

APRIL 2005

Notice to Members

Notices

- 05-24** NASD Announces Exemption from the Research Analyst Qualification Requirements (Series 86 and 87) for Certain Employees of Foreign Affiliates Who Contribute to Member Research Reports
- 05-25** NASD Requests Comment on Proposal to Require Pre-Use Filing of Advertisements and Sales Literature for New Types of Securities and of Television, Video and Radio Advertisements; **Comment Period Expires May 20, 2005**
- 05-26** NASD Recommends Best Practices for Reviewing New Products
- 05-27** NASD Requests Comment on Proposal to Require Principal Pre-Use Approval of Member Correspondence to 25 or More Existing Retail Customers within a 30-Calendar-Day Period; **Comment Period Expires May 27, 2005**
- 05-28** NASD Reminds Members that the TRACE Reporting Period Will Be Reduced to 15 Minutes on July 1, 2005, and Rescinds Interpretive Guidance Regarding Rejected TRACE Transaction Reports
- 05-29** Guidance Regarding Rule 3012(a)(1) Requirement to Test and Verify a Member's Supervisory Policies and Procedures
- 05-30** SEC Approves New Pilot Rule Giving NASD Authority to Receive and Review Complaints against NASD Market Participants that Allege Denial of Access to Their Quotes in the Alternative Display Facility; **Compliance Date: May 26, 2005**

continued



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- 05-31** Pilot Program to Increase Position and Exercise Limits for Equity Options and New Reverse Collar Strategy Added to Equity Option Hedge Exemptions
 - 05-32** SEC Approves Amendments to NASD Rule Governing Predispute Arbitration Agreements with Customers
 - 05-33** Short Sales in Pilot Securities and Order-Marking Requirements under SEC Regulation SHO

Disciplinary and Other NASD Actions

D1

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Notice to Members

APRIL 2005

SUGGESTED ROUTING

Continuing Education
Executive Representatives
Legal & Compliance
Registration
Research
Senior Management
Training

KEY TOPICS

Qualification Examinations
Registration
Research Reports
Rule 1050
Supervision

GUIDANCE

Research Analysts and Research Reports

NASD Announces Exemption from the Research Analyst Qualification Requirements (Series 86 and 87) for Certain Employees of Foreign Affiliates Who Contribute to Member Research Reports

Executive Summary

NASD has amended NASD Rule 1050 to provide an exemption from the research analyst qualification requirements for certain research analysts employed by member foreign affiliates in jurisdictions that NASD and the New York Stock Exchange (NYSE) (together, SROs) have determined have acceptable qualification standards and research analyst conflict of interest rules. Currently, the exemption is available to research analysts in the following jurisdictions: the United Kingdom, China, Hong Kong, Singapore, Thailand, Malaysia, and Japan. Eligibility for the exemption is conditioned on several factors, including imposition of NASD Rule 2711 on foreign affiliates and their research analysts in those instances where the research analyst contributes to the preparation of a member's research report.

The amendment was filed on April 1, 2005, and became effective upon filing.

Questions/Further Information

Questions concerning this *Notice* may be directed to Philip Shaikun, Associate General Counsel, Regulatory Policy and Oversight, at (202) 728-8451.

05-24

Background and Discussion

NASD Rule 1050 requires an associated person who functions as a research analyst to register as such with NASD and pass a qualification examination. Rule 1050 is intended to ensure that research analysts possess a certain competency level to perform their jobs effectively and in accordance with applicable rules and regulations. In the context of this requirement, Rule 1050 defines “research analyst” as “an associated person who is primarily responsible for the preparation of the substance of a research report or whose name appears on a research report.” The term “research report” in Rule 1050 has the meaning as defined in Rule 2711(a)(8): “a written or electronic communication that includes an analysis of equity securities of individual companies or industries, and that provides information reasonably sufficient upon which to base an investment decision.”

Pursuant to Rule 1050, and in conjunction with the NYSE, NASD has implemented the Research Analyst Qualification Examination (Series 86/87). The examination consists of an analysis part (Series 86) and a regulatory part (Series 87). Prior to taking either the Series 86 or 87, a candidate also must have passed the General Securities Registered Representative Examination (Series 7), the Limited Registered Representative (Series 17), or the Canada Module of Series 7 (Series 37 or 38). Persons who were functioning as research analysts on the effective date of March 30, 2004, and submitted a registration application to NASD by June 1, 2004, have until April 4, 2005, to meet the registration requirements.

Rule 1050 currently provides exemptions from the Series 86 examination for certain applicants who have passed Levels I and II of the Chartered Financial Analyst examination or have passed Levels I and II of the Chartered Market Technician Examination and produce only “technical research reports” as that term is defined in Rule 1050.

NASD has observed that members with global operations sometimes produce research reports under a single global brand name or jointly with a research analyst employed by a non-member affiliate—*i.e.*, a “mixed team” research report. NASD and NYSE have deemed such research reports to be attributable to the member and therefore subject to the applicable requirements of Rule 2711. This interpretation has raised the question of whether a research analyst employed by a non-member foreign affiliate who contributes to the preparation of such a research report (foreign research analyst) must meet the licensing and examination requirements set forth in Rule 1050. The determination turns on whether the foreign research analyst is an “associated person” of the NASD member.

Several members have expressed to NASD and NYSE that the determination of “associated person” status can be very difficult to ascertain in a financial services enterprise that has a complex structure of supervision and multiple reporting lines and subsidiaries and/or affiliated firms that span a multitude of foreign jurisdictions. While NASD does not subscribe to the viewpoint that the difficulty of the associated person analysis relieves a member from making the determination of such status, it is

concerned that absent the safe harbor provided in this proposal, members may have a pragmatic incentive, although not a defensible basis, for construing associated person status on an unduly narrow basis.

Therefore, to help alleviate these issues while maintaining—and in some cases, extending—the safeguards in Rules 1050 and 2711 that ensure objective and quality research, the SROs have created an exemption from the research analyst qualification requirements for certain foreign research analysts in jurisdictions that reflect a recognition of the principles that are consonant with the SRO qualification standards and research analyst conflict of interest rules.

The conditions for eligibility for the exemption are as follows:

1. Compliance by the foreign research analyst with registration and qualification requirements or other standards in his or her home jurisdiction that have been designated by the SROs as having acceptable qualification standards and research analyst conflict of interest rules. Based on a review of their regulatory and qualification requirements, the SROs have identified the following jurisdictions as having met the applicable standard: the United Kingdom, China, Hong Kong, Singapore, Thailand, Malaysia, and Japan. NASD will notify the membership in the event that additional jurisdictions are deemed to have met the standard.

Foreign research analysts that have met such requirements in an approved jurisdiction will not be required to pass the Series 86 and 87 exams, provided the member and foreign research analyst comply with the other requirements set forth as conditions for the exemption. Research analysts in jurisdictions that do not have approved standards still would be required to pass the Series 86 and 87 examinations if they are associated persons and participate in the preparation of a member's research report.

2. Global application of member firm standards, including full compliance with the SRO research analyst conflict of interest rules, to a member's affiliated entities and foreign research analysts that qualify for the use of, and would rely upon, these exemptive provisions. Thus, a member would be required to apply to any globally branded, mixed-team, or other research deemed under SRO rules and interpretations to be that of the member, all of the applicable provisions of the SRO rules, as well as any other regulatory or supervisory standards applicable to a member's own research. The personal trading restrictions and other SRO rules applicable to the conduct of a research analyst need only be applied to the specific research reports to which a foreign research analyst contributed in the preparation. These conditions do not apply to research reports that are wholly produced by a foreign affiliate and its employees and are clearly labeled as the product of that foreign affiliate.
3. The annual compliance attestation required by NASD Rule 2711 must encompass the global application of the SRO rules to foreign affiliates that participate in preparing a member's research reports.

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4. Members must agree to have their research approved by a properly registered supervisory analyst or principal in accordance with NASD Rule 1022.
 5. In addition to the disclosure requirements of NASD Rule 2711, each report must include, when applicable, a disclosure on the front cover stating that:

“This research report has been prepared in whole or part by foreign research analysts who may be associated persons of the member or member organization. These research analysts are not registered/qualified as research analysts with the NYSE and/or NASD, but instead have satisfied the registration/qualification requirements or other research-related standards of a foreign jurisdiction that have been recognized for these purposes by the NYSE and NASD.”

In addition, the cover page of a research report must identify: (1) each broker-dealer entity contributing to the report, (2) its location, and (3) the research analysts contributing to the research report from each broker-dealer. The cover page must also contain general disclosure language regarding the relationship of the listed broker-dealers to the NYSE/NASD member firm.

The front page of the research report must reference a separate “Foreign Affiliate Disclosures” section (similar to the “Required Disclosure” section currently mandated by the SROs) located in close proximity to that section. In this proposed disclosure section, the member must disclose the following: (1) information on the nature of the affiliation of the parties, (2) the affiliates’ addresses, and (3) the primary regulator in the jurisdiction(s) in which each affiliate is located.

Eligibility for the exemption in no way bears upon whether the foreign research analyst is an associated person of the member. And to the extent that a member can determine that a foreign research analyst is not an associated person, those individuals need not satisfy the requirements of the exemption.

Members must establish and maintain records that identify those individuals who have availed themselves of the exemption, the basis for such exemption, and evidence compliance with the conditions of the exemption.

The rule change has no impact on the obligation of a broker-dealer, including a foreign broker-dealer, to register pursuant to Section 15(a)(1) of the Securities Exchange Act of 1934 and the rules promulgated thereunder.

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Notice to Members

APRIL 2005

SUGGESTED ROUTING

Advertising
Investment Companies
Legal & Compliance
Senior Management
Variable Contracts

KEY TOPICS

Advertising
Communications with the Public
NASD Rule 2210

REQUEST FOR COMMENT

New Products Sales Material and Television, Video, and Radio Advertisements

NASD Requests Comment on Proposal to Require Pre-Use Filing of Advertisements and Sales Literature for New Types of Securities and of Television, Video and Radio Advertisements; **Comment Period Expires May 20, 2005**

Executive Summary

NASD is proposing to amend its advertising rules to require members to file certain additional categories of advertisements and sales literature with NASD. First, NASD is proposing to require members to file the initial advertisement or item of sales literature concerning a type of security that the member has not previously offered at least 10 business days prior to first use or publication (and continue to do so for the following 90 calendar days). Second, NASD is proposing to require members to file all television, video (including Web site video), radio, or similar broadcasts of 15 seconds or longer at least 10 business days prior to the date of first use or broadcast.

Questions/Further Information

Questions concerning this *Notice* may be directed to Thomas M. Selman, Senior Vice President, Investment Companies/Corporate Financing, at (240) 386-4533; Joseph P. Savage, Associate Vice President, Investment Companies Regulation, at (240) 386-4534; or Philip A. Shaikun, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8451.

05-25

Action Requested

NASD encourages all interested parties to comment on the proposed rule change. Comments must be received by May 20, 2005. Members and other interested parties can submit their comments using the following methods:

- Mail** comments in hard copy to the address below; or
E-mail comments to *pubcom@nasd.com*.

To help NASD process and review comments more efficiently, persons commenting on this proposal should use only one method. Comments sent by hard copy should be mailed to:

Barbara Z. Sweeney
Office of Corporate Secretary
NASD
1735 K Street, NW
Washington, DC 20006-1500

Important Notes: The only comments that will be considered are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the NASD Web site. Generally, comments will be posted on the NASD Web site one week after the end of the comment period.¹

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the NASD Board, and then must be approved by the SEC, following publication in the *Federal Register*.²

Background and Discussion

Sales Material Concerning New Types of Securities

Currently, NASD requires pre-use filing of, among other things, new member advertisements, advertisements or sales literature that include fund-created rankings, sales literature containing bond fund volatility ratings, and advertisements concerning collateralized mortgage obligations or security futures. The proposal would expand the 10-business day pre-use filing requirements to include advertisements and sales literature for new types of securities that the member has not previously offered.

This proposed amendment would serve two purposes. First, it would alert NASD when the industry promotes a new type of security to retail investors. For example, when a regulated firm first promotes a non-conventional investment to its retail customers, such as a new type of asset-backed security, distressed debt, or derivative product, the firm would have to file its initial advertisement or sales literature for these securities at least 10 business days prior to use and continue to file such material for the following 90 calendar days. This pre-use filing requirement should provide NASD with more time to address any sales practice issues that the new type of security presents.

Second, the amendment would subject the sales material for these securities to review by the NASD Advertising Regulation Department (Department). We have found that so-called "launch" material for products that a firm has not previously offered often presents significant compliance issues under our advertising rules. The new security pre-use filing requirement thus would serve a purpose similar to the new member pre-use filing requirement, which permits the Department to pre-review sales material of members that have no experience in advertising compliance. Similarly, under this proposal, the Department could review prior to use sales material for securities with which the member has no experience.

The pre-use filing requirement would not apply to:

- ◆ Sales material concerning a type of security that the member has previously offered.
- ◆ Sales material that is already subject to any filing requirement, such as mutual fund and variable annuity sales material.
- ◆ Sales material that is otherwise specifically excluded from the filing requirements, such as correspondence and institutional sales material.³
- ◆ Sales material concerning securities that previously were traded in the secondary market, such as research reports on exchange-listed securities or publicly traded bonds.

NASD recognizes that the proposed requirement to file advertisements and sales literature for a "type of security that the member has not previously offered" may raise interpretive issues. In general, NASD intends to require the filing of sales material for new categories of investments that the member has not previously offered. For example, if a member previously only offered registered investment companies, and planned on offering unregistered hedge funds to its client base, the proposal would require the member to file its initial sales materials for these products at least 10 business days prior to use and continue to pre-use file all its advertisements and sales literature for these products for the 90-day period following the initial filing. NASD requests comment on whether the term "type of security that the member has not previously offered" needs further clarification, and if so, how NASD should define this term.

Another issue on which we request comment is whether the pre-use filing requirement also should apply to advertisements and sales literature for products that the member has previously offered, but now is offering to a new class of investors for the first time. For example, should the pre-use filing requirement apply if a member prepares sales literature that offers funds of hedge funds to retail investors for the first time, if the member previously had offered funds of hedge funds only to institutional investors? If so, how should this requirement be described in the rule amendment?

Television, Video, and Radio Advertisements

The second proposed amendment would require members to file all television, video (including Web site video), radio, or similar broadcasts of 15 seconds or longer at least 10 business days prior to the date of first use or broadcast. Members could meet this requirement for television and video by filing draft versions, "story boards," or scripts of these advertisements, as long as the member also files the final filmed version of the advertisement within at least 10 business days of first use.

NASD is concerned that in the past some members used broadcast advertisements that raised regulatory issues. For example, several years ago television advertisements for day trading and electronic brokerage firms presented regulatory concerns, which could not be fully addressed until those advertisements were filed with the Department. These issues could have been resolved before the advertisements reached numerous retail investors had the advertisements been filed prior to use with NASD.

NASD recognizes that the minimum, 15-second length requirement could enable firms to distribute shorter, noncompliant broadcasts without filing them prior to use with NASD. The 15-second threshold, however, represents the typical minimum length of broadcast commercials. We are not proposing to require the filing of short sponsorship announcements, Internet banner advertisements, and similar communications. Of course, even these shorter communications must comply with the advertising rules and must obtain registered principal pre-use approval. NASD requests comment on whether the 15-second threshold is an appropriate standard for the pre-use filing requirement.

NASD also is aware that registered representatives sometimes host television or radio shows in which a representative answers questions that viewers or listeners have telephoned or emailed to the representative. In general, the pre-use filing requirement would not apply to such shows, since unscripted appearances on television and radio shows constitute public appearances rather than advertisements. If all or a portion of the show were scripted, however, NASD would regard the scripted portion as an advertisement for the member, and thus the pre-use filing requirement would apply to this portion.

Endnotes

- 1 See *Notice to Members 03-73* (Nov. 2003) (NASD Announces Online Availability of Comments). Personal identifying information, such as names or email addresses, will not be edited from submissions. Persons commenting on this proposal should submit only information that they wish to make publicly available.
- 2 Section 19 of the Securities Exchange Act of 1934 (Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See Exchange Act Section 19 and rules thereunder.
- 3 The proposal would exclude institutional sales material from the pre-use filing requirement. Accordingly, if a member only distributed sales material for its hedge funds to persons meeting the definition of "institutional investor" under NASD Rule 2211, the pre-use filing requirement would not apply. However, we note that the definition of "institutional investor" under Rule 2211 differs in some respects from similar terms in SEC rules, such as the definition of "accredited investor" in SEC Regulation D under the Securities Act of 1933.

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ATTACHMENT A

New language is underlined and deletions are bracketed.

Text of Rule Change

2210. Communications with the Public

(a) and (b) No change.

(c) Filing Requirements and Review Procedures

(1) through (3) No change.

(4) Requirement to File Certain Material Prior to Use

At least 10 business days prior to first use or publication (or such shorter period as the Department may allow), a member must file the following communications with the Department and withhold them from publication or circulation until any changes specified by the Department have been made:

(A) through (C) No change.

(D) The initial advertisement or sales literature concerning a type of security that the member has not previously offered, and all advertisements and items of sales literature for this type of security that are used or distributed during the 90 calendar days following the filing of the initial advertisement or sales literature. This requirement does not apply to an advertisement or item of sales literature:

(i) that any member has previously filed with the Department, and that has not been materially changed;

(ii) that is required to be filed with NASD pursuant to paragraphs (c)(2) or (c)(3) of Rule 2210;

(iii) concerning securities that previously have been traded in the secondary market; or

(iv) concerning a type of security that the member has previously offered.

(5) No change.

(6) Filing of Television, Video, and Radio Advertisements

Television, video (including Web site video), radio and similar advertisements of 15 seconds or longer must be filed at least 10 business days prior to use. A member may satisfy this requirement for television and video advertisements by filing a draft version or “story board” of the advertisement. The member must file the final filmed version of the advertisement within 10 business days of first use. The member must withhold use of the advertisement until changes specified by the Department have been made.

[If a member has filed a draft version or “story board” of a television or video advertisement pursuant to a filing requirement, then the member also must file the final filmed version within 10 business days of first use or broadcast.]

Notice to Members

APRIL 2005

SUGGESTED ROUTING

Internal Audit
Legal and Compliance
Retail
Senior Management

KEY TOPICS

Best Practices
New Products
Non-Conventional Instruments
Rule 3010
Suitability

GUIDANCE

New Products

NASD Recommends Best Practices for Reviewing New Products

Executive Summary

NASD is concerned about the number of increasingly complex products that are being introduced to the market in response to the demand for higher returns or yield. Some of these products have unique features that may not be well understood by investors or registered persons. Others raise concerns about suitability and potential conflicts of interest. While NASD has and will continue to address specific products as appropriate, NASD also urges firms to take a proactive approach to reviewing and improving their procedures for developing and vetting new products. At a minimum, those procedures should include clear, specific and practical guidelines for determining what constitutes a new product, ensure that the right questions are asked and answered before a new product is offered for sale, and, when appropriate, provide for post-approval follow-up and review, particularly for products that are complex or are approved only for limited distribution.

The purpose of this *Notice* is to remind firms of the kind of questions they should be asking before offering a new product, and to highlight a number of best practices employed by some firms that NASD believes others should consider in reviewing their current procedures.

Questions/Further Information

Questions concerning these new reporting provisions can be directed to Eric Moss, Vice President and Director of Emerging Regulatory Issues, at (202) 728-8982; or Laura Gansler, Associate General Counsel, at (202) 728-8275.

