limits

Equity Options

Section 33(b)(3) of the Rules of Fair Practice imposes a ceiling or position limit on the number of conventional and standardized equity options contracts in each options class (i.e, puts or calls) on the same side of the market that a member, a customer, a person associated with a member, or a group of investors acting in concert can write or hold. Accordingly, long calls and short puts are aggregated and short calls and long puts are

[1] "Access" firms are NASD members that conduct a business in exchange-listed options but which are not members of any of the options exchanges upon which the options are listed and traded.

aggregated for position-limit purposes. The position limit for each stock is determined according to a "three-tiered" system that subjects more actively traded securities with larger public floats to higher position limits and less actively traded stocks to lower limits. The NASD rules do not specifically govern how a particular equity option falls within one of the three position-limit tiers. Rather, the NASD position-limit rule provides that the position limit established by an options exchange(s) for a particular equity option is the applicable position limit for purposes of the NASD rule.[2] The position limit for a particular equity security can be obtained from OCC, the relevant options exchange(s), or the NASD Market Surveillance Department. In instances where an equity security is not subject to standardized options trading and, thus, there is no position limit established by an options exchange, the applicable position limit for the conventional option is the lowest tier.

On January 5, 1994, the SEC approved an NASD proposal to increase the current position limits from 3,000, 5,500, and 8,000 contracts to 4,500, 7,500, and 10,500 contracts, respectively.[3] These changes were made to track corresponding position limit increases made by the options exchanges. The NASD believes the increased position limits will afford market participants greater flexibility to employ larger options positions when effectuating their investment strategies. In addition, the NASD believes the increased limits likely will facilitate greater activity in exchange-listed options, thereby enhancing liquidity in the markets for exchange-traded options and the securities underlying those options.

The NASD hedge-exemption pilot program, in effect since February 1990, provides for an automatic exemption from equity option position limits for accounts that have established one of the four most commonly used hedged positions on a limited one-for-one basis (i.e., 100 shares of stock for one option contract or, in the case of an adjusted options contract, the number of shares represented by the adjusted contract). The exempted hedge positions are: (1) long stock/short calls; (2) long stock/long puts; (3) short stock/long calls; and (4) short stock/short puts. Under the pilot program, the largest options position that may be established (combining hedged and unhedged positions) may not exceed twice the basic position limit (i.e., 9,000, 15,000, and 21,000 contracts, respectively).

On March 18, 1994, the SEC approved an NASD proposal to extend and expand its equity option position-limit, hedge-exemption pilot program.[4] Specifically, the pilot program was extended until December 31, 1995, and expanded to provide that the underlying hedged security position may be comprised of securities readily convertible into, or economically equivalent to, the security underlying the corresponding hedging options position. The NASD believes that expanding the hedge-exemption pilot program in this manner will allow investors to hedge instruments that are economically equivalent to stocks more efficiently and effectively. Because the value of a convertible security likely will fluctuate in tandem with the value of the security that it is convertible into, the NASD believes investors with positions in convertible securities should be able to hedge their positions with equity options to the same extent that investors with long or short positions in the underlying security can.[5]

Stock-Index Options

Conventional stock-index options are not subject to position limits, although members trading standardized stock-index options are required to adhere to the position limits established for the option by the exchange on which it trades.

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[2] For a description of the trading volume and float parameters used to determine applicable equity option position limits, *see, e.g.,* Commentary .07 to American Stock Exchange Rule 904 and Interpretations and Policies .02 to Chicago Board Options Exchange Rule 4.11.

[3] *See* Securities Exchange Act Release No. 33432 (January 5, 1994), 59 FR 1979.

[4] *See* Securities Exchange Act Release No. 33783 (March 18, 1994), 59 FR 14229.

[5] The NASD will determine on a case-by-case basis whether an instrument that is being used as the basis for the underlying hedged position is readily convertible into, or economically equivalent to, the security underlying the corresponding option position. In this connection, the NASD will find that an instrument which is not presently convertible into a security, but which will be at a future date, is not a readily "convertible" security for purposes of the hedge-exemption pilot program. In addition, the NASD notes that if a convertible security used to hedge an option position is called for redemption by the issuer, the security would have to be converted into the underlying security immediately or the corresponding option position reduced accordingly. For further guidance in this area, see also the NASD Board of Governor's Prompt Receipt and Delivery of Securities Interpretation issued under Article III, Section 1 of the NASD Rules of Fair Practice. Specifically, Section (b)(5)(a) of the Interpretation provides some guidelines as to positions that are bona fide fully hedged for purposes of the NASD "affirmative determination" requirements for short sales. While Section (b)(5)(a) of the Interpretation provides some guidance, the staff must determine on a case-by-case basis whether an instrument is readily convertible into, or economically equivalent to, the security underlying the corresponding hedging options position.

Options Exercise Limits

Options exercise limits restrict the number of options contracts that a member, customer, person associated with a member, or group of investors acting in concert can exercise within five consecutive business days. Under Section 33(b)(4) of the Rules of Fair Practice, the exercise limits correspond to position limits, such that investors in options classes on the same side of the market are allowed to exercise, during any five consecutive business days, only the number of options contracts set forth as the applicable position limit for those options classes. Accordingly, the SEC's approval of the NASD proposal for higher position limits also increased the NASD exercise limits to 4,500, 7,500, and 10,500 contracts, respectively.

Under the hedge-exemption pilot program for equity options, the exercise limit is equivalent to the size of the options position established pursuant to the hedge-exemption program. Therefore, if the position limit for an option is 7,500 contracts and an investor has established a position of 10,000 contracts (7,500 unhedged and 2,500 hedged), the investor could exercise all 10,000 contracts during five consecutive business days.

As with position limits, standardized and conventional equity options and standardized stock-index options are subject to exercise limits, while conventional stock-index options are not.

Options Position Reporting

Section 33(b)(4) of the Rules of Fair Practice is applicable to all standardized options positions established by "access" firms[6] or their customers and all conventional options positions established by members or their customers. Specifically, the rule requires members to file a report with the NASD if the member's account, a customer's account, or an associated person's account establishes an aggregate options position of 200 or more options contracts of the put class and the call class on the same side of the market covering the same underlying security or index.

In aggregating options on the "same side of the market," long calls in any class of options should be combined with short puts of the same class and short calls should be combined with long puts to determine whether a reportable position exists. Long and short positions for the same class should not be netted or combined (e.g., 200 contracts long and 200 contracts short in the same options class in the same account should both be reported, while 100 contracts long and 100 contracts short in the same options class in the same account should not be reported).

A position report form should be filed in each of the following situations:

- A long and/or short position of 200 or more options contracts of the put class and the call class on the same side of the market is established in the account.

- There is an increase in a previously reported position (e.g., from 250 contracts to 275 contracts).

- There is a decrease in a previously reported position to a position of less than 200 contracts (e.g., from 250 contracts to 199 contracts). Once a position has been reduced to less than 200 contracts, no subsequent position reports would have to be filed until the account once again established a long and/or short position of 200 or more contracts of the put class and the call class on the same side of the market.

Position report forms and instructions can be obtained by contacting Joseph Alotto, Special Investigator, NASD Market Surveillance Department, at (301) 590-6845.

