

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.

Jonathan G. Katz, Secretary.

[FR Doc. 95-26287 Filed 10-23-95; 8:45 am]

BILLING CODE 8010-01-M

Issuer Delisting; Notice of Application To Withdraw From Listing and Registration; (Titan Corporation, Common Stock, \$0.01 Par Value; \$1.00 Cumulative Convertible Preferred Stock, \$1 Par Value) File No. 1-6035

October 18, 1995.

Titan Corporation ("Company") has filed an application with the Securities and Exchange Commission ("Commission"), pursuant to Section 12(d) of the Securities Exchange Act of 1934 ("Act") and Rule 12d2-2(d) promulgated thereunder, to withdraw the above specified securities ("Securities") from listing and registration on the Pacific Stock Exchange Incorporated ("PSE").

The reasons alleged in the application for withdrawing the securities from listing and registration include the following:

According to the Company, the Securities are currently traded on the New York Stock Exchange, Inc. ("NYSE"), The Chicago Stock Exchange, Inc. ("CHX"), and the PSE. The Company incurs annual maintenance fees for each of the exchanges. Currently, the Company is paying an annual fee of \$1,500.00 to the PSE. From time to time, the Company issues additional shares for use in connection with its employee benefit plans. For every 1,000,000 new shares issued, the Company is charged a \$2,500.00 listing fee by the PSE. Since the vast majority of the trading in the Securities occurs on the NYSE, the Company does not believe that it is cost effective to maintain listings on the regional exchanges. Therefore, the Company has determined that a single listing on the NYSE will be sufficient to serve the needs of its stockholders.

Any interested person may, on or before November 8, 1995, submit by letter to the Secretary of the Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, DC 20549, facts bearing upon whether the application has been made in accordance with the rules of the exchanges and what terms, if any, should be imposed by the Commission for the protection of investors. The Commission, based on the information submitted to it, will issue an order granting the application after the date

mentioned above, unless the Commission determines to order a hearing on the matter.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.

Jonathan G. Katz, Secretary.

[FR Doc. 95-26286 Filed 10-23-95; 8:45 am]

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[Release No. 34-36383; File No. SR-NASD-95-39]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc., Relating to Application of the Rules of Fair Practice to Transactions in Exempted Securities and an Interpretation of Its Suitability Rule

October 17, 1995.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. 78s(b)(1), notice is hereby given that on September 18, 1995, the National Association of Securities Dealers, Inc. ("NASD" or "Association") filed with the Securities and Exchange Commission ("SEC" or "Commission") the proposed rule change, and on October 17, 1995, filed amendment No. 1 to the proposed rule change, as described in Items I, II, and III below, which Items have been prepared by the NASD. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The NASD is herewith filing a proposed rule change to: (i) amend Article I, Sections 4 and 5 of the Rules of Fair Practice in order to apply the Rules of Fair Practice to those members registered with the Securities and Exchange Commission solely under the provisions of Section 15C of the Act and to transactions in all securities, except municipals; (ii) merge the NASD's Government Securities Rules, where applicable, into the Rules of Fair Practice; (iii) make clarifying amendments to certain sections and Interpretations under Articles III and IV of the Rules of Fair Practice relating to the government securities business; (iv) amend certain Rules of Fair Practice and Board Interpretations to exempt transactions in government securities; (v) amend Article III, Section 2 of the Rules of Fair Practice by amendment to Subsection 2(b) and adoption of an

Interpretation of the Board of Governors—Suitability Obligations to Institutional Customers; (vi) make technical changes to NASD By-Laws, Schedules to the By-Laws, the Rules of Fair Practice and the Code of Procedure to replace references to provisions of the Government Securities Rules with references to the appropriate Rules of Fair Practice, and to delete the terms "exempted security" or "exempted securities," or, replace these terms with the term "municipal securities," as applicable; and (vii) modify references to SEC Rules 15c3-1 and 15c3-3 to reflect SEC amendments to those rules. Below is the text of the proposed rule change. Proposed new language is italicized; proposed deletions are in brackets.

Certificate of Incorporation—By-Laws

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By-Laws

Article I

Definitions

When used in these By-Laws, and any rules of the Corporation, unless the context otherwise requires, the term:

(a)-(r) No change.

(s) "rules of the Corporation" means all rules of the Corporation including the Certificate of Incorporation, By-Laws, Rules of Fair Practice, [Government Securities Rules,] Code of Procedure, Uniform Practice Code, and any interpretations thereunder.

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Schedules to the By-Laws

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Schedule A

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Sec. 13. Service Charge for Advertisement, Sales Literature, and Other Such Material Filed or Submitted

There shall be a service charge for each and every item of advertisement, sales literature, and other such material, whether in printed, video or other form, filed with or submitted to the Association, except for items that are filed or submitted in response to a written request from the Association's Advertising Regulation Department issued pursuant to the spot check procedures set forth in the Association's Rules of Fair Practice [and Government Securities Rules], as follows: (1) for printed material reviewed, \$50.00, plus \$10.00 for each page reviewed in excess of 10 pages; and (2) for video or audio media, \$50.00, plus \$10.00 per minute for each minute of tape reviewed in excess of 10 minutes.

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Schedule C

This schedule has been prepared pursuant to the provisions of Section 2 of Article II of the Corporation's By-Laws and contains the requirements of registration with the Corporation of persons associated with a member, including the requirements for qualification examinations to be given.

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Part II—Registration of Principals

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(2) Categories of Principal Registration

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(b) Limited Principal—Financial and Operations—

(i)–(iii) No change.