05-26

Background and Discussion

In the current investment environment, investors and brokers are increasingly turning to alternatives to conventional equity and fixed-income investments in search of higher returns or yields. Such products, including asset-backed securities, distressed debt, structured notes, and derivative products, are often complex or have unique features that may not be fully understood by the retail customers to whom they are frequently offered, or even by the brokers who recommend them. Some appear to offer benefits to investors that are already available in the market in the form of less risky, less complicated, or less costly products, prompting concerns about suitability and potential conflicts of interest.

In 2003, NASD published *Notices to Members (NTMs)* addressing the sale of hedge funds and non-conventional instruments to retail customers.¹ More recently, we have proposed new rules tailored specifically to sales of deferred variable annuities, including new sales practice standards, supervisory approval and sales force training requirements,² and a new rule establishing pre-use advertising filing requirements for certain products not previously offered by the selling firm.³ And, as discussed more fully below, we met with numerous firms during the past year to learn more about their practices for developing and vetting new products.

NASD continues to monitor new products carefully and will respond to specific products and problem areas as appropriate. However, we also urge firms to take a proactive approach to reviewing and improving their procedures for developing and vetting new products from a regulatory perspective. While suitability requirements and other sales practice obligations attach to the recommendation and sale of a product, adequate procedures for reviewing new products before they are offered to the public can greatly enhance a firm's ability to detect and avoid conflicts, unsuitable recommendations, and other problems before violations occur.

Written Procedures for Vetting New Products

As part of the supervisory responsibilities imposed by NASD Rule 3010, all firms that sell new products should have formal written procedures to ensure that no new product is introduced to the marketplace before it has been thoroughly vetted from a regulatory as well as a business perspective. At a minimum, those procedures should identify what constitutes a new product, and ensure that the right questions are asked and answered before a new product is offered for sale.

What Is a New Product?

As a threshold matter, a firm's written procedures should include clear, specific, and practical guidelines for determining what constitutes a new product, including when a modification of an existing product is material enough to warrant the same level of review as a new product. Among the things to consider are:

- ◆ Is the product new to the marketplace or the firm?
- ◆ Is the firm proposing to sell a product to retail investors that it has previously only sold to institutional investors? Will the product be offered by representatives who have not previously sold the product?
- ◆ Does the product involve material modifications to an existing product, whether risk to the customer, product structure, or fees and costs?
- ◆ Does the product require material operational or system changes?
- ◆ Is the product an existing product that is being offered in a new geographic region, in a new currency, or to a new type of customer?
- ◆ Would the product involve a new or significant change in sales practices?
- ◆ Does the product raise conflicts that have not previously been identified and addressed?

This list is not necessarily exhaustive of all factors that determine whether a product is new. Firms should not simply assume that if something is "like" a product already in the marketplace, whether offered by the firm or by competitors, that little or no review is necessary. NASD believes that when firms are unsure as to whether something warrants new product review, the best practice is to err on the side of caution, and subject any material modification to an existing product (whether the existing product is sold by the firm or not) to the same level of review as a new product. It is also important that the standards for determining what level of review is appropriate for any given product or modification of a product are clearly communicated and applied throughout the firm in a consistent manner.

Ask the Right Questions

The fundamental goal of every vetting process should be to ensure that the right questions are asked during the review period. Consequently, a firm's policies and procedures addressing new products should be designed to answer these questions. While the right questions will depend in part on the nature of the product, NASD believes that, at a minimum, every firm should ask and answer the following questions before a new product is offered for sale:

- ◆ For whom is this product intended? Is the product proposed for limited or general retail distribution, and, if limited, how will it be controlled? Conversely, to whom should this product NOT be offered?
- ◆ What is the product's investment objective? How does the product add to or improve the firm's current offerings? Can less costly, complex, or risky products achieve the objectives of the product?
- ◆ What assumptions underlie the product, and how sound are they? What market or performance factors determine the investor's return?
- ◆ What are the risks for investors? If the product was designed mainly to generate yield, does the yield justify the risks to principal?
- ◆ What costs and fees for the investor are associated with this product? Why are they appropriate? Are all of the costs and fees transparent? How do they compare with comparable products offered by the firm or by competitors?
- ◆ How will the firm and registered representatives be compensated for offering the product? Will the offering of the product create any conflicts of interest between the customer and any part of the firm or its affiliates? If so, how will those conflicts be addressed? For example, does the firm stand to benefit from the sale of the product beyond the clearly disclosed sales charges or commissions (*i.e.*, revenue sharing arrangements)? If so, the firm may have an obligation under NASD Rule 2110, governing just and equitable principles of trade, to disclose that conflict, even if the product is otherwise suitable, generally or for a particular investor.
- ◆ Does the product present any novel legal, tax, market investment, or credit risks?
- ◆ What is the complexity of the product in structure, function, and description? Does such complexity impair understanding and transparency of the product? Does such complexity impact suitability considerations and/or the training requirements associated with the product?
- ◆ How will the product be marketed? What promotional and sales materials will be used? What risks must be disclosed, and how will that disclosure be made? Some firms require that sales materials be included in the package provided to the committee that will make the final decision.

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- ◆ What are the qualifications of the people making determinations about a new product's assumptions, performance, and risk, and do such qualifications comport with the expertise necessary to reach sound conclusions?
 - ◆ Will the product necessitate the development or refinement of in-firm training programs for registered representatives and their supervisors? If so, how and when will the training be provided?
 - ◆ Will this product be sold only by the firm, or by third parties? How liquid is the product? Is there a secondary market for the product?
 - ◆ Do the firm's current systems support the product, or will new systems be required? If promises will be made to customers (such as volume-based discounts), can current systems deliver on those promises?
 - ◆ Does the structure or a feature of the new product, including the proposed sales plan, implicate any additional regulations (*i.e.*, NASD Rule 2860 or NASD Rule 2720)?

Asking the right questions is critical not only to determine if the product should be offered at all (is it suitable for targeted investors, does it present insurmountable conflicts between the firm and its customers), but also to identify important features of the product that should be highlighted for the sales and marketing staff, and to plan for appropriate training and supervision.

Survey of Best Practices

To help firms determine whether their current procedures for vetting new products are appropriate, NASD has surveyed a number of firms that manufacture proprietary products and/or distribute third-party products and has conferred with certain of its committees, including the NASD Consultative Committees. The remainder of this *Notice* highlights practices employed by some firms that NASD believes others should consider. These practices can make it easier for firms to comply with their various suitability obligations, avoid conflicts, and plan for appropriate training and supervision. This *Notice* is not intended to be a comprehensive roadmap for compliance and supervision with respect to vetting new products, but rather highlights measures that some firms are using to ensure better compliance. Firms should consider the information in this section of the *Notice* in assessing their own procedures and in implementing improvements that are tailored to and work best for their firm. We note that while a particular sound practice may work well for a large firm, the same approach may not be effective or economically feasible for a smaller firm. While firms must adopt procedures and controls that are effective given their size, structure, and operations, a firm may not fail to have policies and procedures concerning new products reasonably designed to achieve compliance with NASD rules and the federal securities laws because of the limitation of its size, structure, or operations. Using the information in this *Notice* may be helpful, but it is not designed as a safe harbor as circumstances may dictate different practices, processes, and procedures.

While the procedures used by the firms we surveyed vary slightly depending on their own business model and culture, they tended to share the following components:

- ◆ A mandatory, standardized process that requires a written “new product” proposal and thorough accompanying documentation, that:
 - assigns clear “ownership” of the product or concept to a particular business unit, product group, or department;
 - is clearly communicated to, and has a high profile within, the firm; and
 - is easily accessible to the business units, often through internal Web-based applications that encourage standardization and uniformity;
- ◆ A preliminary assessment of a proposed product or concept by compliance and/or legal personnel to determine, among other things, whether it is a new product or a material modification of an existing product, and the appropriate level of internal review;
- ◆ For new products or material modifications to existing products, detailed review by a committee or working group made up of representatives from all relevant sectors of the firm, including compliance, legal, finance, marketing, sales, and operations;
- ◆ A formal decision to approve, disapprove, or table the proposal by a new product committee or other decision-making group that includes members of the firm’s senior management; and
- ◆ If the product is approved, some level of post-approval follow-up and review, particularly for products that are complex or are approved only for limited distribution.

Initial Product Review

Whatever the specifics of a firm’s review process, the most successful processes require review and sign-off by every relevant department, before the product is presented to the new products committee for formal approval.

A number of firms stressed the importance of involving legal and compliance personnel at the earliest possible stage. Some firms do this by having compliance and legal personnel attached to specific business units or product groups, so that ideas can be informally discussed with them as the ideas arise. Others include compliance and legal personnel in the initial product assessment, as well as in the detailed review. However it is done, firms that include these perspectives early in the development process report that their business units are likely to view compliance personnel as a positive “part of the team,” rather than as a stumbling block. The opposite can also be true. When compliance is involved only at the end of the process, there may be less time or inclination to modify the product to address compliance concerns, and the sponsors of the product may have a more adversarial relationship with the compliance and legal teams.⁴

The firms we surveyed also reported that it is extremely helpful to have operations, sales, and supervisory personnel participate in the product review process, rather than waiting until after a product has been approved to determine what training, controls, or operational enhancements are necessary. Many important questions are best answered by those personnel. For example, they may be in the best position to determine whether current systems support the product, including delivering on promises such as volume-based discounts. If additional training is required, firms should plan in advance how that training will be administered, and how the firm will ensure that only brokers who have had the required training are allowed to offer the product to customers. Firms also should plan to ensure that the necessary training is available as long as the product is offered. Consideration also should be given to whether offering the product will require any additional licensing for sales personnel.

Firms manage the initial review process differently, with many utilizing Web-based applications to streamline and document the process. While some firms rely on the proposing business unit to shepherd a product through the process, at least one firm has established an independent new products group that is responsible for managing the process and ensuring that all relevant departments have reviewed and signed off on the proposed product before it is submitted for formal approval. The new products group also formally notifies all relevant departments about product modifications that it deems do not warrant full review in a process of negative consent; if any department disagrees with the new product group's initial assessment, the product is submitted for full review.

Formal Approval

After the appropriate initial review has been completed, most of the firms we surveyed require formal approval by a committee consisting of representatives from senior management before a product can be offered, which enhances a firm's ability to apply consistent standards and ensures accountability. The committee may base its decision on a written proposal supported by detailed documentation, an oral presentation, or, as in most cases, both. A number of firms reported that approval of complex or unusual products will often be made contingent of specific limitations or conditions, including to whom the product can be sold, what kind of training must be required, or what kind of market conditions must exist for the approval to remain effective. For example, the product may be approved on the condition that it is offered only to customers whose investment objectives are coded "speculative," who have a certain minimum risk tolerance level, or who have a minimum net wealth. (While these limitations may be helpful, NASD cautions that there is no substitute for a suitability analysis, and "accredited" status under Regulation D of the Securities Act of 1933 is not necessarily an indicator of sophistication, particularly if the value of the investor's home constitutes a significant percentage of his or her net wealth.) Other conditions of approval might include that no more than a set percentage of a customer's net worth be invested in the same or a similar product. In such cases, it is important to determine prior to approval whether that any conditions or limitations are feasible from a training, supervisory, and operations point of view.

Post-Approval Review

Some firms require that complex products, those approved on a contingent or limited basis, or those based on critical market assumptions, be formally reviewed for a specific period of time, often six months or a year. This allows the firm to assess product performance, determine whether product limitations and other post-sale compliance requirements are met, and to evaluate whether market conditions have altered the risks associated with the product. Firms also should ensure that they:

- ◆ track and monitor customer complaints and grievances relating to new products;
- ◆ reassess the firm's training needs regarding a product on a continuing basis;
- ◆ establish procedures to monitor, on an ongoing basis, firm-wide compliance with any terms or conditions that have been placed on the sale of the product;
- ◆ periodically reassess the suitability of the product; and
- ◆ review any product before lifting any restrictions or conditions on the sale of the product.

Conclusion

NASD urges firms to take a proactive approach to reviewing and improving their procedures for developing and vetting new products from a regulatory perspective. At a minimum, firms should have in place written procedures for determining what is a new product, and for making sure that the right questions are asked and answered before a new product is offered for sale. In addition, while NASD recognizes that what specific procedures are appropriate will vary depending on firm size and structure, we believe that the best practices identified above can help firms avoid conflicts, unsuitable recommendations, and other problems before violations occur. Finally, NASD notes that even the most elaborate procedures will not be effective unless they are rigorously implemented, something that ultimately depends on the firm's culture and the level of commitment on the part of the firm's leadership.

Endnotes

- 1 NASD Reminds Members of Obligations When Selling Hedge Funds, *NTM 03-07* (February 2003), and Non-Conventional Investments, *NTM 03-71* (November 2003).
- 2 Proposed New Rule 2821 Regarding Transactions in Deferred Variable Annuities, SR-NASD-2004-183 (December 2004).
- 3 See *NTM 05-25* (April 2005) (NASD Requests Comment on Proposal to Require Pre-Use Filing of Advertisements and Sales Literature for New Types of Securities and of Television, Video and Radio Advertisements; Comment Period Expires May 20, 2005).
- 4 Nothing in this *Notice* is intended to imply that consultation with legal and compliance personnel in itself alters or shifts supervisory responsibilities within the firm.

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Notice to Members

APRIL 2005

SUGGESTED ROUTING

Advertising
Investment Companies
Legal & Compliance
Registered Representatives
Senior Management
Variable Contracts

KEY TOPICS

Advertising
Communications with the Public
NASD Rules 2211 and 3010

REQUEST FOR COMMENT

Principal Pre-Use Approval of Member Correspondence

NASD Requests Comment on Proposal to Require Principal Pre-Use Approval of Member Correspondence to 25 or More Existing Retail Customers within a 30-Calendar-Day Period; **Comment Period Expires May 27, 2005**

Executive Summary

NASD currently defines correspondence to include any written letter or electronic mail message distributed by a member to (a) one or more of its existing retail customers, and (b) fewer than 25 prospective retail customers within any 30 calendar-day period. The definition of correspondence is significant because firms generally are not required to have a registered principal approve correspondence prior to use, and because some of the specific content standards applicable to other types of communications with the public do not apply to correspondence. NASD is proposing to amend Rule 2211 to require that a registered principal approve, prior to use, any correspondence that is sent to 25 or more existing retail customers within a 30-calendar-day period.

Questions/Further Information

Questions concerning this *Notice* may be directed to Thomas M. Selman, Senior Vice President, Investment Companies/Corporate Financing, at (240) 386-4533; Joseph P. Savage, Associate Vice President, Investment Companies Regulation, at (240) 386-4534; or Philip A. Shaikun, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8451.

05-27

Action Requested

NASD encourages all interested parties to comment on the proposed rule change. Comments must be received by May 27, 2005. Members and other interested parties can submit their comments using the following methods:

Mail comments in hard copy to the address below; or

E-mail comments to *pubcom@nasd.com*.

To help NASD process and review comments more efficiently, persons commenting on this proposal should use only one method. Comments sent by hard copy should be mailed to:

Barbara Z. Sweeney
Office of Corporate Secretary
NASD
1735 K Street, NW
Washington, DC 20006-1506

Important Notes: The only comments that will be considered are those submitted pursuant to the methods described above. All comments received in response to this *Notice* will be made available to the public on the NASD Web site. Generally, comments will be posted on the NASD Web site one week after the end of the comment period.¹

Before becoming effective, a proposed rule change must be authorized for filing with the Securities and Exchange Commission (SEC) by the NASD Board, and then must be approved by the SEC, following publication in the Federal Register.²

Background and Discussion

Definition of "Correspondence"

In 2003, the SEC approved as part of NASD's modernization of its advertising rules a change to the definition of "correspondence" in Rule 2211. The new definition of correspondence includes any written or electronic mail message distributed by a firm to one or more of its existing retail customers and to fewer than 25 prospective retail customers within a 30-calendar-day period.³ Previously, "correspondence" included any written or electronic communication prepared for delivery to a single current or prospective customer, and not for dissemination to multiple customers or the general public.

The definition of correspondence is significant in several respects. Firms generally are not required to have a registered principal approve correspondence prior to use, nor are they required to file correspondence with the NASD Advertising Regulation Department (Department).⁴ In addition, correspondence is subject to fewer content restrictions than advertisements and sales literature.

NASD amended the definition in order to provide firms with more flexibility regarding the supervision of e-mail and form letters. However, we understand that many firms voluntarily continue to require registered principal pre-use approval of some correspondence.

NASD has found that some member correspondence to multiple existing customers raises the same sorts of issues that member advertisements and sales literature do. For example, NASD has reviewed form letters that encourage *existing* customers to invest in mutual funds, variable annuities, or other securities and, as such, did not meet the applicable advertising standards of the SEC and NASD rules. As “correspondence” under the existing definition, these communications do not require principal pre-use approval. As a result, in some cases, this correspondence that had already been sent to customers required substantial revisions; in other cases, NASD took informal disciplinary action against the member that distributed the correspondence.

In contrast, had these types of form letters been sent to at least 25 *prospective* retail customers, such correspondence would have required both registered principal pre-use approval and filing with the Department. NASD now questions whether it should apply the principal pre-use approval requirement differently to correspondence sent to prospective and existing retail customers.

Proposed Amendment

NASD is proposing to amend NASD Rule 2211 to require registered principal pre-use approval of any correspondence sent to 25 or more existing retail customers within any 30-calendar-day period (see Attachment A). In so doing, the proposal would impose the same standard for principal pre-use approval on written letters and electronic mail messages distributed by a member to either existing or prospective retail customers. Correspondence with such a wide distribution often will constitute a solicitation to purchase or sell a security or to use a brokerage service. Registered principal pre-use approval would better ensure that this material complies with applicable standards of the advertising rules. Since many firms already require registered principal pre-use approval of such correspondence, NASD believes the benefits of the proposed requirement outweigh any additional burden on members.

NASD does not propose to require that this correspondence be filed with the Department or that it be subject to all of the content standards of the advertising rules. NASD recognizes that correspondence with existing retail customers sometimes involves matters other than the promotion of a member's products or services and, therefore, may not require the same level of investor protection as correspondence to prospective retail customers. Of course, a firm may voluntarily file this correspondence with the Department in order to better ensure that it complies with applicable standards, particularly when the correspondence promotes the firm's products or services.

Endnotes

- 1 See *Notice to Members 03-73* (Nov. 2003) (NASD Announces Online Availability of Comments). Personal identifying information, such as names or e-mail addresses, will not be edited from submissions. Persons commenting on this proposal should submit only information that they wish to make publicly available.
- 2 Section 19 of the Securities Exchange Act of 1934 (Exchange Act) permits certain limited types of proposed rule changes to take effect upon filing with the SEC. The SEC has the authority to summarily abrogate these types of rule changes within 60 days of filing. See Exchange Act Section 19 and rules thereunder.
- 3 NASD has clarified that, for purposes of its rules governing member communications with the public, NASD views instant messaging in the same manner in which it views traditional electronic mail messages. Accordingly, instant messaging by a member or its associated person may qualify as correspondence or sales literature, depending upon the facts and circumstances. See *Notice to Members 03-33* (July 2003) (Clarification for Members Regarding Supervisory Obligations and Recordkeeping Requirements for Instant Messaging).
- 4 NASD Rule 3010(d)(2) governs members' supervision and review of correspondence. The rule requires each member to develop written procedures that are appropriate to its business, size, structure, and customers for the review of incoming and outgoing correspondence with the public relating to its investment banking and securities business. Where such procedures for the review of correspondence do not require review of all correspondence prior to use or distribution, they must include provision for the education and training of associated persons as to the firm's procedures governing correspondence, documentation of such education and training, and surveillance and follow-up to ensure that such procedures are implemented and adhered to.