Exemptions

Section 33(b)(3)(A) of the Rules of Fair Practice provides that the NASD may grant position-limit exemptions in "highly unusual circumstances." Position-limit exemption requests are considered by the Options and Derivatives Subcommittee (Options Subcommittee) of the NASD Trading Committee on a confidential basis. A position-limit exemption request should contain, at a minimum: (1) the size of the position-limit exemption request; (2) the name of the security underlying the option or sufficient information about the underlying security to enable the Options Subcommittee to adequately assess the market for that security (i.e., float, market capitalization, price, primary market, trading volume, etc.); (3) a description of the parties to the transaction; (4) the basis for the exemption; and (5) a statement as to why the market disruption and manipulation concerns underlying position limits would not be compromised if the NASD were to grant the exemption. Depending on the circumstances, the Options Subcommittee also may ask for additional information. Members submitting position-limit exemption requests should direct them to either Glen Shipway, Senior Vice President, Market Operations, The Nasdaq Stock Market, 80 Merritt Boulevard, Trumbull, CT 06611, or Thomas Gira, Assistant General Counsel, The Nasdaq Stock Market, 1735 K Street, N.W., Washington, D.C. 20006.

[6] *See, supra*, note 1.

As a general matter, the NASD has not granted many position-limit exemptions in the past. Recently, however, the Options Subcommittee has been considering an increasing number of exemption requests. Accordingly, in the interests of keeping market participants equally informed of actions taken by the Options Subcommittee in this area, the NASD will publish generic descriptions of the position-limit exemptions and interpretive positions issued by the Options Subcommittee, as well as those requests denied by the Subcommittee, from time to time, in the "For Your Information" section of NASD *Notices to Members*. **Members and customers of members are reminded that these exemptions and interpretations are fact specific in nature and, therefore, it would be a violation of the NASD position-limit rule if a member or customer were to rely solely on a generic description of a position-limit exemption or interpretive position without also obtaining a specific position-limit exemption or interpretive position from the Options Subcommittee.** Following are brief summaries of recent actions taken by the Options Subcommittee in this area.

"Collar Transaction" Involving Conventional Options

The Options Subcommittee considered and granted several exemption requests concerning the aggregation of long put and short call positions in the context of "collar" transactions involving cash-settled, European-style conventional options. In these transactions, the customer purchased long puts and wrote short calls on the same amount of the underlying security to hedge a long stock position. Specifically, the Options Subcommittee determined that, subject to the following conditions and consultation with the NASD on a case-by-case basis, short call and long put positions in a conventional option collar transaction need not be aggregated. Provided that all the conditions are satisfied, the Options Subcommittee also determined that corresponding long call and short put positions in conventional options established to facilitate the collar likewise need not be aggregated. The conditions are as follows:

1. The collar must be established with conventional option contracts, which contracts must provide that:

a. the options can only be exercised if they are in-the-money; and

b. neither option can be sold, assigned, or transferred by the holder without the prior written consent of the writer.

2. The options must be European-style (i.e., only exercisable upon expiration), with the short call and long put expiring on the same date.

3. The strike price of the short call can never be less than the strike price of the long put.

4. No more than one side of the transaction can be in-the-money when the collar is established.

5. The member complies with all NASD requests for information concerning the conventional options.

Non-Applicability Of Section 33 Of The Rules Of Fair Practice To Certain Equity Warrants

The Options Subcommittee issued an interpretive position that Section 33 of the Rules of Fair Practice does not apply to warrants issued by a large, publicly held U.S. company on the common stock of a non-U.S. company in which the U.S. company has a 20 percent ownership interest. The Options Subcommittee found that the 20 percent ownership of the non-U.S. company by the U.S. company brought the warrants within the "issuer written" exemption contained in Section 33(a) of the NASD Rules of Fair Practice.

Application Of The Position-Limit, Hedge-Exemption Program To Call Options Purchased By Issuers On Their Own Stock

The Options Subcommittee issued an interpretive position that an issuer may be deemed to be short its own stock when purchasing call options on its stock to hedge market exposure from employee stock options, stock repurchase programs, and outstanding convertible securities, and for other corporate purposes. Thus, for purposes of the hedge-exemption program, an issuer could purchase calls on its own stock up to twice the applicable limit because it would be deemed to be short the requisite number of shares of stock. This interpretive position should not, however, be construed to be an opinion by the Options Subcommittee with respect to the applicability of SEC Rule 10b-18 to issuers purchasing call options on their own stock, or to purchases by writers of such calls to hedge their position or to acquire stock to deliver upon exercise of the call option. Accordingly, the Option Subcommittee's interpretive position in no way affects or changes the operation of any provision of SEC Rule 10b-18 or the availability of the safe harbor afforded by the rule. It is up to NASD members and issuers to determine when they are within the parameters of the safe harbor afforded by SEC Rule 10b-18.

Answers To Common Questions Concerning Position-Limits, Exercise Limits, And Reporting Requirements

Scope Of The NASD Options Rules

Question #1: Do equity option position limits apply to conventional options with transfer restrictions?

Answer: Yes. A transfer restriction does not make an option any less an option; it is an attribute of an option that is negotiated between the writer and holder of the option. Moreover, the regulatory purposes served by position limits (i.e., prevention of market manipulation and market disruption) are no less compelling for options with transfer restrictions.

Question #2: Do equity option position limits apply to foreign securities?

Answer: Yes. The position-limit rule makes no distinction between U.S. securities and foreign securities. Accordingly, if the foreign security is not subject to options trading in the United States, the position limit will be 4,500 contracts. However, because differences in securities trading practices between U.S. and domestic markets (i.e., units of trading, price levels, etc.) may be pronounced, application of the 4,500 contract position limit to foreign securities not subject to standardized options trading in the U.S. may unnecessarily constrain members' conventional options activities. Accordingly, under appropriate circumstances, the Options Subcommittee may determine that a higher position limit for a foreign security is warranted because the differences between the U.S. equities market and a foreign equities market constitute unusual circumstances.

Question #3: Are standardized equity options listed and traded on markets located outside the U.S. subject to the NASD position-limit rule?

Answer: No. The rules of the foreign exchange on which the option is listed and traded determine the applicable position limit.

Question #4: Do equity option position limits apply to cash-settled options?

Answer: Yes. The fact that an equity option is cash-settled does not exempt it from any provisions of Section 33 of the Rules of Fair Practice, the instrument underlying the option (i.e., an equity security) is the determinative factor. A cash-settled equity option presents the same market manipulation and market disruption concerns as a physically settled equity option.

Question #5: Do the NASD options rules apply to conventional option transactions effected abroad by an NASD member or a foreign branch of an NASD member?

Answer: Yes. If the option is booked and carried with an NASD member, it is subject to the NASD position-limit rule.

Question #6: Do equity option position limits apply to options on preferred stock, American Depositary Receipts, or closed-end country funds?

Answer: For standardized options on these securities, members are obligated to adhere to the position-limits established by the options exchanges. For conventional options on these securities, the NASD interprets common stock to include these instruments. Thus, conventional options on these securities also are subject to the position limits.

Question #7: Do the position limits apply to options on debt instruments?

Answer: No.

Question #8: Are conventional stock index options subject to position limits?