(iv) A member, or an applicant for membership in the Corporation, may upon written request, be exempted by the President of the Corporation, or his delegate, from the requirement to have a Limited Principal-Financial and Operations if:

a. it has been expressly exempted by the Securities and Exchange Commission from SEC Rule 15c3–1 pursuant to the provisions of paragraph (b)(3)1(iii) thereof; or

b. it is subject to the provisions of SEC Rule 15c3–1(a)(2) [or (3)] or to Section 402.2(c) of the rules of the Treasury Department.

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Part VI—Persons Exempt From Registration

(1) The following persons associated with a member are not required to be registered with the Corporation:

* * * * *

(d) persons associated with a member whose functions are related solely and exclusively to:

(i) effecting transactions on the floor of a national securities exchange and who are registered as floor members with such exchange;

(ii) transactions in [exempted] municipal securities[, except as provided in Part X hereof.]; or

(iii) transactions in commodities.

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Rules of Fair Practice

Article I

Adoption and Application

Adoption of Rules

Sec. 1.–3. No change.

Effect on Transactions in [Exempted] Municipal Securities

Sec. 4. The Rules shall not be construed to apply to contracts made prior to the effective date of the Rules

or to transactions in [exempted] municipal securities (as defined in section 3(a)(12) 29) of the Act).

Applicability

Sec. 5. (a) These Rules of Fair Practice shall apply to all members and persons associated with a member[, other than those members registered with the Securities and Exchange Commission solely under the provisions of Section 15C of the Act and persons associated with such members]. Persons associated with a member shall have the same duties and obligations as a member under these Rules of Fair Practice.

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Article III

Rules of Fair Practice

Business Conduct of Members

Sec. 1. A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade.

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• • • Interpretation of the Board of Governors

Prompt Receipt and Delivery of Securities

It shall be deemed a violation of Article III, Section 1 of the Rules of Fair Practice of the Association for a member or person associated with a member to violate the provisions of the following interpretation thereof;

* * * * *

(b) Sales:

(1) Long Sales No change.

(2) "Short Sales"

(a) Customer short sales No member or person associated with a member shall accept a "short" sale order for any customer in any security unless the member or person associated with a member makes an affirmative determination that the member will receive delivery of the security from the customer or that the member can borrow the security on behalf of the customer for delivery by settlement date. This requirement shall not apply, however, to transactions in [corporate] debt securities.

(b) Proprietary short sales No member or person associated with a member shall effect a "short" sale for its own account in any security unless the member or person associated with a member makes an affirmative determination that the member can borrow the securities or otherwise provide for delivery of the securities by the settlement date. This requirement will not apply to transactions in [corporate] debt securities, to bona fide

market making transactions by a member in securities in which it is registered as a Nasdaq market maker, to bona fide market maker transactions in non-Nasdaq securities in which the market maker publishes a two-sided quotation in an independent quotation medium, or to transactions which result in fully hedged or arbitrated positions.

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• • • Interpretation of the Board of Governors

"Free-Riding and Withholding"

Introduction

The following Interpretation of Article III, Section 1 of the Association's Rules of Fair Practice is adopted by the Board of Governors of the Association pursuant to the provisions of Article VII, Section 3(a) of the Association's By-Laws and Article I, Section 3 of the Rules of Fair Practice.

This Interpretation is based upon the premise that members have an obligation to make a bona fide public distribution at the public offering price of securities of a public offering which trade at a premium in the secondary market whenever such secondary market begins (a "hot issue") regardless of whether such securities are acquired by the member as an underwriter, as a selling group member, or from a member participating in the distribution as an underwriter or a selling group member, or otherwise. The failure to make a bona fide public distribution when there is a demand for an issue can be a factor in artificially raising the price. Thus, the failure to do so, especially when the member may have information relating to the demand for the securities or other factors not generally known to the public, is inconsistent with high standards of commercial honor and just and equitable principles of trade and leads to an impairment of public confidence in the fairness of the investment banking and securities business. Such conduct is, therefore, in violation of Article III, Section 1 of the Association's Rules of Fair Practice and this Interpretation thereof which establishes guidelines in respect to such activity.

As in the case of any other Interpretation issued by the Board of Governors of the Association, the implementation thereof is a function of the District Business Conduct Committees and the Board of Governors. Thus, the Interpretation will be applied to a given factual situation by individuals active in the investment banking and securities business who are serving on these committees or on the Board.

They will construe this Interpretation to effectuate its overall purpose to assure a public distribution of securities for which there is a public demand.

This Interpretation will not apply to government securities as defined in Section 3(a)(42) of the Securities Exchange Act of 1934.

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Recommendations to Customers

Sec. 2. (a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

(b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

- (i) the customer's financial status;
- (ii) the customer's tax status;
- (iii) the customer's investment objectives; and
- (iv) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

For purposes of this subsection 2(b), the term "non-institutional customer" shall mean a customer that does not qualify as an "institutional account" under Article III, Section 21(c)(4) of the Rules of Fair Practice.

• • • *Interpretation of the Board of Governors*

Suitability Obligations to Institutional Customers

Preliminary Statement as to Members' Obligations

As a result of broadened authority provided by amendments to the Government Securities Act adopted in 1993, the Association is extending its sales practice rules to the government securities market, a market with a particularly broad institutional component. Accordingly, the Board believes it is appropriate to provide further guidance to members on their suitability obligations when making recommendations to institutional customers. The Board believes this Interpretation is applicable not only to government securities but to all debt securities, excluding municipals.¹

¹ Rules for municipal securities are promulgated by the Municipal Securities Rulemaking Board.