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ATTACHMENT A

Text of proposed rule change. New language is underlined.

2211. Institutional Sales Material and Correspondence

(a) Definitions

No change.

(b) Approval and Record Keeping

(1) Registered Principal Approval

(A) Correspondence. Correspondence need not be approved by a registered principal prior to use, unless it is distributed by a member to 25 or more existing retail customers within any 30 calendar-day period. ~~[but]~~All correspondence is subject to the supervision and review requirements of Rule 3010(d).

(B) No change.

(2) Recordkeeping

No change.

(C) through (e). No change.

Notice to Members

APRIL 2005

SUGGESTED ROUTING

Corporate Finance
Legal and Compliance
Operations
Senior Management
Technology
Trading and Market Making
Training

KEY TOPICS

Debt Securities
Operations
Rule 6200 Series
Transaction Reporting
TRACE

GUIDANCE

Corporate Debt Securities

NASD Reminds Members that the TRACE Reporting Period Will Be Reduced to 15 Minutes on July 1, 2005, and Rescinds Interpretive Guidance Regarding Rejected TRACE Transaction Reports

Executive Summary

On June 14, 2004, the Securities and Exchange Commission (SEC or Commission) approved amendments to Rule 6230(a) of the Trade Reporting and Compliance Engine (TRACE) Rules, the Rule 6200 Series, reducing the reporting period in two stages.¹ In the first stage (Stage One), effective on October 1, 2004, the period to report a transaction in a TRACE-eligible security was reduced from 45 minutes to 30 minutes. NASD is reminding members that the second stage (Stage Two), which reduces the period from 30 minutes to 15 minutes, will become effective on July 1, 2005. NASD is also rescinding interpretive guidance regarding the resubmission of rejected TRACE transaction reports. Rule 6230, as amended by Stage Two rule changes only, is set forth in Attachment A.

Questions/Further Information

Questions concerning this *Notice* should be directed to tracefeedback@nasd.com; Sharon K. Zackula, Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8985; or Elliot Levine, Associate Vice President, Chief Counsel, Transparency Services, Markets, Services and Information, at (202) 728-8405.

05-28

Background and Discussion

In numerous public filings and notices, NASD and SEC stated that the TRACE reporting period would be reduced after members obtained experience reporting corporate bond transactions to TRACE. On October 1, 2003, NASD reduced the period to report a transaction in a TRACE-eligible security from 75 minutes to 45 minutes. One year later, on October 1, 2004, NASD reduced the reporting period from 45 minutes to 30 minutes. At that time, NASD informed members that the TRACE reporting period would be reduced from 30 minutes to 15 minutes effective July 1, 2005.² NASD is issuing this reminder to firms that 15-minute reporting of TRACE-eligible securities transactions will begin on July 1, 2005, as previously announced.

Stage Two 15-Minute Reporting

The impact of the Stage Two changes to TRACE transaction reporting is as follows. Under Rule 6230(a), as amended by Stage Two, a member is required to report a transaction in a TRACE-eligible security within 15 minutes of the time of execution. In addition, NASD is reducing other 30-minute reporting periods to 15 minutes in related provisions in paragraphs (1) through (4) of Rule 6230(a). Specifically, under Rule 6230(a)(1), as amended, if a member executes a transaction within 15 minutes of the time the TRACE System closes, which, on a normal day is 6:30:00 p.m. Eastern Time (ET), a member *is permitted* to report the transaction the next business day that the TRACE System opens, but must do so within 15 minutes after the TRACE System opens for the report to be timely (*i.e.*, on or before 8:14:59 a.m. ET).³ Under Rule 6230(a)(2), and (a)(4), as amended, a member is required to report a transaction that occurs on or after the closing of the TRACE System (*i.e.*, on or after 6:30:00 p.m. ET through 11:59:59 p.m. ET, or during a weekend or holiday) the next business day that the TRACE System opens, and must do so within 15 minutes after the TRACE System opens (*i.e.*, on or before 8:14:59 a.m. ET). Under Rule 6230(a)(3), as amended, a member is required to report any transaction in a TRACE-eligible security that occurs on a business day on or after 12:00:00 a.m. (midnight) through 7:59:59 a.m. ET within 15 minutes of the opening of the TRACE System (*i.e.*, on or before 8:14:59 a.m. ET).

Rescission of Prior Interpretive Guidance

In *Notice to Members (NTM) 04-51* (July 2004) (SEC Approves Amendments to TRACE Rule 6230 to Reduce the Reporting Period to 30 Minutes on October 1, 2004, and to 15 Minutes on July 1, 2005), NASD issued interpretive guidance regarding the re-submission of rejected transaction reports that provided members, in certain limited circumstances, limited and occasional flexibility to report a transaction later than the prescribed period.⁴ The guidance in *NTM 04-51*, Q&A No. 1, is rescinded as of July 1, 2005. As of July 1, 2005, regardless of the reporting mechanism used by the member (e.g., CTCL, Web browser, or third-party intermediary reporting system), a member must identify any rejected transaction report, and correct and resubmit it to TRACE within 15 minutes of the time of execution of the transaction. Any transaction report submitted after the 15-minute period has expired will be a late report, which will be treated as any other type of late transaction report.⁵

NASD will continue to monitor members' reporting to ensure that members have procedures in place that are reasonably designed to ensure that all transaction reports are submitted within 15 minutes of the time of execution, including rejected transaction reports requiring resubmission. Patterns and practices of late submissions due to rejections may be considered a violation of the TRACE Rules and Rule 2110 (Standards of Commercial Honor and Principles of Trade).

Effective Date

The amendments to Rule 6230(a) designated as Stage Two, which require a member to report a transaction in a TRACE-eligible security within 15 minutes of the time of execution, will become effective **July 1, 2005**.

Endnotes

- 1 See Securities Exchange Act Release No. 49854 (June 14, 2004), 69 Fed. Reg. 35088 (June 23, 2004) (File No. SR-NASD-2004-057). See also *NTM 04-51* (July 2004).
- 2 See *NTM 04-51* (July 2004).
- 3 Generally, the TRACE System is open to receive reports Monday through Friday, 8:00:00 a.m. through 6:29:59 p.m., and closes at 6:30:00 p.m. ET. On days when NASD announces that the TRACE System will close early (e.g., at 2:00:00 p.m. ET on the day after Thanksgiving), NASD will announce the early closing and specify when the TRACE System will cease accepting reports. When early closings in TRACE occur, NASD staff interprets Rule 6230(a)(1) as allowing a member (for a transaction that occurs just before the end of the TRACE System closing) to report the transaction on the day of execution before the TRACE System closes or the next business day, to provide the member the same flexibility that is provided when the TRACE System closes at 6:30:00 p.m. ET. Assume, for example, that NASD announces that the TRACE System will close at 2:00:00 p.m. ET, in which case the TRACE System will not accept reports at or after the 2:00:00 p.m. closing. If a 15-minute reporting period is in effect and a member executes a transaction at 1:50:00 p.m. ET, the member may report the transaction on the day of execution (up to 2:00 p.m. ET) or may report the transaction the next business day that the TRACE System is open within 15 minutes of the opening.
- 4 The guidance in *NTM 04-51* (July 2004), Q&A No. 1 regarding the re-submission of rejected trade reports was provided in Q&A format in the context of 30-minute reporting. Similar guidance was published in two prior Notices. See *NTM 02-76* (November 2002) (NASD Issues Interpretive Guidance to the Trade Reporting and Compliance Engine Rules), Q&A No. 1 (in the context of 75-minute reporting), and *NTM 03-58* (September 2003) (NASD Issues Interpretive Guidance to the Trade Reporting and Compliance Engine Rules), Q&A No. 6 (in the context of 45-minute reporting). When NASD published guidance on the re-submission of rejected trade reports in *NTM 04-51*, Q&A No. 1, NASD rescinded its prior guidance on the same subject in *NTM 03-58*, Q&A No. 6. Similarly, when NASD published its guidance in *NTM 03-58*, Q&A No. 6, NASD rescinded its guidance on the same issues found in *NTM 02-76*, Q&A No. 1.
- 5 NASD staff notes that a member may continue to rely on the interpretive guidance in *NTM 04-51* for transactions executed and reported prior to July 1, 2005.

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ATTACHMENT A

New language is underlined; deletions are in brackets.

6200. TRADE REPORTING AND COMPLIANCE ENGINE (TRACE)

* * * * *

6230. Transaction Reporting

(a) When and How Transactions are Reported

A member that is required to report transaction information pursuant to paragraph (b) below must report such transaction information within 15[30] minutes of the time of execution, except as otherwise provided below, or the transaction report will be "late." The member must transmit the report to TRACE during the hours the TRACE system is open ("TRACE system hours"), which are 8:00 a.m. Eastern Time through 6:29:59 p.m. Eastern Time. Specific trade reporting obligations during a 24-hour cycle are set forth below.

(1) Transactions Executed During TRACE System Hours

Transactions in TRACE-eligible securities executed on a business day at or after 8:00 a.m. Eastern Time through 6:29:59 p.m. Eastern Time must be reported within 15[30] minutes of the time of execution. If a transaction is executed on a business day less than 15[30] minutes before 6:30 p.m. Eastern Time, a member may report the transaction the next business day within 15[30] minutes after the TRACE system opens. If reporting the next business day, the member must indicate "as/of" and provide the actual transaction date.

(2) Transactions Executed At or After 6:30 P.M. Through 11:59:59 P.M. Eastern Time

Transactions in TRACE-eligible securities executed on a business day at or after 6:30 p.m. Eastern Time through 11:59:59 p.m. Eastern Time must be reported the next business day within 15[30] minutes after the TRACE system opens. The member must indicate "as/of" and provide the actual transaction date.

(3) Transactions Executed At or After 12:00 A.M. Through 7:59:59 A.M. Eastern Time

Transactions in TRACE-eligible securities executed on a business day at or after 12:00 a.m. Eastern Time through 7:59:59 a.m. Eastern Time must be reported the same day within 15[30] minutes after the TRACE system opens.

(4) Transactions Executed on a Non-Business Day

Transactions in TRACE-eligible securities executed on a Saturday, Sunday, or a federal or religious holiday on which the TRACE system is closed, at any time during that day (determined using Eastern Time), must be reported the next business day within 15[30] minutes after the TRACE system opens. The transaction must be reported as follows: the date of execution must be the first business day (the same day the report must be made); the execution time must be "12:01:00 a.m. Eastern Time" (stated in military time as "00:01:00"); and the modifier, "special price," must be selected. In addition, the transaction must not be designated "as/of." When the reporting method chosen provides a "special price" memo field, the member must enter the actual date and time of the transaction in the field.

(5) and (6) No Change

(b) through (f) No Change

* * * * *

Notice to Members

APRIL 2005

SUGGESTED ROUTING

Legal & Compliance
Operations
Registered Representatives
Senior Management
Trading

KEY TOPICS

Institutional Securities Activities
Rule 3012
(Supervisory Control System)
Rule 3010 (Supervision)
Supervisory Control Procedures
Written Supervisory Procedures

GUIDANCE

Supervisory Controls

Guidance Regarding Rule 3012(a)(1) Requirement to Test and Verify a Member's Supervisory Policies and Procedures

Executive Summary

On September 30, 2004, the Securities and Exchange Commission (SEC) approved NASD's Supervisory Control Amendments in their final form. These amendments became effective on January 31, 2005. A fundamental element of the Supervisory Control Amendments is new Rule 3012 (Supervisory Control System). Rule 3012(a)(1) requires a member to designate one or more principals who will establish, maintain, and enforce a system of supervisory control policies and procedures that tests and verifies that a member's supervisory procedures are reasonably designed to comply with applicable securities laws and regulations, and with applicable NASD rules, and to amend those supervisory procedures when the testing and verification demonstrate a need to do so. In response to requests for guidance on the subject, NASD is issuing this *Notice* to provide members with guidelines members may use to comply with Rule 3012(a)(1).

Questions/Further Information

Questions or comments concerning this *Notice* may be directed to Patricia Albrecht, Assistant General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8026.

05-29

Background

On September 30, 2004, the SEC approved the Supervisory Control Amendments in their final form.¹ The amendments became effective on January 31, 2005.² Although NASD has previously provided members with detailed guidance regarding the general application of the Supervisory Control Amendments,³ members have continued to request specific guidance regarding compliance with Rule 3012's (Supervisory Control System) requirement that members test and verify the adequacy of their supervisory procedures.⁴ Accordingly, NASD is issuing this *Notice* to provide members with guidelines to assist in meeting this requirement.

Discussion

Generally, NASD expects members to consider the following guidelines when designing a system of supervisory control policies and procedures that will test and verify that their supervisory procedures are reasonably designed to achieve compliance with the applicable securities laws, regulations, and NASD rules. It is important, however, for members to understand that this guidance is not to be construed as a checklist of steps guaranteed to constitute an adequate supervisory control system or a substitute for the development of a supervisory control system that is tailored to the needs and circumstances of individual member firms. **In this regard, this guidance does not constitute a safe harbor and members retain the responsibility to design and implement a supervisory control system that is appropriate for their specific businesses and structures.**⁵

Guidelines for Rule 3012(a)(1)

- ◆ The first step a member should consider taking when designing its supervisory control system is to conduct an inventory of all of the member's businesses and of the securities laws, regulations, and NASD rules relevant to those businesses.
- ◆ The member should then analyze the requirements of those applicable laws, regulations, and NASD rules by asking, "what questions do the requirements raise that must be answered?" For example, what conduct is prohibited, compelled, limited, or conditioned? How will the member assure compliance with those requirements? Who at the member firm will be responsible for supervising such conduct, and what are the method and parameters of such supervision?
- ◆ The member should then analyze its own supplementary internal requirements, if any. Will the member's internal business policies further restrict conduct?
- ◆ The member should next compare the answers that result from the analysis conducted above to its current supervisory procedures and use that comparison to determine if any gaps or deficiencies in those procedures are evident.

-
- ◆ The member should then analyze how to address any identified gaps or deficiencies. To do this, the member should first use the same type of question-based approach outlined above. For example, if the member has entered into one or more new businesses or aspects of an existing business, does that call into question other laws or rules or a different application of such laws and rules? Have laws or rules changed in a manner that renders existing procedures inaccurate, obsolete, or incomplete? Has the member's history with respect to customer complaints, litigations/arbitrations, regulatory inquiries or actions, internal surveillance history and experience, branch office examinations, internal audits, or other reported matters in the media or by the regulators with respect to other broker-dealers raised questions as to the sufficiency of the member's procedures?
 - ◆ The answers resulting from this analysis can be distilled into new or amended supervisory procedures that resolve the identified gaps or deficiencies in the member's supervisory procedures.

Members may notice that some of the steps in creating a supervisory control system mirror the guidance NASD has previously provided to assist members in creating the supervisory system and written supervisory procedures required by Rule 3010 (Supervision).⁶ This similarity not only is deliberate, it is necessary. One cannot adequately test and verify a set of supervisory procedures without revisiting the initial decisions that were made when the supervisory system and written supervisory procedures were first created. In addition, a member's supervisory system and written supervisory procedures are not static. Instead, they often become outdated or ineffective as a result of changes in the firm's business lines, products, practices, or new or amended securities laws.⁷ Accordingly, it is in the member's best interest to determine whether its previous answers to the basic questions underpinning its supervisory system continue to apply in light of any changes.

Rule 3012(a)(2)

Rule 3012(a)(2) requires that a member's written supervisory control policies and procedures also include procedures to supervise certain enumerated activities. Specifically, Rule 3012(a)(2) requires procedures for the day-to-day supervisory review of a member's producing managers and the imposition of heightened supervisory procedures for producing managers that meet a certain threshold and the monitoring of certain activities, such as transmittal of funds from or to a customer's accounts, customer changes of address, and/or investment objectives.

Members have raised questions as to the differences, if any, between the terms "written procedures to supervise" (required in Rule 3010) and "written supervisory control policies and procedures" (required in Rule 3012(a)(2)). For purposes of the Rule 3012(a)(1) testing and verification requirement, the term supervisory procedures encompasses both terms. Thus, a member must test and verify (and, if necessary, amend) both types of procedures—written supervisory control policies and procedures, as well as written procedures to supervise—in order to meet the requirements of the

rule to “(A) test and verify that the member’s supervisory procedures are reasonably designed with respect to the activities of the member and its registered representatives and associated persons, to achieve compliance with applicable securities laws and regulations, and with applicable NASD rules and (B) create additional or amend supervisory procedures where the need is identified by such testing and verification.”

Endnotes

- 1 Exchange Act Release No. 50477 (September 30, 2004), 69 F.R. 59972 (October 6, 2004) (SR-NASD-2004-116).
- 2 *Notice to Members (NTM) 04-71* (October 2004).
- 3 See *NTM 05-08* (January 2005) and *NTM 04-71* (October 2004); see also NASD Supervisory Control Amendments Phone-In Workshop Transcript (December 15, 2004), which is available on the NASD Web site at: www.nasd.com/web/groups/educ_progs/documents/education_phone_workshop/nasdw_012809.pdf.
- 4 Rule 3012(a)(1).
- 5 Some members have expressed doubt regarding whether a very small member, such as a sole proprietor, may be able to develop an adequate supervisory control system to test and verify whether its supervisory procedures are reasonably designed to comply with the applicable laws, regulations, and NASD rules. NASD does not share this view. A sole proprietor (or other small member) can demonstrate that he has reviewed his supervisory procedures in light of any rule changes or changes in business operations and determined whether his supervisory procedures are adequate or require amending. The guidance in this *Notice* is applicable to sole proprietorships and other small firms, as well as firms of larger size.
- 6 See *NTM 99-45* (June 1999).
- 7 Rule 3012(a)(1) recognizes the changing nature of a member’s supervisory system by requiring members to submit, no less than annually, a report detailing each member’s system of supervisory controls, the summary of the supervisory controls’ test results, and any additional or amended supervisory procedures created in response to the test results.

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Notice to Members

APRIL 2005

SUGGESTED ROUTING

Executive Representatives
Legal & Compliance
Market Making
Operations
Senior Management
Trading

KEY TOPICS

Access to Quotations
Alternative Display Facility
Market Regulation

GUIDANCE

Denial of Access Complaints

SEC Approves New Pilot Rule Giving NASD Authority to Receive and Review Complaints against NASD Market Participants that Allege Denial of Access to Their Quotes in the Alternative Display Facility; **Compliance Date: May 26, 2005**

Executive Summary

On March 10, 2005, the Securities and Exchange Commission (SEC) approved on a pilot basis new NASD Rule 4400A, which gives NASD the authority to receive and review complaints against NASD Market Participants alleging denial of access to their quotations in the Alternative Display Facility (ADF). In addition, the rule sets forth procedures for reviewing such complaints and delegates authority to NASD's Market Regulation Committee (MRC) to review denial of access determinations rendered in accordance with Rule 4400A. The new rule can be found in Attachment A and becomes effective on **May 26, 2005**.