Answer: No, but they are subject to the position-reporting requirements in Section 33(b)(5) of the Rules of Fair Practice.

Question #9: Do options position limits apply to options on foreign currencies?

Answer: No.

Question #10: Do equity option position limits apply to options written by the issuer of the security underlying the option?

Answer: No. Section 33(a) of the Rules of Fair Practice specifically provides that issuer-written options are not considered options for purposes of Section 33.

Question #11: Equity warrants sold by an issuer on its own stock have economic attributes similar to equity options. Are such warrants, therefore, subject to position and exercise limits?

Answer: No. Equity warrants issued by a company on its own stock, which typically are used to facilitate capital formation, are excluded from the definition of an option for purposes of Section 33.

Aggregation Of Positions

Question #12: Are positions in conventional equity options aggregated with standardized equity option positions for position-limit purposes?

Answer: Yes. All equity options overlying the same security are aggregated for position limit purposes.

Question #13: Are positions in conventional stock-index options aggregated with standardized stock-index option positions?

Answer: No. Only standardized stock-index options are subject to position limits.

Question #14: Assuming the position limit for an equity option is 4,500 contracts, can an investor enter

into one contract covering 600,000 shares and not commit a position-limit violation?

Answer: No. Section 33(b)(2)(E) of the Rules of Fair Practice provides that if a stock option is granted covering some number of shares other than 100, then it is deemed to constitute as many options contracts as that other number of shares divided by 100. Therefore, in this case the options position would be deemed to be 6,000 contracts, not one contract

Question #15: How are equity options positions aggregated for position-limit purposes?

Answer: All standardized and conventional options in each options class (i.e., puts or calls) on the same side of the market are aggregated for position-limit purposes. Accordingly, long calls and short puts are aggregated and short calls and long puts are aggregated. For example, assuming ABC stock is subject to a 7,500 position limit, a member who is long 7,500 ABC calls may at the same time be long 7,500 ABC puts because long calls and long puts (or short calls and short puts) are on opposite sides of the market. However, a member who is long 5,000 ABC calls may not at the same time be short more than 2,500 ABC puts because these positions are on the same side of the market.

Question #16: With an equity option that is subject to a position limit of 4,500 contracts, can an investor hold 5,000 contracts on one side of the market and 4,500 on the other and be in compliance with the position limits because there is net only 500 contracts on one side of the market?

Answer: No. The position-limit rules do not permit netting of options positions on opposite sides of the market. Positions on each side of the market (i.e., long calls and short puts or short calls and long puts) are aggregated and evaluated independent from positions on the opposite side of the market.

Question #17: If a member has 300 contracts on one side of the market and 200 contracts on the other side of the market, must the member report these positions on a gross basis, even though the "net" position is only 100 contracts on one side of the market?

Answer: Yes. As with position limits, the reporting requirements do not permit the netting of positions on the opposite side of the market.

Hedge-Exemption Program
Question #18: How does one obtain a hedge exemption?

Answer: As long as the "hedged" position in excess of the basic limit of 4,500, 7,500, or 10,500 contracts is hedged on a one-for-one basis with a corresponding long (or short) stock position (or securities readily convertible into, or economically equivalent to, such stock), the exemption is automatic. A member would be obligated to file a position report with the NASD Market Surveillance Department pursuant to Section 33(b)(5) of the Rules of Fair Practice, however. Under the pilot program, the largest options position that may be established (combining hedged and unhedged positions) may not exceed twice the basic position limit (i.e, 9,000, 15,000, and 21,000 contacts, respectively).

Question #19: When relying on the hedge exemption, does the entire options position need to hedge a corresponding stock position?

Answer: No. For example, assuming XYZ is subject to a 7,500 contract position limit, a member who is long 750,000 shares of XYZ may be short up to 15,000 XYZ calls, since the "hedge" exemption contained in Section 33(a)(5) of the Rules of Fair Practice permits the member to establish an options position up to 15,000 contracts in size. In this instance, 7,500 of the 15,000 contracts are permissible under the basic position limit contained in Section 33(b)(3)(A)(2) of the Rules of Fair Practice and the remaining 7,500 contracts are permissible because they are hedged by the 750,000 shares.

Question #20: How do the exercise limits apply to an options position that exceeds the basic position limit pursuant to the hedge exemption?

Answer: Under the hedge-exemption pilot program for equity options, the exercise limit is equivalent to the size of the options position established pursuant to the hedge-exemption program. Therefore, if the position limit for an option is 10,500 contracts and an investor has established a position of 21,000 contracts (10,500 unhedged and 10,500 hedged), the investor could exercise all 21,000 contracts during five consecutive business days.

Miscellaneous
Question #21: Who determines which position-limit tier is applicable to a particular equity option and how can members find out what the position limit is for a specific equity option?

Answer: If an equity option is subject to standardized options trading, the NASD position limit for that option is the same limit imposed by the options exchange trading the option. If the security underlying the option is not subject to standardized options trading, the applicable position limit is the lowest tier (i.e., 4,500 contracts). To find out the position limit for an option, members can contact the exchange on which the option trades or the NASD Market Surveillance Department. However,

if a security not subject to standardized options trading would qualify for a position limit higher than 4,500 contracts if it had standardized options traded on it, the Options Subcommittee would consider granting a position limit exemption request for up to such higher position limit.

Question #22: How do you report options positions to the NASD?

Answer: Position report forms and instructions can be obtained by contacting the NASD Market Surveillance Department at (301) 590-6845.

Question #23: If a member reports a position in a standardized option to an options exchange, must the member also report the position to the NASD?

Answer: No. Only "access" firms must report their standardized options positions to the NASD. "Access" firms are NASD members that conduct a business in exchange-listed options but which are not members of any of the options exchanges upon which the options are listed and traded.

Question #24: If the issuer of a security underlying a conventional option declares a two-for-one stock split, would the position limit remain the same?

Answer: Section 33(b)(2)(E) of the Rules of Fair Practice provides that "[a] stock option contract which, when written, grants the right to purchase or sell 100 shares of common stock shall continue to be considered as one contract throughout its life, notwithstanding that, pursuant to its terms, the number of shares which it covers may be adjusted to reflect stock dividends, stock splits, reverse splits, or other similar actions by the issuer of such stock." Therefore, while the limit on the absolute number of contracts would remain the same, the parties to the options contract may mutually agree to adjust the number of shares covered by the options contract to reflect the stock split. Accordingly, in this example, the option contract could be modified to cover 200 shares instead of 100 shares and the applicable position limit would remain the same.

Question #25: What happens to outstanding conventional option positions if the position limit for an option is decreased from 10,500 contracts to 7,500 contracts?

Answer: For conventional option positions outstanding at the time of the decrease, the position limit would remain the same. For conventional options positions established after the decrease, the position limit would be the limit determined according to the three-tiered position limit structure (i.e., 4,500, 7,500, or 10,500 contracts).

Questions concerning this Notice may be directed to Thomas Gira, Assistant General Counsel, Office of General Counsel, at (202) 728-8957 or Joseph Alotto, Special Investigator, Market Surveillance, at (301) 590-6845.