Furthermore, because of the nature and characteristics of the institutional customer/member relationship, the Board is extending this Interpretation to apply equally to the equity securities markets as well.

The NASD's suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct. Members' responsibilities include having a reasonable basis for recommending a particular security or strategy, as well as having reasonable grounds for believing the recommendation is suitable for the customer to whom it is made. Members are expected to meet the same high standards of competence, professionalism, and good faith regardless of the financial circumstances of the customer.

Article III, Section 2(a) requires that, in recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

This Interpretation concerns only the manner in which a member determines that a recommendation is suitable for a particular institutional customer. The manner in which a member fulfills this suitability obligation will vary depending on the nature of the customer and the specific transaction. Accordingly, this Interpretation deals only with guidance regarding how a member may fulfill such "customer-specific suitability obligations" under Article III, Section 2(a) of the Rules of Fair Practice.²

While it is difficult to define in advance the scope of a member's suitability obligation with respect to a specific institutional customer transaction recommended by a member, the Board has identified certain factors which may be relevant when considering compliance with Article III, Section 2(a) of the Rules of Fair Practice. These factors are not intended to be requirements or the only factors to be considered but are offered merely as guidance in determining the scope of a member's suitability obligations.

² This Interpretation does not address the obligation related to suitability that requires that a member have " * * * a 'reasonable basis' to believe that the recommendation could be suitable for at least some customers." In the Matter of the Application of F.J. Kaufman and Company of Virginia and Frederick J. Kaufman, Jr., 50 SEC 164 (1989).

Considerations Regarding the Scope of Members' Obligations to Institutional Customers

The two most important considerations in determining the scope of a member's suitability obligations in making recommendations to an institutional customer are the customer's capability to evaluate investment risk independently and the extent to which the customer intends to exercise independent judgment in evaluating a member's recommendation. A member must determine, based on the information available to it, the customer's capability to evaluate investment risk. In some cases, the member may conclude that the customer is not capable of making independent investment decisions in general. In other cases, the institutional customer may have general capability, but may not be able to understand a particular type of instrument or its risk. This is more likely to arise with relatively new types of instruments, or those with significantly different risk or volatility characteristics than other investments generally made by the institution. If a customer is either generally not capable of evaluating investment risk or lacks sufficient capability to evaluate the particular product, the scope of a member's customer-specific obligations under the suitability rule would not be diminished by the fact that the member was dealing with an institutional customer. On the other hand, the fact that a customer initially needed help understanding a potential investment need not necessarily imply that the customer did not ultimately develop an understanding and make an independent investment decision.

A member may conclude that a customer intends to exercise independent judgment if the customer's investment decision will be based on its own independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations. Where the broker-dealer has reasonable grounds for concluding that the institutional customer is making independent investment decisions and is capable of independently evaluating investment risk, then a member's obligation to determine that a recommendation is suitable for a particular customer is fulfilled.³ Where a customer has delegated decision-making authority to an agent, such as an investment advisor or a bank trust

³ See, note 2.

department, this Interpretation shall be applied to the agent.

A determination of capability to evaluate investment risk independently will depend on an examination of the customer's capability to make its own investment decisions, including the resources available to the customer to make informed decisions. Relevant considerations could include:

- the use of one or more consultants, investment advisers or bank trust departments;
- the general level of experience of the institutional customer in financial markets and specific experience with the type of instruments under consideration;
- the customer's ability to understand the economic features of the security involved;
- the customer's ability to independently evaluate how market developments would affect the security; and
- the complexity of the security or securities involved.

A determination that a customer is making independent investment decisions will depend on the nature of the relationship that exists between the member and the customer. Relevant considerations could include:

- any written or oral understanding that exists between the member and the customer regarding the nature of the relationship between the member and the customer and the services to be rendered by the member;
- the presence or absence of a pattern of acceptance of the member's recommendations;
- the use by the customer of ideas, suggestions, market views and information obtained from other members or market professionals, particularly those relating to the same type of securities; and
- the extent to which the member has received from the customer current comprehensive portfolio information in connection with discussing recommended transactions or has not been provided important information regarding its portfolio or investment objectives.

Members are reminded that these factors are merely guidelines which will be utilized to determine whether a member has fulfilled its suitability obligations with respect to a specific institutional customer transaction and that the inclusion or absence of any of these factors is not dispositive of the determination of suitability. Such a determination can only be made on a case-by-case basis taking into consideration all the facts and circumstances of a particular member/

customer relationship, assessed in the context of a particular transaction.

For purposes of this Interpretation, an institutional customer shall be any entity other than a natural person. In determining the applicability of this Interpretation to an institutional customer, the NASD will consider the dollar value of the securities that the institutional customer has in its portfolio and/or under management. While this Interpretation is potentially applicable to any institutional customer, the guidance contained herein is more appropriately applied to an institutional customer with at least \$10 million invested in securities in the aggregate in its portfolio and/or under management.

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Sec. 3.-20. No change.

Books and Records

Sec. 21.

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Marking of Customer Order Tickets

- (b) (i) A person associated with a member shall indicate on the memorandum for the sale of any security whether the order is "long" or "short," except that this requirement shall not apply to transactions in [corporate] debt securities. An order may be marked "long" if (1) the customer's account is long the security involved or (2) the customer owns the security and agrees to deliver the security as soon as possible without undue inconvenience or expense.
- (ii) No change.