Questions/Further Information

Questions or comments concerning this *Notice* may be directed to Chris Stone, Associate Chief Counsel, Transparency Services, at (202) 728-8457; or Philip Shaikun, Associate General Counsel, Regulatory Policy and Oversight, at (202) 728-8451.

05-30

Background and Discussion

On July 24, 2002, the SEC approved SR-NASD-2002-97, which authorized NASD to operate the ADF on a pilot basis for nine months.¹ The pilot has since been extended until July 26, 2005.² The ADF is a quotation collection, trade comparison, and trade reporting facility developed by NASD in accordance with the SEC's SuperMontage Approval Order³ and in conjunction with NASDAQ's proposal to register as a national securities exchange.⁴

The ADF does not provide an order routing capability; therefore, NASD Rule 4300A requires an NASD Market Participant to provide direct electronic access to other NASD Market Participants and to provide all other NASD members direct electronic access or allow for indirect electronic access to its quotations in the ADF.

The rule change gives NASD the authority to receive and review complaints against an NASD Market Participant alleging denial of direct or indirect access required by NASD Rule 4300A. The rule change does not include complaints that allege: (1) a denial of direct or indirect access because of non-payment of fees for access to an NASD Market Participant's quotations that are imposed by the NASD Market Participant in accordance with SEC rules and regulations or otherwise; or (2) a specific instance or group of instances over discrete time periods where an NASD Market Participant is alleged not to have not honored its quotation in accordance with applicable SEC and NASD rules with respect to orders received electronically pursuant to NASD Rule 4300A.

The process under Rule 4400A for a proper denial of access complaint is as follows: The complainant is required to file a written complaint with ADF Operations via facsimile, personal delivery, courier, or overnight mail that specifically alleges denial of access to an NASD Market Participant's quotation. The complainant is required to serve a copy of the complaint by the same means on the opposite party in accordance with NASD Rule 9134(b).

An officer designated by a President of NASD or one of its divisions then reviews the denial of access complaint to make a determination on the merits of the complaint. The officer may, at his or her discretion, conduct further investigation before rendering a decision as to whether there has been a denial of access in contravention of Rule 4300A. In the event that the officer determines that there has been such a denial of access, he or she will direct the offending party to provide access to its ADF quotes and may limit participation in the ADF by such party if it does not comply promptly with the directive to provide access. The directive and any action to limit participation in the ADF will become effective and remain in place during the pendency of any further review or appeal.

The rule change also provides for a review of the initial determination by a three-member subcommittee consisting of current or former MRC members. A party seeking such review is required to submit a written appeal to NASD by the close of business on the next business day after receipt of the initial determination and to simultaneously serve a copy of the written appeal to the opposite party. The party seeking review is accorded twenty-four (24) hours, or a longer period determined by NASD staff, after submission of the appeal to provide to NASD and the opposing party any supporting written information concerning the appeal. The opposing party then has the same amount of time to submit written documentation in support of its position. A three-member subcommittee of current or former MRC members will then render a final determination to affirm or reverse the determination of the NASD officer based on the record and any hearing it determines to hold in its discretion.

The rule requires the MRC subcommittee to provide written notification of its decision by the close of business the day following its determination. The decision, including affirmation of any directive to provide access or action to limit participation in the ADF rendered by the NASD officer, is effective upon issuance of the written decision and remains in effect during the pendency of further appeals or other legal proceedings. The MRC subcommittee may not impose any additional sanctions, including monetary fines; its authority is limited to affirming or reversing the determination of the NASD officer.

The MRC decision constitutes final NASD action and can be appealed to the SEC. The decision does not prejudice the rights of the parties to subsequently submit the matter to arbitration or another adjudicatory forum as appropriate. Furthermore, the decision does not operate as an estoppel or otherwise bind NASD in any subsequent disciplinary action or other legal proceeding.

The pilot rule will remain in effect for the duration of the ADF pilot, absent any additional rulemaking action by NASD.

Endnotes

- 1 Exchange Act Release No. 46249 (July 24, 2002), 67 FR 49822 (July 31, 2002).
- 2 Exchange Act Release No. 47633 (April 10, 2003), 68 FR 19043 (April 17, 2003); Exchange Act Release No. 49131 (January 27, 2004), 69 FR 5229 (February 3, 2004); Exchange Act Release No. 50601 (October 28, 2004), 69 FR 64611 (November 5, 2004).
- 3 Exchange Act Release No. 43863 (January 19, 2001), 66 FR 8020 (January 26, 2001) (File No. SR-NASD-99-53).
- 4 Exchange Act Release No. 44396 (June 7, 2001), 66 FR 31952 (June 13, 2001) (File No. 10-131).

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ATTACHMENT A

New language is underlined.

4400A. Review of Direct or Indirect Access Complaints

(a) Authority to Receive Complaints

(1) For the purposes of this Rule, a "direct or indirect access complaint" is a complaint against an NASD Market Participant, as defined in Rule 4300A(d)(4), that alleges a denial or limitation of access in contravention of Rule 4300A.

(2) Any member that wishes to file a direct or indirect access complaint shall submit a written complaint, via facsimile, personal delivery, courier or overnight mail, to ADF Operations and simultaneously serve by the same means the respondent in accordance with Rule 9134(b). Officers of NASD designated by a President of NASD or one of its divisions shall have the authority to review and make a determination regarding direct or indirect access complaints.

(3) Based upon a review of the complaint and such investigation that the officer, in his or her sole discretion, may decide to conduct, the officer shall promptly determine whether there has been a denial of access by the NASD Market Participant. If the officer determines that there has been a denial of access in contravention of Rule 4300A, the officer shall direct the offending party to provide access to its ADF quotes and may limit participation in the ADF by such party if it does not comply promptly with the directive. NASD shall provide to the parties written notification of the determination by the close of business following the day the determination is rendered. The determination shall be sent to the facsimile number listed in the parties' contact questionnaire submitted to NASD pursuant to Article IV, Section 3 of NASD's By-Laws or another contact specifically designated by a party. The determination, and any directive to provide access or action to limit participation in the ADF, shall be effective when issued or as specified, and shall remain in effect during any review or appeal. The determination shall not constitute an estoppel as to NASD nor bind NASD in any subsequent administrative, civil, or disciplinary proceeding.

(b) Procedures for Review of Determinations

(1) Any member that seeks review of a determination issued pursuant to paragraph (a) hereof, shall submit a written appeal setting forth the grounds for such review. The written appeal shall be submitted via facsimile, personal delivery, courier or overnight mail, to NASD and served by the same means on the opposite party, in accordance with Rule 9134(b), by close of the next business day after receipt of the written determination. Written appeals that are not served upon NASD and the opposite party by the close of the next business day after receipt of the written determination will not qualify for further administrative consideration, without prejudice as to the rights of a party to submit the dispute to arbitration or another adjudicatory forum.

(2) Once a written appeal has been received in accordance with subparagraph (b)(1) above:

(A) the party seeking review shall have up to twenty-four (24) hours, or such longer period as specified by NASD staff, to submit to NASD and the opposite party via facsimile, personal delivery, courier or overnight mail, any supporting written information concerning the appeal;

(B) after receipt of the foregoing supporting written information, the party served with the appeal shall have up to twenty-four (24) hours, or such longer period as specified by NASD staff, to submit any relevant written information to NASD and the party seeking review via facsimile, personal delivery, courier or overnight mail;

(C) if the party seeking review fails to serve the opposite party any written information required pursuant to this subparagraph, that party's written complaint will not qualify for further administrative consideration, without prejudice as to the rights of a party to submit the dispute to arbitration or another adjudicatory forum.

(3) Each member and/or person associated with a member involved in the review shall provide NASD with any information that it requests to resolve the matter on a timely basis notwithstanding the time parameters set forth in paragraph (b)(2) above.

(4) All requests for information pursuant to this rule shall be sent by the specified means to a receiving location that, from time to time, may be designated by NASD.

(c) Review by a Subcommittee of the Market Regulation Committee

(1) If a party has applied for review of a determination, and the procedural requirements of subparagraph (b) above have been satisfied, the determination shall be reviewed and a decision rendered by a three-member subcommittee comprised of current or former industry members of NASD's Market Regulation Committee. Upon consideration of the record, and after such hearings as it may in its discretion order, the subcommittee, in accordance with the requirements set forth in Rule 4300A, shall affirm or reverse the determination of the NASD officer pursuant to paragraph (a)(3) above.

(2) The subcommittee shall provide written notification of its determination to the parties by the close of business following the day the determination is rendered. The subcommittee's determination shall not prejudice the rights of a party to submit the dispute to arbitration or another adjudicatory forum. The subcommittee's determination, including affirmation of any directive or action rendered in accordance with paragraph (a)(3), shall be effective when issued or as specified, constitute final NASD action, and remain in effect during any review or appeal. The subcommittee's determination shall not constitute an estoppel as to NASD nor bind NASD in any subsequent administrative, civil, or disciplinary proceeding.

Notice to Members

APRIL 2005

SUGGESTED ROUTING

Institutional
Legal & Compliance
Options
Senior management
Trading
Training

KEY TOPICS

Exercise Limits
Hedge Exemption
Options
Position Limits
Rule 2860

GUIDANCE

Options Position and Exercise Limits

Pilot Program to Increase Position and Exercise Limits for Equity Options and New Reverse Collar Strategy Added to Equity Option Hedge Exemptions

Executive Summary

On March 30, 2005, NASD filed for immediate effectiveness with the Securities and Exchange Commission (SEC) amendments to Rule 2860 increasing, for a pilot period, certain stock options position and exercise limits and adding permanently reverse collars to the enumerated strategies set forth in the equity option hedge exemptions.

The rules, as amended, are set forth in Attachment A. The amendments became effective **March 30, 2005**.

Questions/Further Information

Questions concerning this *Notice* may be directed to Gary L. Goldsholle, Associate Vice President and Associate General Counsel, Office of General Counsel (OGC), Regulatory Policy and Oversight (RPO), at (202) 728-8104; or James L. Eastman, Assistant General Counsel, OGC, RPO, at (202) 728-6961.

05-31

Background and Discussion

NASD Rule 2860(b)(3)(A) imposes a ceiling or position limit on the number of conventional and standardized equity options contracts in each class on the same side of the market (*i.e.*, aggregating long calls and short puts or long puts and short calls) that can be held or written by a member, a person associated with a member, a customer, or a group of customers acting in concert.¹ The rule provides that the position limits for equity options are determined according to a five-tiered system in which more actively traded stocks with larger public floats are subject to higher position limits.

NASD recently adopted amendments to its options position limits tiers to match changes approved by the SEC or adopted by other self-regulatory organizations (SROs) with options rules.² Pursuant to a pilot program that began March 30, 2005, and ends September 2, 2005 (Pilot Period), unless extended, the limits for each of the tiers has increased as follows: 1) 13,500 contracts has been increased to 25,000 contracts; 2) 22,500 contracts has been increased to 50,000 contracts; 3) 31,500 contracts has been increased to 75,000 contracts; 4) 60,000 contracts has been increased to 200,000 contracts; and 5) 75,000 contracts has been increased to 250,000 contracts. These tiers apply to both conventional and standardized options. Options exercise limits, which are set forth in Rule 2860(b)(4), and which incorporate by reference the position limits in Rule 2860(b)(3), also have been increased during the Pilot Period.

Rule 2860(b)(3)(A)(vii) contains the equity option hedge exemptions and allows certain hedged positions to exceed the base limits set forth in the five tiers. Options positions hedged pursuant to one of the qualified equity option hedge strategies are exempt from position limits for standardized options, and subject to position limits of five times the standardized limits for conventional options. At the time the position limits for each of the five tiers were increased, the SEC also approved (or SROs adopted) amendments expanding the available strategies under the equity option hedge exemptions to include "reverse collars."³ NASD has made a conforming change to its equity option hedge exemptions. The equity option hedge exemption for a reverse collar applies to a long call position accompanied by a short put position where the long call expires with the short put and the strike price of the long call equals or exceeds the short put and where each long call and short put position is hedged with 100 shares of the underlying security (or other adjusted number of shares). Neither side of the long call, short put position can be in-the-money at the time the position is established. The addition of the reverse collar hedging strategy as part of the equity option hedge exemptions is permanent and is not part of the pilot program.

Endnotes

- 1 A “standardized equity option” is an equity options contract issued, or subject to issuance by, The Options Clearing Corporation that is not a FLEX Equity Option (NASD Rule 2860(b)(2)(VV)). A “conventional option” is an option contract not issued, or subject to issuance by, The Options Clearing Corporation (NASD Rule 2860(b)(2)(N)). NASD’s limits on standardized equity options are applicable only to those members that are not also members of the exchange on which the option is traded; the limits on conventional options are applicable to all NASD members (NASD Rule 2860(b)(1)(A)).
- 2 See Securities Exchange Act Release No. 51322 (March 4, 2005), 70 FR 12260 (March 11, 2005) (SR-PHLX-2005-17); Securities Exchange Act Release No. 51317 (March 3, 2005), 70 FR 12254 (March 11, 2005) (SR-BSE-2005-10); Securities Exchange Act Release No. 51316 (March 3, 2005), 70 FR 12251 (March 11, 2005) (SR-AMEX-2005-029); Securities Exchange Act Release No. 51295 (March 2, 2005), 70 FR 11292 (March 8, 2005) (SR-ISE-2005-14); Securities Exchange Act Release No. 51286 (March 1, 2005), 70 FR 11297 (March 8, 2005) (SR-PCX-2003-55); Securities Exchange Act Release No. 51244 (February 23, 2005), 70 FR 10010 (March 1, 2005) (SR-CBOE-2003-30).
- 3 *Id.*

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ATTACHMENT A

New language is underlined; deletions are in brackets.

2800. SPECIAL PRODUCTS

2860. Options

(a) No Change.

(b) Requirements

(1) and (2) No Change.

(3) Position Limits

(A) Stock Options—Except in highly unusual circumstances, and with the prior written approval of NASD pursuant to the Rule 9600 Series for good cause shown 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, non-member broker, or non-member dealer, an opening transaction through Nasdaq, 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, non-member broker, or non-member dealer, would, acting alone or in concert with others, directly or indirectly, hold or control or be obligated in respect of an aggregate equity options position in excess of:

(i) 13,500 (or 25,000 during the pilot period from March 30, 2005, through September 2, 2005 (“Pilot Period”)) 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

(ii) 22,500 (or 50,000 during the Pilot Period) 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 22,500 (or 50,000 during the Pilot Period) contract position limit shall only be available for option contracts on securities that underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 22,500 (or 50,000 during the Pilot Period) option contracts; or

(iii) 31,500 (or 75,000 during the Pilot Period) 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 31,500 (or 75,000 during the Pilot Period) contract position limit shall only be available for option contracts on securities that underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 31,500 (or 75,000 during the Pilot Period) option contracts; or

(iv) 60,000 (or 200,000 during the Pilot Period) option contracts of the put and the call class on the same side of the market covering the same underlying security, providing that the 60,000 (or 200,000 during the Pilot Period) contract position limit shall only be available for option contracts on securities that underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 60,000 (or 200,000 during the Pilot Period) option contracts; or

(v) 75,000 (or 250,000 during the Pilot Period) option contracts of the put and the call class on the same side of the market covering the same underlying security, providing that the 75,000 (or 250,000 during the Pilot Period) contract position limit shall only be available for option contracts on securities that underlie Nasdaq or exchange-traded options qualifying under applicable rules for a position limit of 75,000 (or 250,000 during the Pilot Period) option contracts; or

(vi) No Change.

(vii) Equity Option Hedge Exemptions

a. The following qualified hedge strategies and positions described in subparagraphs 1. through [5] 6. below shall be exempt from the established position limits under this rule for standardized options. Hedge strategies and positions described in subparagraphs [6] 7. and [7] 8. below in which one of the option components consists of a conventional option, shall be subject to a position limit of five times the established position limits contained in subparagraphs (i) through (vi) above. Hedge strategies and positions in conventional options as described in subparagraphs 1. through [5] 6. below shall be subject to a position limit of five times the established limits contained in subparagraphs (i) through (vi) above. Options positions limits established under this subparagraph shall be separate from limits established in other provisions of this rule.

1. through 3. No Change.

4. Reverse Collars — A long call position accompanied by a short put position where the long call expires with the short put and the strike price of the long call equals or exceeds the short put and where each long call and short put position is hedged with 100 shares of the underlying security (or other adjusted number of shares). Neither side of the long call, short put position can be in-the-money at the time the position is established.

[4.] 5. Collars — A short call position accompanied by a long put position, where the short call expires with the long put, and the strike price of the short call equals or exceeds the strike price of the long put position and where each short call and long put position is hedged with 100 shares (or other adjusted number of shares) of the underlying security or securities convertible into such underlying security. Neither side of the short call/long put position can be in-the-money at the time the position is established.

[5] 6. Box Spreads — A long call position accompanied by a short put position with the same strike price and a short call position accompanied by a long put position with a different strike price.

[6] 7. Back-to-Back Options — A listed option position hedged on a one-for-one basis with an over-the-counter (OTC) option position on the same underlying security. The strike price of the listed option position and corresponding OTC option position must be within one strike price interval of each other and no more than one expiration month apart.

[7] 8. For reverse conversion, conversion, reverse collar and collar strategies set forth above in subparagraphs 2., 3., 4. and 5. [4.], one of the option components can be an OTC option guaranteed or endorsed by the firm maintaining the proprietary position or carrying the customer account.

b. No Change.

(viii) Conventional Equity Options

a. For purposes of this paragraph (b), standardized equity option contracts of the put class and call class on the same side of the market overlying the same security shall not be aggregated with conventional equity option contracts or FLEX Equity Option contracts overlying the same security on the same side of the market. Conventional equity option contracts of the put class and call class on the same side of the market overlying the same security shall be subject to a position limit equal to the greater of:

1. the basic limit of 13,500 (or 25,000 during the Pilot Period) contracts, or
2. any standardized equity options position limit as set forth in paragraphs (b)(3)(A)(ii) through (v) for which the underlying security qualifies or would be able to qualify.

b. In order for a security not subject to standardized equity options trading to qualify for an options position limit of more than 13,500 (or 25,000 during the Pilot Period) contracts, a member must first demonstrate to NASD's Market Regulation Department that the underlying security meets the standards for such higher options position limit and the initial listing standards for standardized options trading.

(B) through (D) No Change.

(4) through (24) No Change.

Notice to Members

APRIL 2005

SUGGESTED ROUTING

Legal & Compliance
Senior Management

KEY TOPICS

Arbitration
Books and Records
Predispute Arbitration Agreements
Rule 3110

GUIDANCE

Predispute Arbitration Agreements

SEC Approves Amendments to NASD Rule Governing Predispute Arbitration Agreements with Customers

Executive Summary

NASD Rule 3110(f) governs a member's use of predispute arbitration agreements with customers. The Securities and Exchange Commission (SEC) has approved changes to NASD Rule 3110(f) to conform the NASD delivery requirement for predispute arbitration agreements with the SEC's recordkeeping rules.¹ The rule change also extends the date by which firms must begin using the disclosure required by the recent changes to NASD Rule 3110(f)(1) from May 1, 2005 until June 1, 2005.² The changes to NASD Rule 3110(f) are attached as Attachment A (new language is underlined; deletions are in brackets).

Questions/Further Information

Questions concerning this *Notice* may be directed to Laura Gansler, Associate General Counsel, Office of General Counsel (OGC), Regulatory Policy and Oversight (RPO), at (202) 728-8275; or Brant K. Brown, Counsel, OGC, RPO, at (202) 728-6927.