Text Of Amendments To Section 33 Of The NASD Rules Of Fair Practice

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

Section 33(b)(3) Position Limits

(a) Stock Options—Except in highly unusual circumstances and with the prior written approval of the Corporation in each instance, no member shall effect for any account in which such member has an interest, or for the account of any partner, officer, director or employee thereof, or for the account of any customer, an opening transaction through the Nasdaq [NASDAQ] System, the over-the-counter market or on any exchange in a stock option contract of any class of stock options if the member has reason to believe that as a result of such transaction the member or partner, officer, director or employee thereof, or customer would, acting alone or in concert with others, directly or indirectly, hold or control or be obligated in respect of an aggregate position in excess of:

(1) 4,500 [3,000] option contracts of the put class and the call class on the same side of the market covering the same underlying security, combining for purposes of this position limit long positions in put options with short positions in call options, and short positions in put options with long positions in call options; or

(2) 7,500 [5,500] options contracts of the put class and the call class on the same side of the market covering the same underlying security, providing that the 7,500 [5,500] contract position limit shall only be available for option contracts on securities which underlie Nasdaq [NASDAQ] or exchange-traded options qualifying under applicable rules for a position limit of 7,500 [5,500] option contracts; or

(3) 10,500 [8,000] option contracts of the put class and the call class on the same side of the market covering the same underlying security, providing that the 10,500 [8,000] contract position limit shall only be available for option contracts on securities which underlie Nasdaq [NASDAQ] or exchange-traded options qualifying under applicable rules for a position-limit of 10,500 [8,000] option contracts; or

(4) such other number of stock options contracts as may be fixed from time to time by the Corporation as the position limit for one or more

classes or series of options provided that reasonable notice shall be given of each new position limit fixed by the Corporation.

(5) Equity Option Hedge Exemption

(a) The following positions, where each option contract is "hedged" by 100 shares of stock or securities readily convertible into or economically equivalent to such stock, or, in the case of an adjusted option contract, the same number of shares represented by the adjusted contract, shall be exempted from established limits contained in (1) through (4) above: (i) long call and short stock; (ii) short call and long stock; (iii) long put and long stock; (iv) short put and short stock.

(b) In no event, however, may position limits for any class of stock options exceed twice the limits established by this subparagraph (3).

(c) The Equity Option Hedge Exemption is a pilot program authorized by the Securities and Exchange Commission through December 31, 1995.

The following examples illustrate the operation of position limits established by subparagraph (3) (all examples assume a position limit of 4,500 contracts):

(a) Customer A, who is long 4,500 [3,000] XYZ calls, may at the same time be short 4,500 [3,000] XYZ calls, since long and short positions in the same class of options (i.e., in calls only, or in puts only) are on opposite sides of the market and are not aggregated for purposes of subparagraph (3).

(b) Customer B, who is long 4,500 [3,000] XYZ calls, may at the same time be long 4,500 [3,000] XYZ puts. Subparagraph (3) does not require the aggregation of long call and long put (or short call and short put) positions, since they are on opposite sides of the market.

(c) Customer C, who is long 1,700 XYZ calls, may not at the same time be short more than 2,800 [1,300] XYZ puts, since the 4,500 [3,000] contract limit applies to the aggregation of long call and short put positions in options covering the same underlying security. Similarly, if Customer C is also short 1,600 XYZ calls, he may not at the same time be long more than 2,900 [1,400] puts, since the 4,500 [3,000] contract limit applies separately to the aggregation of short call and long put positions in options covering the same underlying security.

(d) Customer D, who is short 450,000 shares of XYZ, may be long up to 9,000 XYZ calls, since the "hedge" exemption contained in subparagraph (3)(A)(5) permits Customer D to establish an options position up to 9,000 contracts in size. In this instance, 4,500 of the 9,000 contracts are permissible under the basic position limit contained in subparagraph (3) and the remaining 4,500 contracts are permissible because they are hedged by the 450,000 short stock position.

(b) Index Options—Except in highly unusual circumstances and with the prior written approval of the Corporation in each instance, no member shall effect for any account in which such member has an interest, or for the account of any partner, officer, director or employee thereof, or for the account of any customer, an opening transaction in an option contract of any class of index options displayed on the Nasdaq [NASDAQ] System or dealt in on an exchange if the member has reason to believe that as a result of such transaction the member or partner, officer or employee thereof, or customer, would, acting alone or in concert with others, directly or indirectly, hold or control or be obligated in respect of an aggregate position in excess of position limits established by the Corporation, in the case of Nasdaq [NASDAQ] Index Options, or the exchange on which the option trades.

In determining compliance with this subparagraph (3), option contracts on a market index displayed in the Nasdaq [NASDAQ] System shall be subject to a contract limitation fixed by the Corporation, which shall not be larger than the equivalent of a $300 million position. For this purpose, a position shall be determined by the product of the closing index value times the index multiplier times the number of contracts on the same side of the market.

(c) Index option contracts shall not be aggregated with option contracts on any stocks whose prices are the basis for calculation of the index.

(d) The Corporation will notify the Securities and Exchange Commission at any time it approves a request to exceed the limits established pursuant to this subparagraph.

Section 33(b)(4) Exercise Limits
Except in highly unusual circumstances and with the prior written approval of the Corporation, in each instance, no member or person associated with a member shall exercise, for any account in which such member or person associated with a member has an interest, or for the account of any partner, officer, director or employee thereof or for the account of any customer, any option contract if as a result thereof such member or partner, officer, director or employee thereof or customer, acting alone or in concert with others, directly or indirectly, has or will have exercised within any five (5) consecutive busi-

ness days a number of option contracts of a particular class of options in excess of the limits for options positions in subparagraph (b)(3). The Corporation may institute other limitations concerning the exercise of option contracts from time to time by action of the Corporation. Reasonable notice shall be given of each new limitation fixed by the Corporation.

Section 33(b)(5) Reporting of Options Positions

(a) Each member shall file with the Corporation a report with respect to each account in which the member has an interest, each account of a partner, officer, director or employee of such member, and each customer account, which has established an aggregate position of 200 or more option contracts (whether long or short) of the put class and the call class on the same side of the market covering the same underlying security or index, combining for purposes of this Section long positions in put options with short positions in call options and short positions in put options with long positions in call options.

Such report shall identify the person or persons having an interest in such account and shall identify separately the total number of option contracts of each such class comprising the reportable position in such account. The report shall be in such form as may be prescribed by the Corporation and shall be filed no later than the close of business on the next business day following the day on which the transaction or transactions requiring the filing of such report occurred. Whenever a report shall be required to be filed with respect to an account pursuant to this subsection, the member filing such shall file with the Corporation such additional periodic reports with respect to such account as the Corporation may from time to time prescribe.

(b) In addition to the reports required by subparagraph (a) above, each member shall report promptly to the Corporation any instance in which such member has a reason to believe that a person, acting alone or in concert with others, has exceeded or is attempting to exceed the position limits or the exercise limits set forth in subparagraphs (b)(3) and (4).