Customer Account Information

- (c) Each member shall maintain accounts opened after January 1, 1991 as follows:
 - (1)-(2) No change.
 - (3) for discretionary accounts, in addition to compliance with subsections (1) and (2) above, and Article III, Section 15(b) of these rules, the member shall:
 - (i) obtain the signature of each person authorized to exercise discretion in the account; [and]
 - (ii) record the date such discretion is granted[.]; and
 - (iii) in connection with exempted securities other than municipals, record the age or approximate age of the customer.

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Sec. 22.-24. No change.

Dealing with Non-Members

Sec. 25. (a) No member shall deal with any non-member broker or dealer except at the same prices, for the same commissions or fees, and on the same

terms and conditions as are by such member accorded to the general public.

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• • • Interpretation of the Board of Governors

Transactions Between Members and Non-Members

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2. Transactions in "Exempted Securities"

[Section 4 of Article I of the Rules of Fair Practice provides that the Rules shall not apply to transactions, whether between members or between members and non-members, in] Section 25 of Article III of the Rules of Fair Practice shall not apply to "exempted securities," which are defined by Section 3(a)(12) of the Securities Exchange Act of 1934 as follows:

Text of § 3(a)(12) of '34 Act

"The term 'exempted security' or 'exempted securities' shall include securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States; such securities issued or guaranteed by corporations in which the United States has a direct or indirect interest as shall be designated for exemption by the Secretary of the Treasury as necessary or appropriate in the public interest or for the protection of investors; securities which are direct obligations of or obligations guaranteed as to principal or interest by a State or any political subdivision thereof or any agency or instrumentality of a State or any political subdivision thereof or any municipal corporate instrumentality of one or more States; and such other securities (which may include, among others, unregistered securities, the market in which is predominantly intrastate) as the Commission may, by such rules and regulations as it deems necessary or appropriate in the public interest, or for the protection of investors, either unconditionally or upon specified terms and conditions or for stated periods, exempt from the operation of any one or more provisions of this title which by their terms do not apply to an 'exempted security' or to 'exempted securities'."

[The rules] Section 25 of Article III of the Rules of Fair Practice therefore does not apply to transactions in government or municipal securities if within the definition of "exempted securities." Members may join with non-members or with banks in a joint account, syndicate or group to purchase and distribute an issue of "exempted securities" and may trade such securities with non-members or with banks at different prices or on

different terms and conditions than are accorded to members of the general public.

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Sec. 26.–34. No change.

Communications With the Public

Sec. 35.

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(c) Filing Requirements and Review Procedures

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(3)(C) Except for advertisements related to exempted securities (as defined in Section 3 (a)(12) of the Securities Exchange Act of 1934), municipal securities, direct participation programs or investment company securities, members subject to the requirements of subparagraphs (c)(3)(A) or (c)(3)(B) of this section may, in lieu of filing with the Association, file advertisements on the same basis, and for the same time periods specified in those subparagraphs, with any registered securities exchange having standards comparable to those contained in this section.

(4) No change.

(5) In addition to the foregoing requirements, every member's advertising and sales literature shall be subject to a routine spot-check procedure. Upon written request from the Association's Advertising Department, each member shall promptly submit the material requested. Members will not be required to submit material under this procedure which has been previously submitted pursuant to one of the foregoing requirements and, except for material related to exempted securities (as defined in Section 3(a)(12) of the Securities Exchange Act of 1934), municipal securities, direct participation programs or investment company securities, the procedure will not be applied to members who have been, within the NASD's current examination cycle subjected to a spot-check by a registered securities exchange or other self-regulatory organization using procedures comparable to those used by the Association.

(6) No change.

(7) Material which refers to investment company securities or direct participation programs, or exempted securities (as defined in Sections 3(a)(12) of the Securities Exchange Act of 1934) solely as part of a listing of products and/or services offered by the member, is excluded from the requirements of paragraphs (c)(1) and (c)(2) of this section.

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Sec. 36.–37. No change.

* * * *

Regulation of Activities of Members Experiencing Financial and/or Operational Difficulties

Sec. 38. (a) Application—For the purposes of this rule, the term "member" shall be limited to any member of the Association who is not designated to another self-regulatory organization by the Securities and Exchange Commission for financial responsibility pursuant to Section 17 of the Securities Exchange Act of 1934 and Rule 17d-1 thereunder. Further, the term shall not be applicable to any member who is subject to paragraphs (a)(2)(iv), (a)(2)(v) or (a)(2)(vi) [and (a)(3)] of SEC Rule 15c3-1, or is subject to Article III, Section 38A of the Rules of Fair Practice, or is otherwise exempt from the provisions of said rule.

* * * *

Regulation of Activities of Section 15C Members Experiencing Financial and/or Operational Difficulties

Sec. 38A. (a) Application—For the purposes of this rule, the term "member" shall be limited to any member of the Association registered with the Securities and Exchange Commission pursuant to Section 15C of the Securities and Exchange Act of 1934 that is not designated to another self-regulatory organization by the Securities and Exchange Commission for financial responsibility pursuant to Section 17 of the Securities Exchange Act of 1934 and Rule 17d-1 thereunder. Further, the term shall not be applicable to any member that is subject to Section 402.2(c) of the rules of the Treasury Department, or is otherwise exempt from the provisions of said rule.

(b) A member, when so directed by the Association, shall not expand its business during any period in which:

(1) Any of the following conditions continue to exist, or have existed, for more than fifteen (15) consecutive business days:

(A) A firm's liquid capital is less than 150 percent of the total haircuts or such greater percentage thereof as may from time to time be prescribed by the Association.