Discussion

Delivery Requirement

On November 22, 2004, the SEC approved changes to NASD Rule 3110(f), which governs the use of predispute arbitration agreements with customers.³ The primary purposes of those changes were to require enhanced disclosure to customers about the arbitration process and to clarify the use of certain clauses in predispute arbitration agreements. Those changes also required that members provide a copy of any customer agreement containing a predispute arbitration clause to the customer, who must acknowledge receipt thereof on the agreement or on a separate document, at the time of signing.⁴ The rule change announced in this *Notice* amends the time requirement for delivery of a copy of the customer agreement from the time of signing to within 30 days of signing.⁵ This change conforms the delivery requirement in NASD Rule 3110(f)(2)(B) to that in the SEC's recordkeeping rules.⁶

As amended, NASD Rule 3110(f)(3)(A) requires members to provide customers who request a copy of any predispute arbitration clause or client agreement with a copy within 10 business days of the request. The primary purpose of this provision is to address instances in which members have refused to provide additional copies of agreements to customers who requested them after a dispute arose, making it difficult for customers who had misplaced their original copies to assess their rights and obligations under the agreement. However, it is possible that a customer may make a request pursuant to this provision before the original copy is delivered as required by Rule 3110(f)(2)(B). In such cases, members must provide a copy of the agreement within 10 business days. For example, if a customer requests a copy of the agreement on the date of signing, the member must provide the copy to the customer within 10 business days of receiving that request. However, members may not extend the 30-day time period for compliance with the delivery requirement in NASD Rule 3110(f)(2)(B), even though a member has 10 business days in which to provide a copy of the agreement to a customer upon request. For example, if a customer requests a copy of the customer agreement 25 days after signing, the member still is required to provide the customer with the copy within 30 days of the signing date (rather than within 10 business days of the date the firm received the request). The language added to NASD Rule 3110(f)(3)(A) addresses this situation.

Extension of Compliance Date

The changes to NASD Rule 3110(f) approved by the SEC on November 22, 2004, are scheduled to become effective on May 1, 2005. To give members more time to amend their customer agreements to *comply with the changes to NASD Rule 3110(f)(1) announced in Notice to Members (NTM) 05-09*, the compliance date by which members must begin using the disclosure required by those changes has been extended from May 1, 2005 until June 1, 2005.⁷

Effective Date

By May 1, 2005, members are required to comply with the recent changes to NASD Rule 3110(f) as set forth in *NTM 05-09* and this *Notice*, with the exception of the new disclosure required by NASD Rule 3110(f)(1). Members are not required to use customer agreements with the new disclosure until June 1, 2005; however, members may use the new language earlier if they so choose. Beginning June 1, 2005, all customer agreements containing predispute arbitration clauses must contain the new disclosure required by NASD Rule 3110(f)(1).

Endnotes

- 1 SEC Rel. No. 34-51526 (Apr. 12, 2005), 70 Fed. Reg. 20407 (Apr. 19, 2005) (SR-NASD-2005-045).
- 2 NASD announced the changes to the predispute arbitration agreement disclosure requirements in *Notice to Members 05-09*.
- 3 SEC Rel. No. 34-50713 (Nov. 22, 2004), 69 Fed. Reg. 70293 (Dec. 3, 2004) (SR-NASD-98-74).
- 4 Before the changes, members were required to provide copies of predispute arbitration agreements to customers; however, the rule did not specify when they must do so.
- 5 The rule change also makes a technical amendment by renumbering the four subparagraphs in NASD Rule 3110(f)(4) to conform the numbering in those subparagraphs to existing NASD rule format.
- 6 See SEC Rule 17a-3(a)(17)(i)(B)(1); SEC Rel. No. 34-44992 (Oct. 26, 2001), 66 Fed. Reg. 55817 (Nov. 2, 2001). The earlier changes to NASD Rule 3110(f) were first filed in 1998, prior to the adoption of the SEC rule. See 69 Fed. Reg. at 70293.
- 7 The effective date of the Rule 3110 changes was originally linked to the effective date of amendments to NASD Rule 10304, governing time limits on filing claims in arbitration, which will also take effect on May 1, 2005. See SEC Rel. No. 34-50714 (Nov. 22, 2004), 69 Fed. Reg. 69971 (Dec. 1, 2004) (SR-NASD-2003-101). Extension of the compliance date for NASD Rule 3110(f)(1) does not extend the effective date of the bifurcation provision in NASD Rule 3110(f)(5), which remains the same (May 1, 2005) as the amendments to NASD Rule 10304, or the applicability of any provision in NASD Rule 10304.

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ATTACHMENT A

New language is underlined; deletions are in brackets.

3110. Books and Records

(a) – (f)(2)(A) No change.

(f)

(2) (B) [At the time] Within thirty days of signing, a copy of the agreement containing any such clause shall be given to the customer who shall acknowledge receipt thereof on the agreement or on a separate document.

(3) (A) A member shall provide a customer with a copy of any predispute arbitration clause or customer agreement executed between the customer and the member, or inform the customer that the member does not have a copy thereof, within ten business days of receipt of the customer's request. If a customer requests such a copy before the member has provided the customer with a copy pursuant to subparagraph (2)(B) of this Rule, the member must provide a copy to the customer by the earlier date required by this subparagraph (3)(A) or by subparagraph (2)(B).

(f)(3)(B) No change.

(4) No predispute arbitration agreement shall include any condition that:

(A) [(i)] limits or contradicts the rules of any self-regulatory organization;

(B) [(ii)] limits the ability of a party to file any claim in arbitration;

(C) [(iii)] limits the ability of a party to file any claim in court permitted to be filed in court under the rules of the forums in which a claim may be filed under the agreement;

(D) [(iv)] limits the ability of arbitrators to make any award.

(f)(5) – (h) No change.

Notice to Members

APRIL 2005

SUGGESTED ROUTING

Internal Audit
Legal & Compliance
Operations
Registered Representatives
Senior Management
Systems
Trading
Training

KEY TOPICS

Order Audit Trail System (OATS)
Order Marking
SEC Regulation SHO
Short Sales

GUIDANCE

Issues Relating to the SEC's Adoption of Regulation SHO

Short Sales in Pilot Securities and Order-Marking Requirements under SEC Regulation SHO

Executive Summary

NASD, in conjunction with The Nasdaq Stock Market, Inc. (NASDAQ), is issuing this *Notice to Members* (NTM) to advise member firms and other interested parties of certain actions and issues surrounding the adoption of Regulation SHO by the Securities and Exchange Commission (SEC). First, on January 3, 2005 and April 15, 2005, the staff of the SEC Division of Market Regulation issued two No-Action Letters granting relief from the order-marking requirements under Regulation SHO in certain circumstances. In this regard, NASDAQ has established a "masking" process, as described in the SEC's April 15, 2005, No-Action Letter. Second, NASD wishes to remind members using their own proprietary or vendor order management systems to accept and execute short sales in Regulation SHO pilot securities that such members are responsible for making appropriate system changes to ensure proper handling of pilot securities. In this regard, NASD is encouraging such members to review and test their systems to ensure readiness for the May 2, 2005, Regulation SHO pilot order effective date. Finally, with respect to Order Audit Trail System (OATS) requirements, members also may mark their OATS report consistent with the SEC's order-marking relief.

Questions/Further Information

Questions regarding this *Notice* may be directed to the Office of General Counsel, Regulatory Policy and Oversight, NASD, at (202) 728-8071; the Legal Section, Market Regulation, NASD, at (240) 386-5126; or the Office of General Counsel, The Nasdaq Stock Market, Inc., at (301) 978-8400.

05-33

Discussion

As further detailed in *NTM 04-93*, the SEC recently adopted certain provisions of a new short sale regulation, designated Regulation SHO.¹ Regulation SHO consists, among other provisions, of new SEC Rule 200(g) (order-marking requirements) and new SEC Rule 202T (short sale price test pilot). SEC Rule 200(g) of Regulation SHO requires that sell orders in all equity securities be marked "long," "short," or "short exempt."² SEC Rule 202T established a procedure for the SEC to suspend on a temporary basis the operation of SEC Rule 10a-1(a) and any short sale price test of any exchange or national securities association for those securities designated by SEC order. Together with the Regulation SHO adopting release, the SEC issued an order (Pilot Order) establishing a one-year pilot (Pilot) suspending the provisions of SEC Rule 10a-1(a) and any short sale price test of any exchange or national securities association for short sales of certain securities for certain time periods (Pilot Securities).³ Short sales of Pilot Securities effected during the Pilot should be marked "short exempt."

The Pilot was originally scheduled to commence on January 3, 2005, and end on December 31, 2005. However, a large number of broker-dealers notified the SEC that it would be inefficient and very costly for them to comply with the order-marking requirements for Pilot Securities because of the significant systems changes necessary to ensure proper marking. Further, broker-dealers raised concerns that these systems changes may be in effect only for the one-year Pilot. To assist firms with these issues and concerns, the market centers agreed to "mask" the short sale character of any short sale orders in Pilot Securities so they are executed as short exempt. To allow adequate time for market centers to make necessary programming changes in this regard, the SEC issued a second pilot order postponing the one-year Pilot to commence on May 2, 2005, and end on April 28, 2006.⁴

SEC No-Action Relief

On January 3, 2005, SEC staff issued a No-Action Letter to grant relief from the order-marking requirements of SEC Rule 200(g) of Regulation SHO in certain circumstances. The letter provides that SEC staff will not recommend enforcement action under SEC Rule 200(g) of Regulation SHO against a broker-dealer that marks "short," rather than "short exempt," a short sale effected in certain specified classes of securities or during certain specified time periods that are exempt from the provisions of SEC Rule 10a-1(a) or any short sale price test of any exchange or national securities association as set forth in the No-Action Letter. The No-Action relief is subject to certain conditions described in the letter, including without limitation, that in no event will broker-dealers executing exempt short sales be allowed to mark such sales "long." A copy of the letter is available on the SEC's Web site at [mr-noaction www.sec.gov/divisions/marketreg/mr-noaction/sia010305.htm](http://mr-noaction/www.sec.gov/divisions/marketreg/mr-noaction/sia010305.htm).

In addition, on April 15, 2005, SEC staff issued a No-Action Letter granting further relief from the order-masking requirements. Specifically, this letter provides that SEC staff will not recommend enforcement action against a broker-dealer that marks "short" rather than "short exempt" a short sale effected in any Pilot Security where the broker-dealer, among other things, routes the orders to a market center that has a "masking" process in place. A copy of the letter is available on the SEC's Web site at www.sec.gov/divisions/marketreg/mr-noaction/sia041505.htm.

NASD encourages members and other interested parties to review both No-Action Letters, including the specific conditions of the relief. Additional guidance and information about the Pilot and order-marking requirements are available on the SEC's Web site at www.sec.gov/spotlight/shopilot.htm.

Short Sales in Pilot Securities

Upon commencement of the Pilot on May 2, 2005, orders in NASDAQ-listed and exchange-listed Pilot Securities (including orders entered prior to and remaining open as of May 2, 2005) entered into the NASDAQ Market Center execution system will not be subject to a price test. Broker-dealers that use a proprietary or vendor order management system to execute orders internally must ensure that the appropriate system changes are completed prior to May 2, 2005 such that sell short orders in Pilot Securities are handled and executed in accordance with Regulation SHO. In particular, broker-dealers must ensure that internalized sell short orders in Pilot Securities are executed without the application of a price test. Accordingly, NASD encourages member firms that use such systems to test these systems to ensure proper handling of Pilot Securities.

Upon commencement of the Pilot on May 2, 2005, and for the duration of the Pilot, broker-dealers may mark sell short orders in Pilot Securities "short" instead of "short exempt" when entering them into the NASDAQ Market Center execution system. The NASDAQ Market Center execution system will not perform a short sale validation of sell short orders in Pilot Securities, regardless of whether such orders entered into the NASDAQ Market Center execution system are marked "short" or "short exempt."

Similarly, for purposes of OATS reporting, members may mark orders and transactions in Pilot Securities as "sell short," if appropriate, rather than "sell short exempt." Members are reminded, however, that this guidance is limited to orders and transactions covered by the SEC's No-Action relief. For example, short sale transactions that qualify for other exemptions under Rule 3350 or SEC Rule 10a-1, such as the market maker exemption, must continue to be marked as "short sale exempt."

Endnotes

- 1 See Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004).
- 2 The compliance date for SEC Rule 200(g) of Regulation SHO was January 3, 2005.
- 3 See Exchange Act Release No. 50104 (July 28, 2004), 69 FR 48032 (August 6, 2004) (Pilot Order). The Pilot Order suspends the price tests for: (1) short sales in the stocks identified in Appendix A of the Pilot Order; (2) short sales in any security included in the Russell 1000 index effected between 4:15 p.m. EST and the open of the consolidated tape on the following day; and (3) short sales in any security not included in paragraphs (1) and (2) above effected in the period between the close of the consolidated tape and the open of the consolidated tape the following day.
- 4 See Exchange Act Release No. 50747 (November 29, 2004), 69 FR 70480 (December 6, 2004) (Second Pilot Order).

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Disciplinary and Other NASD Actions

REPORTED FOR APRIL

NASD® has taken disciplinary actions against the following firms and individuals for violations of NASD rules; federal securities laws, rules, and regulations; and the rules of the Municipal Securities Rulemaking Board (MSRB). The information relating to matters contained in this *Notice* is current as of the end of March 2005.

Firms Expelled, Individuals Sanctioned

Florida Discount Securities, Inc. (CRD #44859 Boca Raton, Florida) and Bruce Elliot Rich (CRD #2005846, Registered Principal, Boca Raton, Florida) submitted an Offer of Settlement in which Florida Discount Securities, Inc., was expelled and Rich was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, the firm and Rich consented to the described sanction and to the entry of findings that they used and employed deceptive, fraudulent, and manipulative devices and contrivances involving the solicitation, purchase, and sale of the common stock of highly speculative OTC equity securities to unsuspecting public customers. In addition, NASD found that they egregiously failed to supervise the sales activities and conduct of Florida Discount's registered representatives and associated persons. The findings also stated that Rich failed to respond to NASD requests for information. (NASD Case # CMS040094)

Magellan Securities Inc. (CRD #15986, Harper Woods, Michigan) and Terry Michael Laymon (CRD #304342, Registered Principal, Grosse Pointe Woods, Michigan) submitted an Offer of Settlement in which the firm was expelled from NASD membership and Laymon was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, the firm and Laymon consented to the described sanctions and to the entry of findings that the firm permitted Laymon to be associated as its president and sole owner requiring him to act in a principal capacity while he was subject to "disqualification" as defined in Article III, Section 4 of NASD By-laws. The findings stated that Laymon intentionally, recklessly, or negligently created false account statements with incorrect or inflated valuations to induce a public customer to continue to maintain accounts with the firm. The findings also stated that the firm, acting through Laymon, failed to qualify and register as a person associated with the firm, a financial and operations principal, or an introducing broker-dealer financial and operations principal. In addition, the findings stated that the firm permitted Laymon to perform duties as a general securities principal while his registration status with NASD was inactive due to his failure to complete in a timely matter the Regulatory Element of NASD's Continuing Education Requirement. The findings further stated that the firm, acting through Laymon, failed to file 3070 reports disclosing reportable events and failed to amend Form BD and Form U4 to report these disciplinary actions. NASD found that Laymon failed to respond completely and timely to NASD requests for information. (NASD Case #C8A030081)

Firm Fined, Individuals Sanctioned

Hennion & Walsh, Inc. (CRD #1315386, Parsippany, New Jersey), Richard Hennion (CRD #13153586, Registered Representative, Totowa, New Jersey), and William Walter Walsh (CRD #1174993, Registered Principal, Mountain Lakes, New Jersey) were fined \$40,000, jointly and severally. Hennion was also fined \$35,000, suspended from association with any NASD member in all capacities for four months, and required to requalify in all capacities. Walsh was fined \$25,000, suspended in all supervisory capacities for four months, and required to requalify in all principal capacities. In addition, Hennion & Walsh, Inc., was fined \$10,000 and ordered to retain an independent consultant approved by NASD to review its written policies and procedures and to prepare and submit to NASD a report setting forth the consultant's recommendations and the firm's actions to implement those recommendations. The sanctions were based on findings that the firm failed to have reasonable supervisory systems and procedures. The findings also stated that Walsh failed to exercise reasonable supervision over Hennion. The findings further stated that Hennion made unsuitable recommendations to a public customer and exercised discretion in the customer's account without written authorization.

Walsh's suspension will begin July 18, 2005, and end at the close of business November 17, 2005. Hennion's suspension began March 7, 2005, and will end at the close of business July 6, 2005. (NASD Case # C9B040013)

Firms Fined

Calyon Securities (USA) Inc. (CRD #190, New York, New York) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined \$25,000, and required to revise within 30 business days its written supervisory procedures with respect to the applicable securities laws, regulations, and NASD rules concerning Automated Confirmation Transaction ServiceSM (ACTSM) reporting. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to accept or decline in ACT transactions in eligible securities within 20 minutes after execution. The findings also stated that the firm failed to report to TRACE transactions in TRACE-eligible securities within 75 minutes after execution. In addition, NASD found that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with respect to applicable securities laws, regulations, and NASD rules concerning ACT reporting. (NASD Case #CLG050013)

Citigroup Global Markets Inc. (CRD #7059, New York, New York) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$107,500, and required to pay \$1,706.01 in restitution. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to report to ACT the correct symbol indicating whether transactions were buy, sell, sell short, sell short exempt, or cross for transactions in eligible securities. The findings also stated that the firm, in transactions with public customers, failed to use reasonable diligence to ascertain the best inter-dealer market and failed to buy or sell in such market so that the resultant price to its customer was as favorable as possible under prevailing market conditions. NASD found that the firm executed short sale transactions in certain securities, all of which were NASDAQ National Market[®] (NNM[®]) securities at or below the current inside bid when the current inside bid was below the preceding inside bid in the security. NASD found that the firm submitted to NASD inaccurate short interest position reports. In addition, NASD found that the firm failed to provide written notification disclosing to its public customers its correct market maker status in each such security. The findings also stated that the firm failed to provide written notification disclosing to its public customer its correct capacity in transactions. NASD found that the firm incorrectly reported to ACT the second leg of "riskless" principal transactions in NNM and NASDAQ SmallCapSM securities, and incorrectly designated the capacity of such transactions as principal. The findings also state that the firm failed to display immediately customer limit orders in NASDAQ securities in its public quotation. (NASD Case #CLG050004)

GFI Securities LLC (CRD #19982, New York, New York) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined \$25,000, and required to revise within 30 business days its written supervisory procedures with respect to the applicable securities laws, regulations, and NASD rules concerning ACT reporting. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to accept or decline in ACT transactions in eligible securities within 20 minutes after execution. In addition, NASD found that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with respect to applicable securities laws, regulations, and rules of NASD concerning ACT reporting. (NASD Case #CLG050012)

GVR Company LLC (CRD #111528, Chicago, Illinois) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined \$65,000, and required to pay \$12,280.91, plus interest, in restitution to the parties

involved in transactions. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it executed orders at a price that was inferior to the national best bid and offer at the time of execution. The findings also stated that the execution quality provided to the orders was inconsistent with just and equitable principles of trade. (NASD Case #CLG050014)

Perrin, Holden & Davenport Capital Corp. (CRD #38785, New York, New York) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$22,500, and required to revise within 30 business days its written supervisory procedures with respect to the applicable securities laws, regulations, and NASD rules concerning limit order display, quote rules, short sale rules, and SEC Rule 11Ac1-6. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to show the correct time of execution, the time of entry, and the terms and conditions on the memorandum of brokerage orders. The findings also stated that the firm failed to make publicly available a report on its routing of non-directed orders in covered securities. In addition, NASD determined that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with respect to the applicable securities laws and regulations, and NASD rules concerning limit order display, quote rules, short sale rules, and SEC Rule 11Ac1-6. (NASD Case #CLG050008)

Susquehanna Capital Group (CRD #29337, Bala Cynwyd, Pennsylvania) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$37,500, and required to revise within 30 business days its written supervisory procedures with respect to the applicable securities laws, regulations, and NASD rules concerning aspects of trade reporting, including the 20-minute rule, late trade reporting, and accurate use of trade reporting modifiers. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to report to ACT the correct symbol indicating whether the firm executed transactions in eligible securities in a principal or agency capacity, and whether transactions were buy, sell, sell short, sell short exempt, or cross.