NASD NOTICE TO MEMBERS 94-47

SEC Issues Policy Governing Broker/ Dealer Activity On Bank Premises

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 NASD is publishing this Notice to inform members of the terms and conditions of a Securities and Exchange Commission (SEC) staff no-action letter recently issued to the Chubb Securities Corporation (the Chubb letter), which sets forth the SEC's policy on broker/dealer activity on bank premises. Under the Chubb letter, a broker/dealer operating on the premises of a financial institution is required to enter into a written Customer Access Agreement with the financial institution. This agreement must stipulate that the broker/dealer exclusively will be responsible for all securities business conducted at the financial institution, and further, that the broker/dealer will take certain steps with regard to its physical location, customer disclosure procedures, and promotional literature to clearly distinguish the brokerage services it provides from the banking functions of the financial institution. The SEC has stated that it will no longer respond to requests for no-action relief regarding networking arrangements structured in accordance with the terms and conditions set forth in the Chubb letter.

Discussion

In a no-action letter dated November 24, 1993, responding to Chubb Securities Corporation, a registered broker/dealers, the staff of the SEC's Division of Market Regulation (SEC staff) addressed broker/dealers networking arrangements with depository institutions, including federal savings associations and their service corporations. By the terms of the Chubb letter, the SEC staff provided assurances that under specified circumstances the staff would not recommend enforcement action under Section 15(a)(1) of the Securities Exchange Act of 1934 where a registered broker/dealers entered into networking arrangements with various depository institutions to provide brokerage services on the premises of such institutions, without such institutions or their unregistered employees registering as broker/dealers. Section 15(a)(1), among other things, generally provides that it shall be unlawful for any broker or dealer to effect any purchase or sale of any security unless such broker or dealer is registered with the SEC. Some of the significant terms and conditions of the Chubb letter have been highlighted in the discussion that follows. However, because of its importance, the NASD encourages members to read the Chubb letter in its entirety. Accordingly, the full text of the letter is attached to this Notice.

Chubb Letter Highlights

For networking arrangements, the terms of the Chubb letter require that the registered broker/dealers and each financial institution enter into a written Customer Access Agreement that sets forth the responsibilities of the parties, the conditions of the arrangement, and the compensation to be received by the financial institution. Among other things, the agreements must state that transactions in securities may be effected only by persons who are registered with the broker/dealers and qualified under the rules of the NASD. Further, the broker/dealers must agree to control, supervise, and be responsible for all of its registered representatives, including any bank employees who also act in the capacity of registered representatives.

The financial institution, in turn, by the terms of the Customer Access Agreement, must agree to allow supervisory personnel of the broker/dealers and representatives of the SEC, the NASD, and any other applicable federal and state govern-

ment authorities, to inspect the financial institution's premises and books and records maintained with respect to brokerage activities. In addition, the financial institution must agree to monitor its unregistered employees to ensure that unregistered employees perform only clerical and ministerial functions with regard to investment-related activities.

In addition to the aforementioned conditions, the Chubb letter specifically provides, among other things, that:

• The broker/dealer's registered representatives must inform all securities customers, and obtain a written acknowledgment from the customers, that all purchases and sales made through the account are not guaranteed by the financial institution or insured by the Federal Deposit Insurance Corporation (FDIC) or any other federal or state deposit guarantee fund.

• The brokerage services must be conducted in an area that is physically separate from the financial institution's regular business activities in a manner that clearly distinguishes the brokerage services from those of the financial institution.

• Materials used to promote the availability of brokerage services must be approved by the broker/dealer for compliance with the federal securities laws prior to distribution and will be deemed materials of the broker/dealer. Further, references to financial institutions in advertising or promotional materials must be for the purpose of identifying only the location where brokerage services are available, and the references must not appear prominently in such materials.

Interagency Statement

Members also should be aware of guidelines issued on February 15, 1994, by the Board of Governors of the Federal Reserve System, the FDIC, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision in the "Interagency Statement on Retail Sales of Nondeposit Investment Products" (the Interagency Statement). The Interagency Statement embodies many of the investor protection concepts of the SEC's Chubb letter, and, although directed towards banks, also affects NASD members with regard to their regulatory compliance obligations. Specifically, as discussed in the Interagency Statement, NASD members should be aware that, as a consequence of conducting brokerage activities in connection with banking entities, bank regulators have taken the position that they have responsibility and authority to oversee and monitor the conduct of broker/dealers, and members may be requested to provide banking regulators with access to their books and records. In this regard, the NASD and the SEC continue to work closely with the bank regulators in an effort to develop an effective means to eliminate unnecessary duplication and regulatory overlap. Members may obtain copies of the Interagency Statement from their NASD District Office, or the Regulation staff members referenced below.

NASD Initiatives

This Notice reflects the NASD's ongoing commitment to assist members doing business on bank premises in their efforts to comply with the NASD Rules of Fair Practice and the federal securities laws. Bank-affiliated members and members participating in bank networking arrangements previously have been advised by the NASD to take precautions to protect investors by addressing issues of potential investor confusion. In particular, members have been advised to institute procedures to ensure that investors understand the distinctions between bank products and securities products offered and sold by broker/dealers, and to ensure that full disclosure is made regarding the risks associated with non-deposit investment products. Most recently, in NASD *Notice to Members 94-16* (March 1994), the NASD reminded members of their obligations under the Rules of Fair Practice to ensure that communications are accurate and complete regarding the disclosure of material information about mutual fund sales. Similarly, in *Notice to Members 93-87* (December 1993), the NASD provided members guidance for meeting their obligations under the Rules of Fair Practice when marketing mutual funds as replacements for maturing certificates of deposit.

Questions regarding this Notice may be directed to Regulation staff members Clark Hooper, Vice President, Advertising/Investment Companies Regulation, at (202) 728-8325; Daniel M. Sibears, Director, Regulatory Policy, at (202) 728-6911; or Sarrita Cypress, Attorney, Regulatory Policy, at (202) 728-8203.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

DIVISION OF
MARKET REGULATION

November 24, 1993

Ian E. Celecia, Esq.
Chubb Securities Corporation
One Granite Place
P.O. Box 2005
Concord, New Hampshire 03302

Re: Chubb Securities Corporation

Dear Mr. Celecia:

In your letter of September 1, 1993, on behalf of Chubb Securities Corporation ("CSC"), as supplemented by telephone conversations with the staff, you request assurance that the staff would not recommend enforcement action to the Commission under Section 15(a)(1) of the Securities Exchange Act of 1934 ("Exchange Act") if CSC enters into networking arrangements with certain federal and state chartered banks, savings and loan associations, savings banks, and credit unions (collectively, "Financial Institutions") and, where required by law, their service corporation subsidiaries, to provide securities brokerage services on the premises of such Financial Institutions, as described in your letter, without the Financial Institutions, the required service corporations, or their unregistered employees registering as broker-dealers under Section 15(b) of the Exchange Act.

We understand the facts to be as follows:

CSC, a wholly-owned subsidiary of Chubb Life Insurance Company of America, is a registered broker-dealer and member of the National Association of Securities Dealers, Inc. ("NASD"). CSC proposes to enter into networking arrangements with Financial Institutions to provide securities brokerage services to customers of such Financial Institutions and the general public, on the premises of the Financial Institutions. Where required by the laws or regulations governing a Financial Institution, the Financial Institution will enter into the networking arrangement with CSC through a service corporation subsidiary of the Financial Institution.