(B) A firm's liquid capital minus total haircuts is less than 150 percent of its minimum dollar capital requirement.

(C) The deduction of ownership equity and maturities of subordinated debt scheduled during the next six months would result in any one of the conditions described in (A) or (B) of this subparagraph (1).

(2) The Association restricts the member for any other financial or operational reason.

(c) A member, when so directed by the Association, shall forthwith reduce its business:

(1) To a point enabling its available capital to comply with the standards set forth in subparagraphs (b)(1) (A), (B), or (C) of this rule if any of the following conditions continue to exist, or have existed, for more than fifteen (15) consecutive business days:

(A) A firm's liquid capital is less than 125 percent of total haircuts or such greater percentage thereof as may from time to time be prescribed by the Association.

(B) A firm's liquid capital minus total haircuts is less than 125 percent of its minimum dollar capital requirement.

(C) The deduction of ownership equity and maturities of subordinated debt scheduled during the next six months would result in any one of the conditions described in (A) or (B) of this subparagraph (1).

(2) As required by the Association when it restricts a member for any other financial or operational reason.

• • • Explanation of the Board of Governors

Restrictions on a Member's Activity

This explanation outlines and discusses some of the financial and operational deficiencies which could initiate action under the rule. Subparagraphs (b)(2) and (c)(2) of [the rule] Sections 38 and 38A recognize that there are various unstated financial and operational reasons for which the Association may impose restrictions on a member so as to prohibit its expansion or to require a reduction in overall level of business. These provisions are deemed necessary in order to provide for the variety of situations and practices which do arise and, which if allowed to persist, could result in increased exposure to customers and to broker-dealers.

In the opinion of the Board of Governors, it would be impractical and unwise to attempt to identify and list all of the situations and practices which might lead to the imposition of restrictions or the types of remedial actions the Corporation may direct be taken because they are numerous and cannot be totally identified or specified with any degree or precision. The Board believes, however, that it would be helpful to members' understanding to list some of the other bases upon which the Corporation may conclude that a member is in or approaching financial difficulty.

• • • Explanation of Board of Governors

Explanation

(a) For purposes of subparagraphs (b)(2) and (c)(2) of [the rule] *Section 38*, a member may be considered to be in or approaching financial or operational difficulty in conducting its operations and therefore subject to restrictions if it is determined by the Corporation that any of the parameters specified therein are exceeded or one or more of the following conditions exist:

(1) The member has experienced a reduction in excess net capital of 25% in the preceding two months or 30% or more in the three-month period immediately preceding such computation.

(2) The member has experienced a substantial change in the manner in which it processes its business which, in the view of the Corporation, increases the potential risk of loss to customers and members.

(3) The member's books and records are not maintained in accordance with the provisions of SEC Rules 17a-3 and 17a-4.

(4) The member is not in compliance, or is unable to demonstrate compliance, with applicable net capital requirements.

(5) The member is not in compliance, or is unable to demonstrate compliance, with SEC Rule 15c3-3 (Customer Protection Reserves and Custody of Securities).

(6) The member is unable to clear and settle transactions promptly.

(7) The member's overall business operations are in such a condition, given the nature and kind of its business that, notwithstanding the absence of any of the conditions enumerated in subparagraphs (1) through (6), a determination of financial or operational difficulty should be made, or

(8) The member is registered as a Futures Commission Merchant and its net capital is less than 7% of the funds required to be segregated pursuant to the Commodity Exchange Act and the regulations thereunder.

(b) For purposes of subparagraphs (b)(2) and (c)(2) of *Section 38A*, a member may be considered to be in or approaching financial or operational difficulty in conducting its operations and therefore subject to restrictions if it is determined by the Corporation that any of the parameters specified therein are exceeded or one or more of the following conditions exist:

(1) The member has experienced significant reduction in excess liquid capital in the preceding month or in the

three-month period immediately preceding such computation.

(2) The member has experienced a substantial change in the manner in which it processes its business which, in the view of the Corporation, increases the potential risk of loss to customers and members.

(3) The member's books and records are not maintained in accordance with the provisions of *Section 404.2* of the Treasury Department rules.

(4) The member is not in compliance, or is unable to demonstrate compliance, with applicable capital requirements of *Section 402* of the Treasury Department rules.

(5) The member is not in compliance, or is unable to demonstrate compliance, with *Section 403.4* of the Treasury Department rules (*Customer Protection—Reserve and Custody of Securities*).

(6) The member is unable to clear and settle transactions promptly.

(7) The member's overall business operations are in such a condition, given the nature and kind of its business that, notwithstanding the absence of any of the conditions enumerated in subparagraphs (1) through (6), a determination of financial or operational difficulty should be made.

(8) The member is registered as a Futures Commission Merchant and its net capital is less than required by *Section 402.1(d)* of the Treasury Department rules.

([b]c) If the Corporation determines that any of the conditions specified in subparagraphs (a) or (b) of this Explanation exist, it may require that the member take appropriate action by effecting one or more of the following actions until such time as the Corporation determines they are no longer required:

(1) Promptly pay all free credit balances to customers.

(2) Promptly effect delivery to customers of all fully-paid securities in the member's possession or control.

(3) Introduce all or a portion of its business to another member on a fully-disclosed basis.

(4) Reduce the size or modify the composition of its inventory.

(5) Postpone the opening of new branch offices or require the closing of one or more existing branch offices.

(6) Promptly cease making unsecured loans, advances or other similar receivables, and, as necessary, collect all such loans, advances or receivables where practicable.

(7) Accept no new customer accounts.