NASD also found that the firm failed to report the time of execution through ACT for last sale reports of transactions. The findings also stated that the firm improperly submitted to ACT cancellation reports in eligible securities, and failed to submit required information to the Order Audit Trail SystemSM (OATSSM) for orders and transmitted reports that contained inaccurate, incomplete, or improperly formatted data. In addition, NASD determined that the firm failed to accept or decline in ACT transactions in eligible securities within 20 minutes after execution. NASD found that the firm failed,

within 90 seconds after execution, to transmit through ACT last sale reports of transactions, and failed to designate as late last sale reports, in NNM securities, NASDAQ SmallCap securities, and eligible securities. NASD also determined that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with respect to the applicable securities laws and regulations, and NASD rules concerning aspects of trade reporting including the 20-minute rule, late trade reporting, and accurate use of trade reporting modifiers. (NASD Case #CLG050010)

Trident Partners, Ltd. (CRD #41258, Jericho, New York) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined \$17,500. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to comply with SEC Rule 15c2-4, in that the firm did not set up a bank escrow account in connection with a contingency offering of an affiliated issuer and permitted excessive commissions to be charged in agency transactions and excessive markups to be charged in principal transactions. The findings also stated that Trident effected transactions in corporate debt securities during a time when its membership agreement had not been amended to include corporate debt securities as a business line. In addition, NASD determined that Trident failed to receive required notifications from the Financial Crimes Enforcement Network (FinCen) because the firm failed to update its primary anti-money laundering (AML) contact with NASD. The findings also included that the firm failed to conduct required independent testing of its AML compliance program. (NASD Case #CLI1050001)

Kenneth Steven Stovall (CRD #1068508, Registered Representative, Hillsborough, California) submitted an Offer of Settlement in which he was censured and fined \$10,000. Without admitting or denying the allegations, Stovall consented to the described sanctions and the entry of findings that he exercised discretion in the accounts of public customers without obtaining written authorization from the customers and acceptance of the account by his member firm. (NASD Case #C01040018)

Individuals Barred or Suspended

Peter T. Antipatis (CRD #2955420, Registered Representative, Coral Springs, Florida) submitted a Letter of Acceptance, Waiver, and Consent in which he was permanently barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Antipatis consented to the described sanctions and to the entry of findings that he circulated false and misleading investment opinions and research reports, which included fraudulent and deceptive representations and omissions of

material facts about speculative, low-priced securities that were promoted by a stock promotion and public relations firm for which he worked and from which he received a salary. NASD also found that Antipatis did not include financial information about companies he covered in his investment opinions and failed to disclose material negative information about the companies that he covered.

The findings also stated that Antipatis' investment opinions were not based on principals of fair dealing and good faith, were not fair and balanced, and did not provide a sound basis for evaluating the facts in regard to any particular security or type of security. In addition, NASD found Antipatis omitted material facts or qualifications that, in light of the context of the material presented, caused the communications to be misleading. The findings also indicated that Antipatis made false, exaggerated, unwarranted, or misleading statements or claims in his communications with the public. The findings also included that Antipatis published, circulated, or distributed public communications, or caused such public communications to be published, circulated, or distributed, that he knew or had reason to know contained untrue statements of material fact or were otherwise false or misleading. In addition, NASD found that Antipatis, in his communications with the public, predicted or projected performance, implied that past performance will recur, or made exaggerated or unwarranted claims, opinions, or forecasts. NASD also found that Antipatis' investment opinions or research reports contained only favorable research, opinions, or news about the companies he covered and that Antipatis directly or indirectly offered the favorable research report and a specific rating as consideration or inducement for the receipt by him of business or compensation. Moreover, NASD determined that Antipatis was registered with a member firm for the sole purpose of avoiding a lapse in his registration and re-examination requirements.

The findings also stated that Antipatis failed to provide prompt written disclosure to his member firm that he was working for, and being compensated by, a company for writing investment opinions and research reports. Antipatis did not disclose the true nature of his work and deceived his member firm into believing that his outside employment was not investment related. The findings also stated that Antipatis failed to notify his member firm, in writing, of his securities accounts at another member firm, and failed to notify a member firm of his associated status with another member firm. (NASD Case #CMS040204)

Rafael Ernesto Avila (CRD #4341162, Registered Representative, Boca Raton, Florida) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Avila consented to the described sanction and to the entry of findings that he

received \$92,000 from public customers to invest in securities for the customers, but failed to follow the customers' instructions and converted the funds to his own use and benefit. The findings stated that Avila owned or maintained control over two brokerage accounts at an NASD member firm, but failed to disclose his association with his member firm to the firm carrying the accounts, and failed to disclose the existence of the accounts to his member firm. The findings also stated that Avila failed to provide prompt written notice to his member firm that he was employed by, or received compensation from, an outside business activity. (NASD Case #C07050009)

Robert Roger Beuret (CRD #20718, Registered Representative, Fort Lauderdale, Florida) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the allegations, Beuret consented to the described sanction and to the entry of findings that he failed to exercise due care to prevent the sale of unregistered securities to the public.

Beuret's suspension began February 22, 2005, and concluded at the close of business March 7, 2005 (NASD Case #CE3050001)

John Edward Brigandi (CRD #1388900, Registered Representative, Greenvale, New York) was barred from association with any NASD member in any capacity and ordered to pay costs in the amount of \$2,403.94. The sanction was based on findings that Brigandi's recommendations and trading activity in the account of a public customer were unsuitable and excessive given the customer's financial situation, needs, and objectives. NASD determined that Brigandi's conduct was egregious in that he acted recklessly and without regard for his customer's best interests.

Brigandi has appealed this action to the NAC, and the sanctions are not in effect pending consideration of the appeal. (NASD Case #C10040025)

Gilbert Alan Cardillo (CRD #1110960, Registered Principal, Riverhead, New York) was fined \$6,600, suspended from association with any NASD member in all capacities for 10 business days, and ordered to offer to pay a public customer, upon the customer's surrender of his certain annuity certificate. The sanctions were based on findings that Cardillo made an unsuitable recommendation to a public customer without having reasonable grounds for believing that his recommendation of a variable annuity was suitable for the customer, and that he failed to obtain relevant information concerning the suitability of his recommendation before executing the transaction, particularly concerning the

customer's need for liquidity and income, and the customer's lack of investment sophistication and inability to monitor the sub-accounts.

Cardillo's suspension began February 21, 2005, and concluded March 4, 2005. (NASD Case #C10030087)

Kenneth Joseph Clairmont, Jr. (CRD #4107628, Registered Representative, Albany, New York) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000, suspended from association with any NASD member in any capacity for three months, ordered to disgorge \$25,000 received in connection with the securities sales, and pay partial restitution, plus interest. The fine and restitution must be paid before Clairmont reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Clairmont consented to the described sanctions and to the entry of findings that he engaged in private securities transactions without prior written notice to, or approval from, his member firm.

Clairmont's suspension began April 4, 2005, and will conclude July 3, 2005. (NASD Case #C11050003)

Paul Conte (CRD #3094358, Registered Representative, Atlanta, Georgia) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 15 business days. Without admitting or denying the allegations, Conte consented to the described sanction and to the entry of findings that he falsified letters of authorization related to public customers who shared a joint account by cutting and pasting their signatures onto the letters of authorization.

Conte's suspension began April 4, 2005, and will conclude at the close of business April 22, 2005. (NASD Case #C10050003)

Chris Herbert Craig (CRD #1623738, Registered Representative, Fenton, Michigan) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$2,500 and suspended from association with any NASD member in any capacity for 30 business days. The fine must be paid before Craig reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Craig consented to the described sanctions and to the entry of findings that he failed to respond in timely manner to NASD requests for documents and information.

Craig's suspension began April 4, 2005, and will conclude at the close of business May 13, 2005. (NASD Case #C8A050014)

Massimo Fabio Colella (CRD #4145734, Registered Representative, Hagerstown, Maryland) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Massimo consented to the described sanction and to the entry of findings that he charged a personal expense, or caused a personal expense to be charged, to a personal credit card owned by a business associate, who was also a co-worker, without that person's knowledge or authorization. NASD also found that Colella willfully failed to disclose material facts on a Form U4. (NASD Case #C9A050004)

James Michael Coyne, Sr. (CRD #601719, Registered Principal, Media, Pennsylvania) was fined \$10,000, required to pay costs of \$4,070.80, and suspended from association with any NASD member in any capacity for four months. The sanctions were based on findings that Coyne engaged in excessive trading in public customer accounts that conflicted with his customer's financial needs and investment objectives. NASD found that Coyne engaged in the short-term purchase and sale of securities without having a reasonable basis for believing that such transactions were suitable based upon the frequency of the transactions, the nature of account, and financial situation and needs of public customers. In addition, NASD found Coyne made unsuitable use of margin in the account of public customers.

Coyne's suspension began February 22, 2005, and will conclude at the close of business June 21, 2005. (NASD Case #C9A030041)

Daniel Quinn Dellinger (CRD #2343092, Registered Representative, Glenview, Illinois) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 15 business days. The fine must be paid before Dellinger reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Dellinger consented to the described sanctions and to the entry of findings that he engaged in outside business activities, received \$15,287 in compensation, and failed to provide written notice to his member firm of his intent to engage in such activities.

Dellinger's suspension began April 4, 2005, and will conclude at the close of business April 22, 2005. (NASD Case #C8A050010)

Jody Charles Dobrinich (CRD #4331720, Associated Person, Stauntun, Illinois) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any

capacity for one year. The fine must be paid before Dobrinich reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Dobrinich consented to the described sanctions and to the entry of findings that he willfully failed to disclose a material fact on his Form U4.

Dobrinich's suspension began April 4, 2005, and will conclude April 3, 2006. (NASD Case #C8A050015)

Stewart Reed Ford (CRD #2382297, Registered Representative, Dana Point, California) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$47,253 and suspended from association with any NASD member in any capacity for two years. The fine must be paid before Ford reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Ford consented to the described sanctions and to the entry of findings that he participated in private securities transactions, received \$42,253 in commissions, and failed to provide prior written notice to, and receive prior written approval from, his member firm.

Ford's suspension began April 4, 2005, and will conclude April 3, 2007. (NASD Case #C02050012)

Jay James Gianni (CRD #2134234, Registered Representative, Lancaster, New York) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity with a right to reapply after five years. Without admitting or denying the allegations, Gianni consented to the described sanction and to the entry of findings that he participated in private securities transactions without providing prior written notice to, and receiving prior written approval from, his member firm. (NASD Case #C8A050011)

Alvin Edwin Gramentz (CRD #720914, Registered Principal, Bonita Springs, Florida) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Gramentz consented to the described sanction and to the entry of findings that he failed to respond to NASD requests for information. (NASD Case #C04050007)

Jason William Gregg (CRD #4486108, Registered Representative, Bear, Delaware) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Gregg consented to the described sanction and to the entry of findings that he was identified in the records of a bank

affiliated with his member firm as a co-owner of bank accounts maintained at the bank and caused sham service fee refunds to be credited to the accounts. The findings also stated that Gregg made various withdrawals from the accounts totaling \$2,160, and used the funds for his own benefit. (NASD Case #C9A050006)

Roger Grieco (CRD #3124651, Registered Representative, Greenvale, New York) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$7,500 and suspended from association with any NASD member in any capacity for 45 days. The fine shall be due and payable either immediately upon reassociation with a member firm following the suspension, prior to any application, or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Grieco consented to the described sanctions and to the entry of findings that he effected a private securities transaction away from his member firm by facilitating an investment in a \$50,000 promissory note for public customers. NASD found that Grieco failed to provide written notification to his member firm prior to effecting the transaction.

Grieco's suspension began April 4, 2005, and will conclude at the close of business May 18, 2005. (NASD Case #C10050006)

Pany Chan Keo (CRD #2659272, Registered Representative, Long Beach, California) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 15 business days. The fine must be paid before Keo reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Keo consented to the described sanctions and to the entry of findings that he owned or maintained control over a brokerage account at an NASD member firm, but failed to disclose his association with his member firm to the firm carrying the accounts and failed to disclose the existence of the account to his member firm.

Keo's suspension began April 4, 2005, and concluded at the close of business April 22, 2005. (NASD Case #C02050014)

Larry King Jr. (CRD #2702152, Registered Representative, Detroit, Michigan) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, King consented to the described sanction and to the entry of findings that he misused a public customer's bank account funds in that he induced the customer to sign, unknowingly, withdrawal slips and a certified check request form, and made \$75,409.59 in withdrawals from customer's account and used the funds for a purpose other

than the benefit of the customer for a period of time before returning the funds to the customer. The findings also stated that King failed to respond to NASD requests for documents and information. (NASD Case #C8A050012)

Suk Hun "John" Ko (CRD #2786161, Registered Representative, La Crescenta, California) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for one year. The fine must be paid before Ko reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Ko consented to the described sanctions and to the entry of findings that he sent reports and letters to public customers that contained improper predictions of returns with respect to stocks and mutual fund investments, and other misleading and exaggerated statements.

Ko's suspension began April 4, 2005, and will conclude April 3, 2006. (NASD Case #C02050011)

Nathan Gerald Kroening (CRD #2332862, Registered Representative, Two Rivers, Wisconsin) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 60 days. The fine must be paid before Kroening reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Kroening consented to the described sanctions and to the entry of findings that he affixed the signature of a public customer to the "W-9 Information" portion of the account worksheet form without the customer's consent.

Kroening's suspension began April 4, 2005, and will conclude at the close of business June 2, 2005. (NASD Case #C8A050013)

Jayne Alexander Kurtyka (CRD #1171623, Registered Representative, West Chicago, IL) submitted an Offer of Settlement in which he was fined \$17,500, suspended from association with any NASD member in any capacity for 30 days, and required to requalify by examination as a Series 7 General Securities Representative within 90 days after the date of the order, or he will cease to act in such capacity until he has requalified as a Series 7 General Securities Representative. Without admitting or denying the allegations, Kurtyka consented to the described sanctions and to the entry of findings that he recommended and effected securities transactions in the account of a public customer, including purchasing securities on a margin, without having a reasonable basis for believing that the recommendations

and resultant transactions were suitable for the customer based upon the customer's age, total net worth, liquid net worth, investment experience, financial situation, and investment objectives.

The findings also stated that Kurtyka exercised discretion in the account of a public customer without obtaining written authorization from the customer and written acceptance of the account as discretionary by his member firm. In addition, the findings stated that Kurtyka prepared, or caused to be prepared, and mailed, or caused to be mailed, a form letter considered by NASD to be sales literature that was not fair and balanced and omitted material facts or qualification, causing the form letter to be misleading. The findings further stated that the form letter also failed to disclose the material differences between the general nature of the fund's portfolio and the securities indexes against which it was compared.

Kurtyka's suspension began April 4, 2005, and will conclude at the close of business May 3, 2005. (NASD Case #CAF040067)

Kyong K. Lee (CRD #2926153, Registered Representative, Virginia Beach, Virginia) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Lee consented to the described sanctions and to the entry of findings that he caused funds to be withdrawn from a public customer's variable annuity, deposited these funds into his bank account, and then lent the funds to a third party without the authorization of the customer. (NASD Case #C9A050007)

Philip Allen Lehman (CRD #1345038, Registered Principal, Englewood, Ohio) was barred from association with any NASD member in any capacity. The sanction was based on findings that Lehman failed to respond to NASD requests for documents and information, and to appear to provide testimony. (NASD Case #C8A040060)

Arthur Conrad Levy (CRD #2199632, Registered Principal, Palm Beach Gardens, Florida) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Levy consented to the described sanction and to the entry of findings that, in connection with class B share liquidations for public customers, he falsified firm records by entering codes into his firm's computer system that falsely indicated that the customers had died or were disabled, which had the effect of waiving the CDSC charges for customers when they were not entitled to the waiver. (NASD Case #C07050011)

Mark Larry Lewis (CRD #1901446, Registered Principal, West Hills, California) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 30 business days. The fine must be paid before Lewis reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Lewis consented to the described sanctions and to the entry of findings that he effected, or caused to be effected, transactions in the securities account of a public customer by exercising discretionary power in those accounts without having obtained the customer's and his member firm's prior written authorization.

Lewis' suspension began April 4, 2005, and will conclude at the close of business May 13, 2005. (NASD Case #C02050010)

Chantha Owen Lueung (CRD #2839141, Registered Principal, Yonkers, New York) submitted a Letter of Acceptance, Waiver, and Consent in which he was permanently barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Lueung consented to the described sanctions and to the entry of findings that he fraudulently recommended and sold the securities of a certain company to public customers. NASD found that Lueung told his customers that he conducted an appropriate investigation and reasonable due diligence into the company, but failed to do so. The findings also stated that Lueung made material misrepresentations about the company's securities and failed to disclose material adverse facts that he was or should have been aware of, including the company's financial condition. NASD also found that Lueung made statements about the company and its business, including stock price projections and guarantees, for which he had no basis. (NASD Case #CLG050016)

Edward Alan Martin (CRD #2193457, Registered Principal, Franklin, Tennessee) submitted an Offer of Settlement in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Martin consented to the described sanction and to the entry of findings that he converted a public customer's funds to his own use and benefit without the customer's knowledge or consent. (NASD Case#C05040084)

Mark Edward McCaffrey (CRD #1811502, Registered Representative, Rockville, Maryland) submitted a Letter of Acceptance, Waiver, and Consent in which he was permanently barred from association with any NASD member in any capacity. Without admitting or denying the allegations, McCaffrey consented to the described sanctions and to the entry of findings that he received a check totaling \$500,000 from a public customer for investment purposes, deposited

the check to a personal bank account, and used the funds for his own benefit. NASD also found that McCaffrey failed to respond to NASD requests for information. (NASD Case #C9A050005)

Pierre Michael Mikhail (CRD #2816910, Registered Representative, Alta Loma, California) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for two years. The fine must be paid before Mikhail reassociates with any NASD member following the suspension or before requesting relief from any statutory disqualification. Without admitting or denying the allegations, Mikhail consented to the described sanctions and to the entry of findings that he effected, or caused to be effected, the purchase of a whole life insurance policy for a public customer without the customer's knowledge or consent.

Mikhail's suspension began April 4, 2005, and will conclude April 3, 2007. (NASD Case #C02050015)

Mark Francis Mizenko (CRD #1812411, Registered Representative, Kent, Ohio) was barred from association with any NASD member in any capacity. The sanction was based on findings that Mizenko committed forgery by tracing a corporate officer's name onto a document without his knowledge or permission and by using his notary seal to affix a purported corporate seal onto a document.