CSC will provide brokerage services on the premises of each Financial Institution in an area that is physically separate from the Financial Institution's regular business activities, in such a way as to clearly segregate and distinguish CSC from the Financial Institution. The area in which CSC provides brokerage services will clearly display CSC's name and an indication that

CSC is a member of the NASD, and will be registered with the NASD as a branch office of CSC. Under the networking arrangements, CSC will provide brokerage services only on the premises of the Financial Institutions themselves, and not in areas where a service corporation has a location independent of the Financial Institution.

The networking arrangement between CSC and each Financial Institution (including its required service corporation) will be governed by a Customer Access Agreement, which will set forth the responsibilities of the parties, the conditions of the arrangement, and the compensation to be received by the Financial Institution (including its required service corporation). As a registered broker-dealer, CSC will comply with all statutory and regulatory requirements applicable to broker-dealers, including applicable rules of self-regulatory organizations ("SROs"). CSC will exclusively control, supervise, and be responsible for all securities business conducted in its locations at the Financial Institutions. Under the networking arrangements, transactions in securities may be effected only by registered representatives of CSC, some of whom also may be employees of the Financial Institution, including its required service corporation ("Dual Employees"). CSC will control, properly supervise, and be responsible for all its registered representatives, including any Dual Employees acting in their capacity as CSC registered representatives.

Any materials used by CSC or the Financial Institutions (including required service corporations) to advertise or promote the availability of brokerage services under the networking arrangements will be approved by CSC for compliance with the federal securities laws prior to distribution. All such materials will be deemed to be CSC's materials, and will indicate clearly that the brokerage services are being provided by CSC and not the Financial Institution or its required service corporation; that neither the Financial Institution nor its required service corporation is a registered broker or dealer; that the customer will be dealing solely with CSC with respect to the brokerage services; and that CSC is not affiliated with the Financial Institution or its required service corporation. References to a Financial Institution in advertising or promotional materials will be for the purpose of identifying the location where brokerage services are available only, and will not appear prominently in such materials.

All confirmations, account statements, and other customer communications regarding securities transactions under the networking arrangements will be sent directly to the customer by CSC or by the issuer, transfer agent, or principal underwriter of the security. All documentation sent by CSC directly to a

customer, including confirmations and account statements, will indicate clearly that the brokerage services are provided by CSC and not by the Financial Institution or its required service corporation. If any documentation regarding securities transactions is sent directly to a customer of CSC by an issuer, transfer agent, or principal underwriter, CSC will be responsible for ensuring that such materials comply with the federal securities laws; and the name of the Financial Institution or its required service corporation will not appear on such materials.

Each Financial Institution (including required service corporations) will allow supervisory personnel of CSC and representatives of the Commission, the NASD and other SROs of which CSC is a member, as well as other applicable federal and state governmental authorities, to inspect the Financial Institution's premises where CSC conducts brokerage activities and any books and records maintained by CSC with respect to brokerage activities. Each Financial Institution (including required service corporations) will be deemed to be an associated person of CSC within the meaning of Section 3(a)(18) of the Exchange Act.

Employees of the Financial Institutions (including required service corporations) who are not registered representatives of CSC will not engage in any securities or investment-related activities on behalf of CSC. Unregistered employees will be prohibited from recommending any security or giving any other form of investment advice, describing investment vehicles such as mutual funds, discussing the merits of any security or type of security with a customer, or handling any question that might require familiarity with the securities industry or the exercise of judgment regarding securities and investment alternatives. Unregistered employees will refer all securities-related questions to registered representatives of CSC. All telephone inquiries related to CSC will be answered solely by registered representatives of CSC. Unregistered employees will be prohibited from accepting or transmitting orders, handling customer funds or securities (except that unregistered employees may effect electronic funds transfers to CSC from an account at the Financial Institution or required service corporation at a customer's request) or having any involvement in securities transactions other than providing clerical and ministerial assistance.

Unregistered employees of the Financial Institutions (including required service corporations) will not receive any compensation based on transactions in securities or the provision of securities advice. Unregistered employees may, however, be paid a nominal fee for referring Financial Institution customers to CSC. The amount of any such fees, which will be unrelated to

the volume of securities traded by the customer, will be determined and paid by the Financial Institution (or required service corporation). Unregistered employees will be paid no more than one fee per customer referred. Other than this one-time, nominal fee, unregistered employees will not receive any other compensation, such as trips, free meals, or monetary awards, as the result of a referral or the number of referrals made. Supervisory employees will not receive any fees for referrals made by their subordinates.

CSC will provide conduct manuals to unregistered employees of the Financial Institutions (and required service corporations) that specify the limits on their permissible activities, as set forth above. Each Financial Institution (including required service corporations) will monitor the activities of its unregistered employees, and ensure their compliance with the limits on their permissible activities as set forth in the conduct manual. Furthermore, CSC will conduct periodic reviews to assure that the Financial Institutions (including required service corporations) and their unregistered employees comply with the limits on their activities set forth in the conduct manual. CSC also will provide each of its registered representatives with a copy of CSC's compliance manual. Registered representatives will adhere to the policies and procedures contained in CSC's compliance manual. CSC will monitor its registered representatives' compliance in this regard.

All brokerage services provided at the Financial Institutions (including required service corporations) will be provided by registered representatives of CSC, either Dual Employees or otherwise, all of whom will be registered and qualified as necessary with the Commission, the NASD, and any appropriate state regulatory authorities, and all of whom will be associated persons of CSC within the meaning of Section 3(a)(18) of the Exchange Act. Each Financial Institution (including required service corporations) will agree that any Dual Employee whom the Commission, the NASD, or CSC bars or suspends from association with CSC or any other broker-dealer will be terminated or suspended, accordingly, from all securities activities by the Financial Institution (and its required service corporation). The securities activities of each Dual Employee will be supervised by the supervisory personnel of CSC, who are registered securities principals. The amount of any transaction-related compensation paid to CSC's registered representatives, including Dual Employees, under the networking arrangement, will be determined solely by CSC. For convenience with respect to tax and social security withholding, health, retirement, and other benefits, transaction-related compensation may be paid to Dual Employees by the employer Financial Institution (including

required service corporations), provided that it is clear that such payments are made on behalf of CSC from funds allocated by CSC for payment of Dual Employees.

Registered representatives are required to inform all securities customers, and obtain a written acknowledgment from such customers, that the brokerage services are being provided by CSC and not by the Financial Institution (or its required service corporation), and that the offered securities are not guaranteed by the Financial Institution (or its required service corporation) or insured by the Federal Deposit Insurance Corporation ("FDIC") or any other federal or state deposit guarantee fund relating to financial institutions.

CSC will not solicit customers of a Financial Institution in connection with the purchase or sale of the securities of that institution or any of its affiliates (including required service corporations). CSC may execute unsolicited transactions in the equity securities of the Financial Institution or its affiliates (including required service corporations) on behalf of a Financial Institution customer, provided that the customer signs an affidavit affirming that the transaction was effected on an unsolicited basis and that the customer has been informed that the securities are not insured by the Financial Institution or any of its affiliates (including required service corporations), the FDIC, or any other state or federal deposit guarantee fund relating to financial institutions. No debt securities of the Financial Institution or its affiliates (including its required service corporations) will be sold, on an unsolicited basis or otherwise, on any part of the premises of the Financial Institution that is generally accessible to the public.