(8) Undertake an immediate audit by an independent public accountant at the member's expense.

(9) Restrict the payment of salaries or other sums to partners, officers, directors, shareholders, or associated persons of the member.

(10) Effect liquidating transactions only.

(11) Accept unsolicited customer orders only.

(12) File special financial and operating reports and/or

(13) Be subject to such other restrictions or take such other action as the Corporation deems appropriate under the circumstances in the public interest and for the protection of members.

Approval of Change in Exempt Status Under SEC Rule 15c3-3

Sec. 39. (a) Application—For the purposes of this section, the term "member" shall be limited to any member of the Association who is subject to SEC Rule 15c3-3 and is not designated to another self-regulatory organization by the Securities and Exchange Commission for financial responsibility pursuant to Section 17 of the Securities Exchange Act of 1934 and Rule 17d-1 promulgated thereunder. Further, the term shall not be applicable to any member that is subject to Section 402.2(c) of the rules of the Treasury Department.

(b) A member operating pursuant to any exemptive provision as contained in subparagraph (k) of SEC Rule 15c3-3 under the Securities Exchange Act of 1934 ("Rule 15c3-3"), shall not change its method of doing business in a manner which will change its exemptive status from that governed by subparagraph (k)(1) or (k)(2)([b]i) to that governed by subparagraph (k)(2)([a]i); or from subparagraph (k)(1), (k)(2)([a]i) or (k)(2)([b]i) to a fully computing firm that is subject to all provisions of Rule 15c3-3; or commence operations that will disqualify it for continued exemption under Rule 15c3-3 without first having obtained the prior written approval of the Association.

* * * * *

Sec. 40.-49. No change.

Article IV

Complaints

Sec. 1. No change.

* * * * *

Complaints by Public against Members for Violations of Rules

Sec. 2. Any person feeling aggrieved by any act, practice or omission of any member or any person associated with a member of the Corporation, which such person believes to be in violation of the Securities Exchange Act of 1934,

the rules and regulations thereunder, the rules of the Municipal Securities Rulemaking Board, or any of the Rules of Fair Practice of the Corporation, may, on the form to be supplied by the Board of Governors, file a complaint against such member or such persons associated with a member in regard thereto with any District Business Conduct Committee of the Corporation, and any such complaint shall be handled in accordance with the Code of Procedure of the Corporation.

Complaints by District Business Conduct Committees

Sec. 3. Any District Business Conduct Committee which, on information and belief, is of the opinion that any act, practice, or omission of any member of the Corporation or any person associated with a member is in violation of the Securities Exchange Act of 1934, the rules and regulations thereunder, the rules of the Municipal Securities Rulemaking Board, or any of the Rules of Fair Practice of the Corporation, may, on the form to be supplied by the Board of Governors, file a complaint against such member or such person associated with a member in regard thereto with itself or with any other District Business Conduct Committee of the Corporation, as the necessities of the complaint may require, and any such complaint shall be handled in accordance with the Code of Procedure and in the same manner as if it had been filed by an individual or member.

Complaints by the Board of Governors

Sec. 4. The Board of Governors shall have authority when on the basis of information and belief it is of the opinion that any act, practice or omission of any member of the Corporation or of any person associated with a member is in violation of the Securities Exchange Act of 1934, the rules and regulations thereunder, the rules of the Municipal Securities Rulemaking Board, or any rule of fair practice of the Corporation to file a complaint against such member of such person associated with a member in respect thereto or to instruct any District Business Conduct Committee to do so, and any such complaint shall be handled in accordance with the Code of Procedure.

Article V

Sanctions for Violation of the Rules

Sec. 1. Any District Business Conduct Committee, Market Surveillance Committee, the National Business Conduct Committee, any other committee exercising powers assigned

by the Board, or the Board in the administration and enforcement of the [se Rules,] Securities Exchange Act of 1934, the rules and regulations thereunder, or the rules of the Municipal Securities Rulemaking Board, or any of the Rules of Fair Practice, and after compliance with the Code of Procedure, may (1) censure any member or person associated with a member, and/or (2) impose a fine upon any member or person associated with a member, and/or (3) suspend the membership of any member or suspend the registration of a person associated with a member, if any, for a definite period, and/or for a period contingent on the performance of a particular act, and/or (4) expel any member or revoke the registration of any person associated with a member, if any, and/or (5) suspend or bar a member or person associated with a member from association with all members, and/or (6) impose any other fitting sanction deemed appropriate under the circumstances, for each or any violation of any of these Rules by a member or person associated with a member or for any neglect or refusal to comply with any orders, directions or decisions issued by any such committee or by the Board in the enforcement of these Rules, including any interpretative ruling made by the Board, as any such committee or the Board, in its discretion, may deem to be just; provided, however, that no such sanction imposed by any such committee shall take effect until the period for appeal therefrom or review thereof by the National Business Conduct Committee or the Board, as applicable, has expired and any such appeal or review has been completed in accordance with the Code or Procedure; and provided, further, that all parties to any proceeding resulting in a sanction shall be deemed to have assented to or to have acquiesced in the imposition of such sanction unless any party aggrieved thereby shall have made application for review pursuant to the Code of Procedure, within fifteen (15) days after the date of the decision rendered in such proceeding.

* * * * *

Article VI

No change.

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[GOVERNMENT SECURITIES RULES]

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[GOVERNMENT SECURITIES RULES]—
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[Government Securities Rules]

[Adoption of Rules]

[Sec. 1. The following provisions are adopted pursuant to Article VII, Section 1(a)(8) of the NASD By-Laws and Section 15A(f)(2) of the Securities Exchange Act of 1934.]