This decision has been appealed to the SEC, and the sanction is not in effect pending consideration of the appeal. (NASD Case #C8B030012)

Kyle William Morgan (CRD #2610322, Registered Representative, St. Augustine, Florida) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the allegations, Morgan consented to the described sanctions and to the entry of findings that he exercised discretionary trading authority in a public customer's accounts without obtaining the customer's prior written authorization and his member firm's prior written acceptance of the accounts as discretionary.

Morgan's suspension began March 28, 2005, and concluded at the close of business April 8, 2005. (NASD Case #C07050010)

Richard Francis O'Leary (CRD #1096188, Registered Principal, Newport Beach, California) was barred from association with any NASD member in any capacity. The sanction was based on findings that O'Leary failed to respond completely to NASD requests for information and failed to appear for an on-the-record interview. (NASD Case #C02040035)

Christopher Joseph Preisero (CRD #2871086, Registered Representative, Brooklyn, New York) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any and all capacities for 35 days. Preisero consented to the described sanctions and to the entry of findings that he failed to disclose material facts on his Form U4.

Preisero's suspension began April 4, 2005, and will conclude May 8, 2005. (NASD Case #C10050005)

Michael B. Reynolds (CRD #4721573, Associated Person, Lighthouse Point, Florida) was barred from association with any NASD member in any capacity. The sanction was based on finding that Reynolds stole a check from his supervisor, forged the supervisor's signature on the check, and converted the funds to his own use and benefit without his supervisor's knowledge or authorization. The findings also stated that Reynolds failed to respond to NASD requests for information. (NASD Case #C07040069)

Dennis Roy Roth (CRD #1418538, Registered Principal, Rockville, Maryland) submitted an Offer of Settlement in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Roth consented to the described sanction and to the entry of findings that he issued a research report in which he recommended the purchase of an OTC Bulletin Board-traded company, which contained baseless and exaggerated sales projections, price predictions, and an unsupported claim that the company would achieve profitability. In addition, NASD found that Roth failed to disclose that he was being paid by the company in cash and securities to promote the company and to solicit investors to purchase its securities at the time of the issuance of the research report. (NASD Case #CMS040016)

Patrick Frank Santullo (CRD #410800, Registered Representative, Hebron, Kentucky) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined \$8,000 and suspended from association with any NASD member in any capacity for 15 business days. Without admitting or denying the allegations, Santullo consented to the described sanctions and to the entry of findings that he erroneously executed purchases in the trust account of a public customer that exceeded the available assets of the account. The findings also stated that Santullo sold the overbought securities from the trust account, causing the customer to bear the loss of the diminished value of the securities and to pay the commissions for the purchase and sale of the securities. In addition, NASD determined that Santullo executed unauthorized sales of securities in a trust

account, whose beneficiary was a public customer, without the knowledge or consent of the customer or the account trustees.

Santullo's suspension began April 4, 2005, and will conclude at the close of business April 22, 2005. (NASD Case #C05050007)

Abraham Schiller (CRD #2375377, Registered Representative, Tamarac, Florida) was barred from association with any NASD member in any capacity and ordered to pay \$55,077.19, plus interest, in restitution to his member firm. The sanctions were based on findings that Schiller entered fictitious contribution changes into his firm's computer system falsely representing that plan participants had increased their periodic contributions into their retirement plans. The findings stated that Schiller made other entries into the firm's system to attempt to conceal his unearned commissions totaling \$55,077.19, and prevent his firm from reversing the commissions to which he was not entitled. The findings also stated that Schiller failed to respond to NASD requests for information and to appear for an on-the-record interview. (NASD Case #C07040080)

Barry Leonard Schwartz (CRD #1034556, Associated Person, Huntington, New York) was barred from association with any NASD member in any capacity. The sanction was based on findings that Schwartz failed to appear for an NASD on-the-record interview. (NASD Case #CMS040104)

Lawrence Bryan Schweiger (CRD #736288, Registered Principal, Plantation, Florida) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Schweiger consented to the described sanction and to the entry of findings that he participated in private securities transactions, and failed to provide prior written notice to, and receive prior written approval from, his member firm. (NASD Case #C07050012)

David Joseph Shaw (CRD #1003961, Registered Principal, Indianapolis, Indiana) submitted an Offer of Settlement in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Shaw consented to the described sanction and to the entry of findings that, without the knowledge or consent of a public customer, he transferred \$977,547 in funds from customer's accounts into accounts under his control, and used the funds for his own use and benefit and not the use or benefit of the customer. The findings stated that Shaw, by use of the instrumentalities of interstate commerce or the mails, intentionally or recklessly employed devices to defraud public

customers by making untrue statements of material facts or omitting to state material facts necessary to make the statements not misleading. The findings also stated that, after listening to the representations made by Shaw, customers invested \$336,000, and, without their knowledge or consent, Shaw used these funds to his own use and benefit and not the use or benefit of the customers. NASD found that Shaw affixed the signatures of public customers on the firm's "Authority to Transfer Funds" forms and submitted the forms to his firm authorizing the transfer of \$50,000 from the accounts of public customers to an account he controlled, and, without the knowledge or consent of the customers, used these funds for his own use or benefit and not the benefit of the customers. NASD also found that Shaw failed to respond to NASD requests for information. (NASD Case #C8A040121)

Scott Stern (CRD #1581268, Registered Representative, San Diego, California) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Stern consented to the described sanction and to the entry of findings that he recommended and effected securities transactions in the account of a public customer without having a reasonable basis for believing that his recommendations and transactions were suitable based on the customer's objectives, financial situation, and needs. The findings stated that Stern exercised discretionary trading authority in public customers' accounts without obtaining the customers' prior written authorization and his member firm's prior written acceptance of the accounts as discretionary. The findings further stated that Stern effected unauthorized trades in the accounts of public customers and settled a customer complaint for \$10,000 without his firm's knowledge or approval. (NASD Case #C02050008)

Robert John Vitale (CRD #2695384, Registered Representative, Parkland, Florida) submitted a Letter of Acceptance, Waiver, and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Vitale consented to the described sanction and to the entry of findings that he participated in fraudulent and deceptive devices and contrivances involving trading in stocks through the use of interstate commerce, the mails, or a facility of a national securities exchange. NASD also found that Vitale failed to appear and testify as requested by NASD. (NASD Case #C05050006)

Decisions Issued

Patrick Orvil Nugent (CRD #1498083, Registered Principal, Sunnyvale, California) was barred from association with any NASD member in any capacity. The sanction is based on findings that Nugent engaged in private securities transactions without giving prior written notice to, or receiving prior approval from, his member firm.

This decision has been appealed to the NAC, and the sanction is not in effect pending consideration of the appeal. (NASD Case #C01040010)

Robert Michael Ryerson (CRD #1224662, Registered Principal, Freehold, New Jersey) was fined \$230,000, suspended for two years in all capacities from association with any NASD member, and required to requalify in all capacities. These sanctions were based on findings that Ryerson participated in the sale of securities without providing prior written notice to, and obtaining prior written approval from, his member firm. Ryerson was also suspended from association with any NASD member in all capacities for 15 business days and fined \$5,000 based upon a finding that he shared commissions with a non-NASD member. Ryerson was further suspended for one year from associating with any NASD member in all capacities, and fined \$10,000 for failing to timely appear for an NASD on-the-record interview. The suspensions are to run concurrently.

The decision has been appealed to the NAC, and the sanctions are not in effect pending consideration of the appeal. (NASD Case #C9B040033)

Complaints Filed

NASD issued the following complaints. Issuance of a disciplinary complaint represents the initiation of a formal proceeding by NASD in which findings as to the allegations in the complaint have not been made, and does not represent a decision as to any of the allegations contained in the complaint. Because these complaints are unadjudicated, you may wish to contact the respondents before drawing any conclusions regarding the allegations in the complaint.

Nicholas Apodiakos (CRD #1595927, Registered Representative, Brighton, Massachusetts) was named as a respondent in an NASD complaint alleging that he instructed a public customer to withdraw \$60,000 from the customer's brokerage account, recommended that she purchase a "private investment" offering a 10 percent tax-free return over

a one-year period, and instructed the customer to make the checks payable to a third party. The complaint alleges that Apodiakos did not use the funds to purchase the tax-free investment; instead, the third party cashed the checks and split the proceeds with Apodiakos. The complaint further alleges that Apodiakos instructed the customer to sell shares in a mutual fund in order to make an additional purchase of the tax-free investment, and to make a \$19,000 check payable to a third party to purchase the tax-free investment; however, the funds were not used to purchase the investment as the customer intended, and the third party cashed the check and gave at least some of the proceeds to Apodiakos. (NASD Case #C11050002)

William Edward Kassar, Jr. (CRD #2245223, Registered Principal, Lattingtown, New York) and Reid Steven Malvin (CRD #4550756, Registered Representative, Glen Cove, New York) were named as respondents in an NASD complaint alleging that they intentionally or recklessly engaged in manipulative or deceptive devices or contrivances in connection with the purchase or sale of securities, and intentionally or recklessly effected transactions in, or induced the purchase or sale of, securities by means of manipulative, deceptive, or other fraudulent devices or contrivances. The complaint also alleged that Kassar and Malvin acted without regard for public customers' investment objectives, financial resources, and the character of the customers' accounts. The complaint further alleged that the respondents did not have a reasonable basis to believe that their recommendations and the resulting transactions were suitable for the public customers in light of the customers' financial situations, investment objectives, and needs. The transactions resulted in concentrated positions in individual speculative stocks that were inappropriate for the customers. The complaint also alleged that Kassar effected, or caused to be effected, trades in a public customer's account, without the customer's prior knowledge or consent. The complaint alleged that Kassar and Malvin conducted trades in a public customer's account on margin despite the fact that there was no margin agreement. In addition, the complaint alleged that Kassar took actions to settle a public customer's complaint without the knowledge or consent of his member firm. The complaint further alleged that Kassar provided false, deceptive, inaccurate, and/or incomplete testimony to NASD during an on-the-record interview. (NASD Case #CL1050003)

Darwin Raul Martinez (CRD #1493059, Registered Representative, Queens Village, New York) was named as a respondent in an NASD complaint alleging that he stole property from public customers of his member firm having a value totaling \$6,000. (NASD Case #C10050004)

Firms Expelled for Failing to Pay Fines and/or Costs in Accordance with NASD Rule 8320

Bancshares First
Dublin, Ohio
(February 24, 2005)

Clark Street Capital, Inc.
Levittown, New York
(February 24, 2005)

F1 Trading.Com, Inc.
Mineola, New York
(February 24, 2005)

Hanmi Securities, Inc.
Los Angeles, California
(February 24, 2005)

Individuals Barred Pursuant to NASD Rule 9552 for Failure to Provide Information Requested under NASD Rule 8210

Jeffrey King
Sellersberg, Indiana
(February 25, 2005)

Darla Jade Shih-Hseih
Delray Beach, Florida
(February 24, 2005)

Individuals Revoked for Failing to Pay Fines and/or Costs in Accordance with NASD Rule 8320

Eul Hyung Choi
Los Angeles, California
(February 24, 2005)

Frank Thomas Devine
Oswego, Illinois
(February 24, 2005)

Albert Anthony Schneck, Jr.
Staten Island, New York
(February 24, 2005)

Thomas Andrew Timberlake
Tampa, Florida
(February 24, 2005)

Individuals Suspended Pursuant to NASD Rule Series 9510 for Failure to Comply with an Arbitration Award or a Settlement Agreement

(The date the suspension began is listed after the entry. If the suspension has been lifted, the date follows the suspension date.)

Andrew Nelson Finder
Tampa, Florida
(February 25, 2005)

Phillip St. Jean Keegan
Mill Valley, California
(February 24, 2005)

Florida Brokerage Firm LH Ross Expelled, Owner Franklyn Michelin Barred for Life to Settle NASD Charges of Widespread, Ongoing Fraud

Brokerage, Michelin Withdraw Appeals of Prior Hearing Panel Decisions; Previously Ordered Sanctions, Including over \$11 Million in Restitution, Remain in Force

NASD has expelled Boca Raton, FL-based brokerage firm LH Ross & Company, Inc., from the securities industry and barred its owner and president, Franklyn Michelin, for life to resolve charges of manipulation, fraud, excessive markups, sales of unregistered securities, books and records violations, and supervisory violations in two pending enforcement actions against the firm. Both matters were scheduled to go before NASD hearing panels.

As part of the settlement, LH Ross and Michelin agreed to withdraw their appeals of three previous NASD hearing panel decisions that found, among other things, that LH Ross had engaged in widespread fraud in the sales of unregistered securities in multiple self-offerings and that LH Ross and Michelin had failed to cooperate with NASD investigators. Those previous decisions collectively imposed sanctions that included expelling LH Ross (twice), barring Michelin, ordering the payment of more than \$11.45 million in restitution to harmed investors, and imposing \$550,000 in fines. Those sanctions are now final.

In recent months, NASD has used two of its emergency powers for the first time to protect investors from LH Ross's ongoing fraudulent and illegal sales activities by issuing its first temporary cease-and-desist order in August 2004, and its first summary suspension of a securities firm in February 2005.

"Using its cease-and-desist authority, NASD put an immediate halt to the firm's continuing fraudulent sales activity," said NASD Vice Chairman Mary L. Schapiro. "Later, NASD used its summary suspension authority to halt the firm's remaining operations. Through its vigilance and dedication to investor protection, NASD succeeded in bringing this fraudulent enterprise to an end."

At its peak, LH Ross operated 17 branch offices around the country and employed approximately 180 brokers.

As part of its settlement with NASD, LH Ross and Michelin have also agreed to:

- Provide, within 60 days, a complete and accurate sworn accounting of the use of proceeds raised in the 2003 and 2004 self-offerings of preferred LH Ross stock. The accounting must detail the precise amounts raised in the self-offerings; every deposit and disbursement of those funds; every movement of those funds after their initial deposit into an account; and the identity and contact information for every investor in the preferred stock, along with the amounts of their investments.
- Execute consent directives giving NASD direct access to LH Ross's and Michelin's bank account records.
- Cooperate in NASD's ongoing investigation of individual LH Ross brokers, as well as any other investigation or disciplinary proceeding concerning monies raised through the 2003 and 2004 preferred stock offerings.

The two pending cases resolved in the settlement involve:

- The "pump and dump" manipulation in 2003 of the common stock of Trident Systems International, Inc., a shell company with virtually no assets or operating history. NASD found that LH Ross and Michelin engaged in an unregistered distribution of Trident stock, using fraudulent sales practices that included unauthorized trading, failure to execute customer sell orders, and material misrepresentations and omissions of material facts. NASD also found that LH Ross and Michelin charged customers fraudulent and excessive markups.
- Fraudulent trading of six stocks on five trading days in 2003 that generated more than \$360,000 in immediate financial gains. NASD found that LH Ross, Michelin, and two LH Ross brokers would identify a stock that had declined significantly during the course of a trading day, acquire a block of that stock late in the afternoon, and then sell the stock to unsuspecting retail customers at the stock's earlier, higher price. To facilitate the scheme, they falsified order tickets by time-stamping them early in the trading day.

LH Ross and Michelin have withdrawn their appeals of NASD hearing panel decisions in these cases:

- On January 14, 2005, an NASD hearing panel expelled LH Ross from the securities industry for fraud and other violations related to its sales of unregistered preferred stock self-offerings in 2003 and 2004. At least 150 investors in 27 states purchased the preferred stock. Saying LH Ross's fraud had caused "widespread, significant, and identifiable customer harm" and calling future sales solicitations by the firm an "extreme threat to the investing public," the hearing panel also fined the firm \$500,000 and ordered it to pay restitution and interest of more than \$11.45 million. It also imposed a permanent cease-and-desist order to replace the temporary order that had been in place since August 31, 2004.
- On January 25, 2005, in a separate disciplinary proceeding against the firm and Michelin, an NASD hearing panel expelled LH Ross and barred Michelin for failing to provide requested information to NASD investigators and thus impeding an NASD investigation.
- On December 15, 2004, a hearing panel found that LH Ross and Michelin had failed to pay an arbitration award and had filed a meritless defense in opposing NASD Dispute Resolution's suspension notice for that failure to pay. The panel ordered LH Ross and Michelin to pay nearly \$70,000 in restitution to the arbitration claimant, fined them \$50,000, and suspended Michelin for six months.

The brokerage is also at the center of numerous state disciplinary actions. Citing a variety of securities violations, regulators in Texas, Connecticut, New Hampshire, and Maine have revoked LH Ross's licenses to do business in their states. Utah regulators recently issued an emergency order suspending LH Ross's license, while regulators in Colorado have scheduled an April 8 hearing on possible revocation the firm's license.

LH Ross and Michelin settled the two pending enforcement actions without admitting or denying the allegations, but consented to the entry of NASD's findings. By withdrawing their appeals of the prior hearing panel decisions, LH Ross and Michelin are no longer challenging the findings of fraud and other violations in those cases.

NASD's investigation of individuals associated with LH Ross and their fraudulent sales activities is continuing.

Thomas Weisel Partners to Pay \$1.75 Million to Settle NASD Charges of IPO, E-Mail Retention Violations

NASD ordered Thomas Weisel Partners of San Francisco, CA to pay \$1.75 million for engaging in improper initial public offering (IPO) allocation practices and for failing to retain e-mails. That total represents \$1.3 million in ill-gotten profits and an additional \$450,000 fine.

NASD found that during 1999 and 2000, Weisel received unusually high commissions from certain institutional customers within one day of Weisel's allocating shares of hot IPOs to those customers. The firm accepted these commissions, which were sometimes more than \$1 per share, in connection with institutional-sized agency trades in highly liquid securities. These commissions were far in excess of a typical rate of \$.06 per share for such transactions, and the services Weisel provided did not justify the excessive commission amounts that were paid. Despite the receipt of such excessively high commissions, Weisel made no inquiries into the transactions.

"There was no legitimate reason to pay hundreds of thousands of dollars more than other firms would have charged to carry out routine trades," said NASD Vice Chairman Mary L. Schapiro. "By accepting high payments under these circumstances, Thomas Weisel Partners failed to observe the high standards of commercial honor and just and equitable principles of trade demanded by NASD rules."

NASD found that Weisel was an active manager of underwritings during the Internet boom and participated in a number of hot IPOs during the period at issue. Many of those IPOs exhibited price increases of more than 100 percent over the public offering prices at the opening of trading on the first day. Customers who were successful in obtaining IPO shares from Weisel in such offerings stood to make significant profits by selling those shares in the immediate aftermarket.

NASD found that in nine transactions on one day—March 3, 2000—three customers paid Weisel over \$1.2 million in unusually high commissions to execute institutional-sized trades in liquid securities at commission rates of \$1 per share and above. At \$.06 per share, commissions for the transactions would have totaled just \$122,400. On the same day, the customers received large allocations of two hot IPOs.

NASD found that one of those customers paid Weisel \$670,800 in commissions on two trades—at commission rates of \$1.08 per share and \$1.20 per share. These payments

resulted in commissions \$635,400 greater than if the customer had paid a commission of \$.06 per share. On the same day, the customer received allocations of 58,000 shares of an IPO that increased more than 286 percent from the public offering price on that day, and 1,000 shares of an IPO that increased more than 139 percent from its public offering price. Had the customer sold the IPO shares at the close of trading on the day of the IPO, the customer would have realized profits of over \$4 million.