CSC will pay a fee to the each Financial Institution (including required service corporations) based on all securities transactions that occur at or are attributable to activities conducted on that Financial Institution's premises. CSC will provide a copy of this letter to each Financial Institution (including required service corporations) and will ensure that each Financial Institution (including required service corporations) understands its obligations under the networking arrangement.

Response:

On the basis of your representations and the facts presented, and strict adherence thereto by CSC, the Financial Institutions (including required service corporations) and their unregistered employees, and particularly in view of the fact that CSC is a registered broker-dealer and all personnel engaged in securities activities under the networking arrangements will be

fully subject to the regulatory requirements of the federal securities laws and the applicable rules of SROs, the staff would not recommend enforcement action to the Commission under Section 15(a)(1) of the Exchange Act if CSC offers brokerage services under the networking arrangements described above without the Financial Institutions (including required service corporations) and their unregistered employees registering as broker-dealers under Section 15(b) of the Exchange Act. This staff position is based in part on CSC's representation that it will control, properly supervise, and be responsible for all registered representatives participating in the networking arrangements. Consequently, any designation of such registered representatives as "independent contractors" will have no effect on CSC's responsibilities under the federal securities laws, including without limitation Sections 15(b) and 20(a) of the Exchange Act.[1]

This position concerns enforcement action only and does not represent a legal conclusion regarding the applicability of the statutory or regulatory provisions of the federal securities laws. Moreover, this position is based solely on the representations that you have made; any different facts or conditions may require a different response.

Sincerely,

Catherine McGuire
Chief Counsel

[1] See Hollinger v. Titan Capital Corp., 914 F.2d 1564, 1572-78 (9th Cir. 1990), cert. denied, 111 S. Ct. 1621 (1991).

Chubb Securities Corporation

1934 Act/15(b)

September 1, 1993

Office of Chief Counsel
Division of Marketing Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

RE: Chubb Securities Corporation

Dear Sir/Ms.:

I serve as in-house counsel for Chubb Securities Corporation ("CSC") a wholly owned subsidiary of Chubb Life Insurance Company of America ("ChubbLife"). CSC is a broker-dealer registered under Section 15 of the Securities and Exchange Act of 1934 (the "Exchange Act") and a member of the National Association of Securities Dealers, Inc. ("NASD"). The purpose of this letter is to request a no-action letter from the Staff of the Securities and Exchange Commission (the "Staff").

No Action Request

We respectfully request the assurance of the Staff that it would not recommend enforcement action to the Securities and Exchange Commission (the "Commission") if, as described in detail below, CSC enters into networking arrangements with federal and state "Financial Institutions" (defined below), involving the offer and sale by CSC to customers of such Financial Institutions and others, on the premises of the Financial Institutions, of securities (i.e. mutual funds, unit investment trusts, variable annuities, variable life insurance, limited partnership interests, and similar securities) without the Financial Institutions or their non-registered employees registering with the Securities and Exchange Commission as broker-dealers pursuant to Section 15(b) of the Exchange Act.

The Parties

CSC

CSC is a New Hampshire Corporation and wholly owned subsidiary of ChubbLife, a national insurance company also incorporated in New Hampshire. CSC is a broker-dealer registered with the Commission and with those states where it conducts brokerage activities, and is a properly licensed member of the NASD.

CSC's registered representatives are generally independent contractors (as opposed to being employees of CSC) and registered or licensed as broker-dealer agents of CSC in those states where they conduct business and with the NASD.

CSC operates as a fully-disclosed introducing broker-dealer and generally executes and clears securities transactions for its customer accounts through a clearing broker that has entered into a contract with CSC. Certain CSC accounts are handled on a subscription basis directly with certain mutual fund companies. Customer accounts are maintained by the clearing broker-dealer or the mutual funds when appropriate.

CSC offers a variety of investment products, including equities, debt securities, open-end mutual funds, unit investment trusts, variable annuities, variable life insurance, limited partnership interests, and other similar investment products. Options, commodities and futures are not offered by CSC. It is anticipated that most of CSC's securities activities on the Financial Institution premises will involve mutual funds, unit investment trusts and variable annuities.

The Financial Institutions

Institutions that may participate in the networking arrangement include federal and state chartered banks, savings and loan associations, savings banks, and credit unions ("Financial Institutions") that are permitted to engage in activities related to the networking arrangement described herein, pursuant to federal and state laws, rules and regulations governing the activities of such Financial Institutions. Where required by applicable law or by federal or state authorities with jurisdiction over the activities of the Financial Institution, a Financial Institution shall enter into the networking arrangement through its "Service Corporation" subsidiary, (the term "Financial Institution" shall include any required Service Corporation subsidiary that a Financial Institution may use to participate in the networking arrangement).

The Networking Arrangement

The Structure of the Arrangement

The arrangement between CSC and the Financial Institutions provides that CSC will provide brokerage services to customers of the Financial Institutions and the general public on the premises of such Financial Institutions without the Financial Institutions or their required Service Corporations or their respective non-registered employees registering as broker-dealers.

The arrangement between CSC and the Financial Institution will be governed by a Customer Access Agreement, which sets forth the responsibilities of the parties, the requisite conditions of the arrangement, and the compensation to be received by the Financial Institution.

General Conditions of the Arrangement

CSC's Role

CSC is a registered broker-dealer and will comply with all statutory and regulatory requirements applicable to broker-dealers. All personnel engaged in securities activities will be subject to the federal and state securities laws and rules of any applicable self-regulatory organizations.

The arrangement provides that securities will be offered and sold, and all transactions in such securities may be transacted only by registered representatives, who either are registered representatives of CSC, or when applicable, registered representatives of CSC who are also employees of the Financial Institution.

CSC shall control and supervise all securities business conducted in its locations at the Financial Institutions.

CSC will control, properly supervise, and be responsible for all registered representatives registered through CSC, including any Financial Institution employees acting in their capacity as CSC registered representatives.

Financial Institution's Securities

No securities of the Financial Institution or its affiliates will be sold on any part of the premises of the Financial Institution, and no Financial Institution customer will be solicited by a registered representative to purchase securities of the Financial Institution or its affiliates. Unsolicited sales of these securities are permitted, provided that both the client and CSC's representative are not on the premises of the Financial Institution in question.

Insurance Products and Services

If permitted by state insurance laws or any other applicable laws, certain registered representatives of CSC may also be licensed insurance agents of ChubbLife or any other insurance company, and may offer certain variable and non-variable insurance products for sale from the CSC offices located at the Financial Institution.

CSC Offices

CSC's offices though located on the premises of the Financial Institution will be physically separate from the Financial Institution's regular activities, in such a way as to clearly segregate and distinguish CSC from the Financial Institution. The securities area will be identified specifically and registered with the NASD and any applicable state as a branch office of CSC. CSC's name will be clearly displayed, as well as an indication that CSC is an NASD member.

Compensation to the Financial Institution

CSC may pay a fee to the Financial Institution or its required Service Corporation based on all securities transactions which occur at, or are attributable to, activities conducted on that particular Financial Institution's premises.

Referral Fees

Non-registered employees of the Financial Institution will not receive transaction-related compensation and, accordingly, any referral fee will be a one-time fee of nominal, fixed-dollar amount, wholly unrelated to the execution of securities transactions or the volume of securities traded by the customer, and paid by the Financial Institution.