[Applicability]

[Sec. 2. (a) These rules shall apply to the government securities business of all members and persons associated with a member in order to implement and enforce the provision of the Securities Exchange Act of 1934 and the rules promulgated thereunder including the rules of the Treasury Department. Unless otherwise indicated herein, the requirements of these rules are in addition to those contained in the Rules of Fair Practice for members that are subject to the provisions of the Rules of Fair Practice. Persons associated with a member shall have the same duties and obligations as a member under these rules.]

[(b) A member or person associated with a member, who has been expelled, cancelled, or revoked from membership or from registration or who has been barred from being associated with all members, shall cease to have any privileges of membership or registration. A member or person associated with a member who has been suspended from membership or registration shall also cease to have any privileges of membership or registration other than those under the Code of Procedure or insurance programs sponsored by the

Corporation. In neither case shall such a member or person associated with a member be entitled to recover any admission fees, dues, assessments, or other charges paid to the Corporation.]

[(c) A member or person associated with a member who has been suspended from membership or from registration shall have all of the obligations imposed by the By-Laws, these rules, and other regulations of the Corporation.]

[Definitions in By-Laws and Rules of Fair Practice]

[Sec. 3. Unless the context otherwise requires, or unless defined in these rules, terms used in the rules and provisions hereby adopted, if defined in the By-Laws or Rules of Fair Practice shall have the meaning as defined therein.]

[Books and Records]

[Sec. 4.]

[Requirements]

[(a) Each member shall keep and preserve books, accounts, records, memoranda, and correspondence in conformity with all applicable laws, rules, regulations, and statements of policy promulgated thereunder and with the rules of this Association.]

[Information on accounts]

[(b) Each member shall maintain accounts of customers in such form and manner as to show the following information: name, address, and whether the customer is legally of age; signature of the registered representative introducing the accounts and signature of the member or the partner, officer, or manager accepting the account for the member. If the customer is associated with or employed by another member, this fact must be noted. In discretionary accounts, the member shall also record the age or approximate age and occupation of the customer as well as the signature of each person authorized to exercise discretion in such account.]

[Record of written complaints]

[(c) Each member shall keep and preserve either a separate file of all written complaints of customers and action taken by the member, if any, or a separate record of such complaints and a clear reference to the files containing the correspondence connected with such complaint.]

[“Complaint” defined]

[(d) A “complaint” shall be deemed to mean any written statement of a customer or any person acting on behalf of a customer alleging a grievance involving the activities of those persons

under the control of the member in connection with the solicitation or execution of any transaction or the disposition of securities or funds of that customer.]

[Supervision]

[Sec. 5.]

[Written procedures]

[(a) Each member shall establish, maintain, and enforce written procedures that will enable it to supervise properly the activities of each registered representative and associated person to ensure compliance with the applicable provisions of the Securities Exchange Act of 1934, rules, regulations, and statements of policy promulgated thereunder including the rules of the Treasury Department, and with the applicable rules of this Association.]

[Responsibility of member]

[(b) Final responsibility for proper supervision shall rest with the member. The member shall designate a partner, officer, or manager to carry out the written supervisory procedures. A copy of such procedures shall be kept in each office of the member.]

[Eligibility investigated]

[(c) Each member shall have the responsibility and the duty to ascertain by investigation the absence of any statutory disqualification as that term is defined under Section 3(a)(39) or 15C(c) of the Securities Exchange Act of 1934 and that any application for registration by an associated person is complete and accurate.]

[Regulation of Activities of Members Experiencing Financial and/or Operational Difficulties]

[Sec. 6. (a) Application—For the purposes of this rule, the term “member” shall be limited to any member of the Association registered with the Securities and Exchange Commission pursuant to Section 15C of the Securities Exchange Act of 1934 that is not designated to another self-regulatory organization by the Securities and Exchange Commission for financial responsibility pursuant to Section 17 of the Securities Exchange Act of 1934 and Rule 17d-1 thereunder. Further, the term shall not be applicable to any member that is subject to Section 402.2(c) of the rules of the Treasury Department.]

[(b) A member, when so directed by the Association, shall not expand its business during any period in which:]

[(1) Any of the following conditions continue to exist, or have existed, for

more than fifteen (15) consecutive business days:]

[(A) A firm’s liquid capital is less than 150 percent of the total haircuts or such greater percentage thereof as may from time to time be prescribed by the Association.]

[(B) A firm’s liquid capital minus total haircuts is less than 150 percent of its minimum dollar capital requirement.]

[(C) The deduction of ownership equity and maturities of subordinated debt scheduled during the next six months would result in any one of the conditions described in (A) or (B) of this subparagraph (1).]

[(2) The Association restricts the member for any other financial or operational reason.]

[(c) A member, when so directed by the Association, shall forthwith reduce its business:]

[(1) To a point enabling its available capital to comply with the standards set forth in subparagraphs (b)(1)(A), (B), or (C) of this rule if any of the following conditions continue to exist, or have existed, for more than fifteen (15) consecutive business days:]

[(A) A firm’s liquid capital is less than 125 percent of total haircuts or such greater percentage thereof as may from time to time be prescribed by the Association.]

[(B) A firm’s liquid capital minus total haircuts is less than 125 percent of its minimum dollar capital requirement.]

[(C) The deduction of ownership equity and maturities of subordinated debt scheduled during the next six months would result in any one of the conditions described in (A) or (B) of this subparagraph (1).]