NASD also found that, from January 1999 through the third quarter of 2001, Weisel violated recordkeeping rules by failing to ensure that e-mails were kept for the required minimum three-year period. Under Weisel's system, the firm's employees could permanently delete e-mails from the firm's e-mail system, and the firm lacked an adequate mechanism to save internal e-mail for associated persons. As a result, Weisel was unable to produce all of its e-mails to NASD.

In settling with NASD, Weisel neither admitted nor denied the charges, but they consented to the entry of NASD's findings.

NASD Fines Citigroup Global Markets, American Express, and Chase Investment Services More Than \$21 Million for Improper Sales of Class B and C Shares of Mutual Funds

Firms to Offer Remediation on over 275,000 Transactions to over 50,000 Households

NASD censured and fined Citigroup Global Markets, Inc., American Express Financial Advisors, and Chase Investment Services a total of \$21.25 million for suitability and supervisory violations relating to mutual fund sales practices between January 2002 and July 2003. These cases are part of a larger, ongoing investigation into mutual fund sales practices.

The cases against Citigroup and Chase involve their recommendations and sales of Class B and Class C shares of mutual funds, while the action involving American Express relates only to Class B shares. In all three cases, the firms made recommendations and sales of mutual funds to their customers without considering or adequately disclosing, on a consistent basis, that an equal investment in Class A shares would generally have been more economically advantageous for their customers by providing a higher overall rate of return. The firms also had inadequate supervisory and compliance policies and procedures relating to these mutual fund sales.

In particular, NASD found that the firms did not consistently consider that large investments in Class A shares of mutual funds entitle customers to breakpoint discounts on sales charges, generally beginning at the \$50,000 investment level, which are not available for investments in other share classes.

Investors may be entitled to breakpoints based on the amount of a single mutual fund purchase; the total amount of multiple purchases in the same family of funds; and/or the total amount of mutual fund investments held, at the time of the new purchase, by members of the customer's "household"—typically, accounts of close family members.

Unlike Class A shares, Class B shares are also subject to contingent deferred sales charges (CDSCs) for a period of time, generally six years. Class B and Class C shares are also subject to higher ongoing fees than Class A shares for as long as they are held. Even though investors do not pay a front-end sales charge for Class B or Class C shares, the potential CDSCs and the higher ongoing fees significantly affect the return on mutual fund investments, particularly at higher dollar levels.

"In recommending mutual funds that offer different share classes, brokers must consider the costs for each class and the effect those costs will have on a customer's investment, and recommend the share class that is most advantageous to the customer," said NASD Vice Chairman Mary L. Schapiro.

Since 2002, NASD has provided an online *Mutual Fund Expense Analyzer* to assist brokers and investors in comparing how sales charges, fees, and other fund expenses can affect returns.

In resolving these actions, the firms have agreed to a remediation plan that includes over 50,000 households and more than 275,000 transactions in Class B shares, and, to a lesser extent, Class C shares. The plan generally covers investors who, between January 1, 2002 and March 22, 2005, purchased Class B shares aggregating to \$50,000 or more, depending upon the particular fund's pricing structure. A limited number of investors who purchased Class C shares during the same time frame (generally those who purchased \$500,000) will also be included in the remediation plan. A number of exclusions also apply.

NASD's settlement with Citigroup includes more than 18,000 households, involving more than 90,000 Class B and Class C share transactions. NASD fined Citigroup \$6.25 million, which takes into consideration the \$20 million fine and other sanctions the Securities and Exchange Commission (SEC) is imposing on Citigroup to settle a related enforcement action involving sales of Class B shares, among other things.

NASD's settlement with American Express includes more than 30,000 households and 182,000 Class B share transactions. NASD fined American Express \$13 million. NASD's settlement with Chase involves more than 2,000 households and 4,000 Class B and C share transactions. NASD fined Chase \$2 million. The amount of the fines was based on the estimated additional commissions each firm received in connection with affected Class B share transactions.

Within approximately five months, each firm will notify affected customers that they will have an opportunity to convert certain of their Class B and/or Class C shares to Class A shares so that customers will be restored to the position they would have been in had they originally purchased Class A shares. In addition, those customers who sold some or all of their Class B or Class C shares may be eligible to receive a cash payment relating to the shares that were sold. The plan will take up to nine months to complete, and each firm will provide a response center to handle customer inquiries and to assist affected customers.

NASD is posting a special section on its Web site—*Improper Sale of Mutual Fund Class B and C Shares: Remediation Information for Investors*—to assist investors covered by the remediation plan.

For information about the differences in mutual fund share classes, see the NASD Investor Alerts *Understanding Mutual Fund Classes* and *Class B Mutual Fund Shares: Do They Make the Grade?* (For information about breakpoint discounts on Class A share investments, see the NASD Investor Alerts *Mutual Fund Breakpoints: A Break Worth Taking* and *Mutual Fund Breakpoints: Are You Owed A Refund?*)

Each of the firms settled the actions without admitting or denying the allegations, but consented to the entry of NASD's findings.

NASD Fines Spear, Leeds & Kellogg \$1 Million for Concealing Sales of IPO Shares

Firm Implemented Internal System to Prevent Detection, Reporting of Sales by DTC

NASD censured and fined Spear, Leeds & Kellogg, L.P. (now known as Goldman Sachs Execution & Clearing, L.P.) \$1 million for creating and implementing an internal system to conceal sales of securities allocated in initial public offerings (IPOs) from the Depository Trust Corporation (DTC).

In 1997, DTC, which provides clearance and settlement services to the securities industry, implemented a system approved by the Securities and Exchange Commission (SEC) to track sales of shares in initial public offerings. The purpose of the system was to allow underwriters to monitor the flipping of new issues. This IPO Tracking System produced IPO Tracking Reports, which identified customer accounts that had sold IPO shares within certain time periods following the allocation of shares. DTC provided IPO Tracking Reports to underwriters upon request. Underwriters used the report information in a number of ways, including determining allocations in future IPOs, and imposing penalty bids on firms whose customers sold IPO shares prior to the expiration of the tracking period.

Spear Leeds had objected to the IPO Tracking System in a comment letter to the SEC during the approval process for the system. In its comment letter, Spear Leeds raised concerns that the system would prevent anonymity in the securities market and restrict secondary market sales. The SEC rejected those concerns.

NASD found that around the time the system was implemented, some Spear Leeds customers objected to their sales of IPO shares being identified through the IPO tracking system, citing concerns about preserving the anonymity of their trading activity, and thereby preserving their ability to obtain future IPOs. In response, Spear Leeds developed and implemented a system designed to conceal sales of IPO shares from the IPO Tracking System.

NASD's disciplinary action rests on Spear Leeds' actions to conceal IPO information from market participants. "For a firm to design a system to deprive underwriters and other market participants of critical information relating to IPO allocations—information that they are entitled to—is deeply troubling, and a serious violation of the high ethical standards required of firms," said NASD Vice Chairman Mary L. Schapiro.

The tracking system required participating firms such as Spear Leeds to establish two accounts—an IPO Control Account and a Free Account. The IPO Tracking system identified the sale of IPO shares when shares were moved from the IPO Control Account to the Free Account. NASD found that to avoid detection by DTC through the tracking system, Spear Leeds completed delivery on the sales of IPO shares for its customers by borrowing shares from third parties rather than moving shares from the IPO Control Account. That way, it appeared that the customers still owned their shares, and the sales were not detected and included in the IPO Tracking Report. Once the time period for tracking sales of IPO shares under the IPO Tracking system was over, Spear Leeds replaced borrowed shares by delivering shares from the IPO Control Account back to the third-party lenders.

NASD found that Spear Leeds used this system to circumvent DTC's IPO Tracking System from approximately August 1997 through January 2001. Spear Leeds never informed DTC that it had implemented this system. As a result, numerous sales of IPO shares in accounts at Spear Leeds were not reflected in reports generated by the DTC system.

NASD found that in creating and implementing this system and in failing to disclose its effects to DTC, Spear Leeds violated NASD rules by failing to act in a manner that was consistent with high standards of commercial honor.

In settling this matter, Spear Leeds neither admitted nor denied the charges, but consented to the entry of NASD's findings.

The Goldman Sachs Group acquired Spear Leeds in late 2000. In January 2005, Spear Leeds changed its name to Goldman Sachs Execution & Clearing, L.P.

Jefferson Pilot to Pay over \$500,000 in First VUL Market Timing Action; NASD Also Fines Affiliate \$125,000 for E-Mail Retention Violations

NASD fined Jefferson Pilot Variable Corporation, a Concord, NH broker-dealer, \$325,000 for failing to have an adequate supervisory system in place to prevent market timing and excessive trading in the sub-accounts of its Ensemble series of variable universal life insurance policies (VULs). Jefferson Pilot is the exclusive distributor of Ensemble VULs, which are issued by a Jefferson Pilot insurance affiliate. In addition, the firm must pay \$238,697 in restitution to the affected funds.

Separately, NASD fined another affiliate, Jefferson Pilot Securities Corp. (JPSC), also of Concord, \$125,000 for failing to retain all e-mail communications of its registered persons.

This is the first NASD enforcement action to date involving market timing in VUL sub-accounts. Last June, NASD settled a case involving market timing in the sub-accounts of variable annuities. VULs offer a fixed premium schedule and a minimum death benefit. They differ from traditional whole life insurance in that cash values are allocated to various sub-accounts, each reflecting investments in particular mutual funds that are separate from the general assets of the insurance company.

"Market timing and excessive trading by a few can hurt other fund shareholders by diluting share value and raising transaction costs," said NASD Vice Chairman Mary L. Schapiro. "Jefferson Pilot's failure to conduct a meaningful review of its supervisory systems resulted in the impermissible market timing and excessive trading, which in turn resulted in harm to other policy holders with assets in these sub-accounts."

NASD found that, despite having an electronic system ostensibly designed to recognize and block sub-account transfers in excess of policy limits, Jefferson Pilot failed to determine whether the system was functional. Given the firm's exclusive reliance on this system to monitor sub-account transfers, such follow-up and review was essential. As a result of this failure, 292 Ensemble series VUL policyholders were permitted to exceed the 20-transfers-per-policy-year limit described in the prospectus.

NASD found that in 2003, Jefferson Pilot failed to prevent two VUL policyholders, through the purchase and sale of sub-account units, from engaging in market timing in the shares of three different funds. The two market timers exceeded the prospectus limits by 116 transfers, realizing additional profits

of \$238,697. From January 1, 2001 through December 31, 2003, at least 290 other VUL policyholders had been following an investment strategy that required periodic rebalancing of their sub-account portfolio. Although not market timers, those policyholders still exceeded the VUL prospectus transfer limitations.

Of the \$238,697 in restitution, Jefferson Pilot previously paid \$119,024 to the JPVF International Equity Portfolio. The remainder—an additional \$119,673—will be paid to the following funds: American Century Variable Products, Inc., VP International Fund (\$66,191) and Franklin Templeton Variable Insurance Products Trust Templeton Foreign Securities Fund (\$53,482).

NASD also found that the Jefferson Pilot securities affiliate, JPSC, failed to maintain and preserve all internal e-mail communications for 217 registered persons who were also employed by their affiliated life insurance company. From at least January 1, 2001 through December 31, 2003, JPSC's e-mail system purged the e-mail communications of those 217 registered persons after 60 days. NASD rules require that e-mail communications be retained for no less than three years.

In addition to fining and censuring both firms, NASD required Jefferson Pilot to certify that it has disclosed all instances of transfers within VUL sub-accounts that contravened the limitations set forth in the applicable prospectus and that it has implemented appropriate supervisory controls to enforce prospectus transfer limits; and JPSC was required to certify that it has reviewed its procedures relating to preservation of electronic mail communications and that it has established reasonable supervisory controls to ensure e-mail retention.

In settling this matter, neither firm admitted nor denied the charges, but they consented to the entry of NASD's findings.

NASD Charges Knight Securities' Kenneth Pasternak, John Leighton with Supervisory Violations in Fraudulent Sales to Institutional Customers

Charges Against Former CEO, Head of Sales Desk Follow \$79 Million Settlement with Knight

NASD charged Kenneth Pasternak, former CEO of Knight Securities, L.P., and John Leighton, former head of the firm's Institutional Sales Desk, with supervisory violations in connection with fraudulent sales to institutional customers in 1999 and 2000.

In December 2004, Knight paid \$79 million to settle NASD and SEC charges that it had defrauded institutional customers through the fraudulent and deceptive conduct of its leading

institutional sales trader, who was John Leighton's brother. That sanction included \$25 million in fines and a payment of \$54 million in ill-gotten profits and interest into a Fair Fund established by the SEC for compensating harmed investors.

The action charges Pasternak and Leighton with failing to supervise Leighton's brother and failing to establish and enforce a system designed to ensure compliance with federal securities laws and NASD rules. NASD's investigation of Leighton's brother is continuing. From January 1999 to September 2000, Leighton's brother was responsible for generating nearly \$135 million in trading profits for Knight, or approximately 30 percent of the trading profits of Knight's entire Institutional Sales Desk. NASD's complaint calls the magnitude of the profits generated by Leighton's brother—both in absolute terms and in profit per share—"extraordinary."

"In this case, it is inconceivable that fraudulent trading of this magnitude could go on for so long and generate such an exorbitant amount of excess profits and escape detection by the firm's supervisory systems and the supervisors themselves," said NASD Vice Chairman Mary L. Schapiro. "Supervisors are obligated to take appropriate steps to ensure that persons acting under their supervision comply with securities law and regulations, and we will not hesitate to take action against supervisors who fail to fulfill that responsibility,"

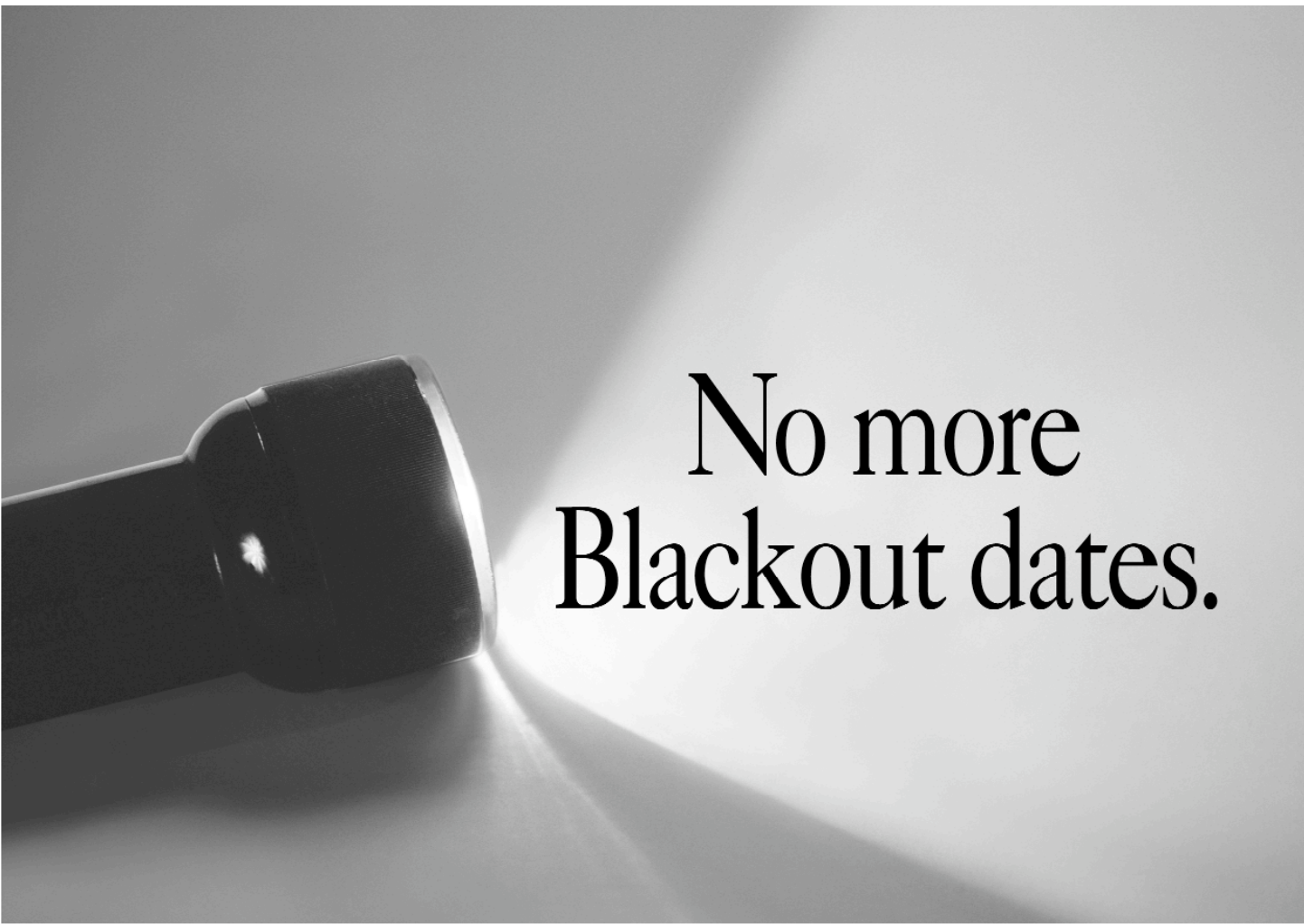
John Leighton was his brother's supervisor and, under a unique profit-sharing arrangement approved by Pasternak, received half of his brother's trading compensation. NASD's complaint alleges that John Leighton received millions of dollars during 1999 and 2000 from his brother's trading profits, including ill-gotten profits from his brother's fraudulent trading. Their profit-sharing arrangement and family ties created an inherent conflict of interest, and gave John Leighton a strong incentive not to question his brother's trading or how he was able to generate such enormous profits. NASD's complaint alleges that John Leighton did not conduct, and did not arrange for anyone else to conduct, any meaningful supervisory review of his brother's trading and did not take any steps reasonably designed to achieve compliance with federal securities laws and NASD rules.

Pasternak was the Chief Executive Officer of Knight and John Leighton's supervisor. Pasternak was also the designated supervisor of the firm's Institutional Sales Desk in John Leighton's absence. NASD's complaint alleges that Pasternak was responsible for the deficient supervisory structure by assigning John Leighton to supervise his brother's trading while at the same time approving their unique profit-sharing arrangement. Pasternak also failed to have the firm adopt any supervisory procedures or systems that would address the conflict inherent in this unusually suspect arrangement and the deficient supervisory structure he approved.

NASD's complaint alleges that although Pasternak knew that John Leighton assigned most of Knight's largest institutional customer accounts to his brother, and knew that Leighton's brother generated an inordinate amount of profits for Knight in absolute terms and a grossly disproportionate amount of the profits of the firm's Institutional Sales Desk, Pasternak did not take reasonable steps to determine whether John Leighton was monitoring or reviewing his brother's trading, did not review or monitor the trading himself, and did not assign anyone else to do so. Neither John Leighton nor Pasternak questioned the extraordinary profits or took any steps to see how Leighton's brother was making them.

Pasternak served on NASD's Board of Governors from May 30, 2000 to September 17, 2001.

Under NASD rules, a firm or individual named in a complaint can file a response and request a hearing before an NASD disciplinary panel. Possible remedies include a fine, censure, suspension, or bar from the securities industry, disgorgement of gains associated with the violations, and payment of restitution.



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