Notice-Acknowledgement

Registered representatives are required to inform all securities customers, and all securities customers are required to acknowledge in writing, that the brokerage services are being provided by CSC and not by the Financial Institution or its required service corporation, and that the offered securities acquired by customers are not guaranteed by the Financial Institution nor insured by any agency of the U.S. government.

No-Action Letter

CSC will provide a copy of your no-action letter to each Financial Institution and will ensure that the Financial Institutions are informed of their obligations under the arrangement.

Confirmation Slips -- Account Statements

Upon the completion of any brokerage transaction, CSC or the issuer will send all confirmation slips, account statements and other documentation regarding the securities transaction directly to the customer. All documentation sent by CSC directly to a customer, including confirmation slips and account statements, will indicate clearly that the services are provided by CSC and not by the Financial Institution.

Training

CSC will provide each registered representative with a copy of the CSC's compliance manual, and monitor compliance thereof.

Registered representatives will be bound to adhere strictly to the policies and procedures contained in CSC's compliance manual.

CSC will provide non-registered Financial Institution employees with conduct manuals that specify the limits of these employees' activities.

Financial Institution Non-registered Employees

The Financial Institution's employees who are not registered representatives of CSC may not engage in any securities-related or investment-related activities on behalf of CSC. Non-registered employees are prohibited from recommending any security, giving any form of advice, describing investment vehicles such as mutual funds, discussing the merits of any security with a customer, or handling any questions that might require familiarity with the securities industry or require the exercise of judgement regarding securities. All securities related questions will be directed to registered representatives. Non-registered employees are prohibited from accepting or transmitting orders and handling customer funds and securities. Non-registered employees of the Financial Institution, if involved at all in the networking arrangement, are limited to purely clerical and ministerial activities.

The networking arrangement herein described will not prohibit a trust department of a Financial Institution from engaging in any securities activities permitted by law.

The Financial Institution shall monitor the activities of, and ensure the compliance by, non-registered Financial Institution employees with CSC's standards of conduct as set forth in the conduct manual.

Financial Institution Non-Securities Activities

The Financial Institution or its required Service Corporation are obligated to conduct their business activities completely separate from the securities brokerage activities conducted by CSC and its registered representatives.

Financial Institution's Status

The Financial Institution will be deemed to be an associated person of CSC within the meaning of Section 3(a)(18) of the Exchange Act.

Service Corporations

Service Corporations will be used only when the regulations governing a particular Financial Institution explicitly require that the activities called for in the networking arrangement be conducted through a Service Corporation rather than through the Financial Institution itself. Brokerage services will be provided on the premises of the Financial Institution, and not in areas where the Service Corporation has a location independent of the Financial Institution.

Access

Supervisory personnel of CSC and representatives of state and federal regulatory authorities and of any other entity having jurisdiction over the operation of its brokerage services will have unimpeded access during normal business hours to inspect the premises, and any books and records maintained in connection with the operation of the brokerage services.

Advertising and Promotional Materials

The Financial Institution or its required service corporation may advertise the availability of the securities brokerage services to their customers subject to the prior approval of CSC.

All advertising and sales literature concerning the networking arrangement will refer to the Financial Institution only so as to identify the location where the brokerage services will be available, and such references to the Financial Institution will not appear prominently in the advertising.

Any such advertising from CSC or the Financial Institution will be deemed to be CSC's materials, and will indicate clearly that:

(1) the brokerage services are being provided by CSC and not by the Financial Institution;

(2) the Financial Institution is not a registered broker-dealer;

(3) the customer will be dealing solely with CSC with respect to the brokerage services;
(4) the broker-dealer is not affiliated with the Financial Institution, and
(5) the offered securities are not insured by any agency of the U.S. government.

Financial Institution Registered Representatives

Though not part of the original networking arrangement, CSC anticipates that there may be other networking arrangements where employees of a Financial Institution will also serve as registered representatives of CSC, in which case the following conditions will apply:
(1) The Financial Institution will agree that any one of its employees who is also a registered representative of CSC and which the Commission, the NASD or CSC bars or suspends from association with CSC or any other broker-dealer, shall be terminated or suspended from all securities activities by the Financial Institution.
(2) Each Financial Institution employee acting as a registered representative of CSC must be registered and qualified as necessary with the Commission, the NASD and any appropriate state regulatory authorities.
(3) The securities activities of all Financial Institution employees who are also registered representatives of CSC are to be supervised by the supervisory personnel of CSC, who are registered securities principals.
(4) Financial Institution employees who are registered representatives of CSC may conduct business on behalf of the Financial Institution when not acting as registered representatives of CSC.
(5) For convenience with respect to tax and social security withholding, health, retirement and other benefits, all transaction-related compensation to be paid by CSC to Financial Institution employees who are registered representatives of CSC, may be paid instead to the Financial Institution on behalf of CSC.
(6) Although Financial Institution employees who are registered representatives of CSC may receive their compensation from the Financial Institution, the amount of any transaction-based compensation will be determined by CSC and paid on behalf of CSC.
(7) Financial Institution employees who are registered representatives of CSC will be deemed associated persons of CSC under Section 3(a)(18) of the Exchange Act.

Analysis

Section 15(a) of the Exchange Act provides that "it shall be unlawful for any broker or dealer to effect any transactions in, or induce or attempt to induce ... the purchase or sale of, any security ... unless such broker or dealer is registered in accordance with Section 15(b) of the Act." The Staff has granted numerous no-action requests concerning networking arrangements between registered broker-

dealers and Financial Institutions similar to the one described above, [see, e.g., Mid-Hudson Savings Bank FSB (Publicly Available May 28, 1993); Bankers Financial Partners, Incorporated (Publicly Available May 14, 1993); D.A. Davidson & Co. (Publicly Available March 1, 1993); Interactive Financial Solutions, Inc. (Publicly Available December 15, 1992); Liberty Securities Corporation (Publicly Available October 21, 1992); Anchor National Financial Services, Incorporated (Publicly Available January 22, 1992); etc.]. The Staff's response in these previous no-action letters focussed, among other factors, on the fact that all securities activities were engaged in by a registered broker-dealer, all personnel engaged in such securities activities would be fully subject to the securities laws and applicable rules of self-regulatory organizations, and the registered broker-dealer would control, properly supervise, and be responsible for all registered representatives participating in the brokerage services networking arrangement.

Accordingly, pursuant to such prior no-action letters issued by the Staff, and based on strict adherence to the foregoing representations concerning the networking arrangement by all parties involved, it is our view that neither the Financial Institution nor any of its employees (other than those Financial Institution employees acting as registered representatives of CSC) are required to register with the Commission as broker-dealers pursuant to Section 15(b) of the Exchange Act.

Please stamp and return the enclosed copy of this letter in the postage paid envelope provided to confirm your receipt of this request.

If you should require additional information or clarification do not hesitate to call the undersigned at 1-800-258-3848 extension 5346.

Thank you for your prompt consideration to this no-action request.

Very truly,

Ian E. Celecia
Attorney

encl.
cc: Bruce Stefany, President, CSC
Mary Toumpas, Compliance Officer, CSC
Shari Lease, Assistant Counsel