[(2) As required by the Association when it restricts a member for any other financial or operational reason.]

[• • • Explanation of the Board of Governors]

[Restrictions on a Member’s Activity]

[This explanation outlines and discusses some of the financial and operational deficiencies which could initiate actions under the rule. Subparagraphs (b)(2) and (c)(2) of the rule recognize that there are various unstated financial and operational reasons for which the Association may impose restrictions on a member so as to prohibit its expansion or to require a reduction in overall level of business. These provisions are deemed necessary in order to provide for the variety of situations and practices which do arise and, which if allowed to persist, could result in increased exposure to customers and to broker-dealers.]

[In the opinion of the Board of Governors, it would be impractical and

unwise to attempt to identify and list all of the situations and practices that might lead to the imposition of restrictions or the types of remedial actions the Corporation may direct be taken because they are numerous and cannot be totally identified or specified with any degree of precision. The Board believes, however, that it would be helpful to members' understanding to list some of the other bases upon which the Corporation may conclude that a member is in or approaching financial difficulty.]

[(a) For purposes of subparagraphs (b)(2) and (c)(2) of the rule, a member may be considered to be in or approaching financial or operational difficulty in conducting its operations and therefore subject to restrictions if it is determined by the Corporation that any of the parameters specified therein are exceeded or one or more of the following conditions exist:]

[(1) The member has experienced significant reduction in excess liquid capital in the preceding month or in the three-month period immediately preceding such computation.]

[(2) The member has experienced a substantial change in the manner in which it processes its business which, in the view of the Corporation, increases the potential risk of loss to customers and members.]

[(3) The member's books and records are not maintained in accordance with the provisions of Section 404.2 of the Treasury Department rules.]

[(4) The member is not in compliance, or is unable to demonstrate compliance, with applicable capital requirements of Section 402 of the Treasury Department rules.]

[(5) The member is not in compliance, or is unable to demonstrate compliance, with Section 403.4 of the Treasury Department rules (Customer Protection—Reserve and Custody of Securities).]

[(6) The member is unable to clear and settle transactions promptly.]

[(7) The member's overall business operations are in such a condition, given the nature and kind of its business that, notwithstanding the absence of any of the conditions enumerated in subparagraphs (1) through (6), a determination of financial or operational difficulty should be made.]

[(8) The member is registered as a Futures Commission Merchant and its net capital is less than required by Section 402.1(d) of the Treasury Department rules.]

[(b) If the Corporation determines that any of the conditions specified in subparagraph (a) of this Explanation exists, it may require that the member

take appropriate action by effecting one or more of the following actions until such time as the Corporation determines they are no longer required:]

[(1) Promptly pay all fee credit balances to customers.]

[(2) Promptly effect delivery to customers of all fully paid securities in the member's possession or control.]

[(3) Introduce all or a portion of its business to another member on a fully disclosed basis.]

[(4) Reduce the size or modify the composition of its inventory.]

[(5) Postpone the opening of new branch offices or require the closing of one or more existing branch offices.]

[(6) Promptly cease making unsecured loans, advances, or other similar receivables, and, as necessary, collect all such loans, advances, or receivables where practicable.]

[(7) Accept no new customer accounts.]

[(8) Undertake an immediate audit by an independent public accountant at the member's expense.]

[(9) Restrict the payment of salaries or other sums to partners, officers, directors, shareholders, or associated persons of the member.]

[(10) Effect liquidating transactions only.]

[(11) Accept unsolicited customer orders only.]

[(12) File special financial and operating reports.]

[(13) Be subject to such other restrictions or take such other actions as the Corporation deems appropriate under the circumstances in the public interest and for the protection of members.]

[Approval of Change in Exempt Status Under SEC Rule 15c3-3]

[Sec. 7. (a) Application—For the purposes of this rule, the term "member" shall be limited to any member of the Association that is not designated to another self-regulatory organization by the Securities and Exchange Commission for financial responsibility pursuant to Section 17 of the Securities Exchange Act of 1934 and Rule 17d-1 thereunder. Further, the term shall not be applicable to any member that is subject to Section 402.2(c) of the rules of the Treasury Department.]

[(b) A member operating pursuant to any exemptive provision as contained in subparagraph (k) of SEC Rule 15c3-3 under the Securities Exchange Act of 1934 (Rule 15c3-3), shall not change its method of doing business in a manner that will change its exemptive status from that governed by subparagraph (k)(1) or (k)(2)(ii) to that governed by

subparagraph (k)(2)(i); or from subparagraph (k)(1), (k)(2)(i), or (k)(2)(ii) to a fully computing firm that is subject to all provisions of Rule 15c3-3; or commence operations that will disqualify it for continued exemption under Rule 15c3-3 without first having obtained the prior written approval of the Association.]

[(c) In making the determination as to whether to approve or to deny in whole or in part an application made pursuant to subsection (b), the Association staff shall consider, among other things, the type of business in which the member is engaged, the training, and experience, of persons associated with the member, the member's procedures for safeguarding customer funds and securities, the member's overall financial and operational condition and any other information deemed relevant in the particular circumstances and the time these measures would remain in effect.]

[Communications With the Public]

[Sec. 8]

[(a) Definitions]

[(1) Advertisement—For purposes of this section and any interpretation thereof, "advertisement" means material published, or designed for use in, a newspaper, magazine, or other periodical, radio, television, telephone or tape recording, videotape display, signs or billboards, motion pictures, telephone directories (other than routine listings), or other public media.]

[(2) Sales Literature—For purposes of this section and any interpretation thereof, "sales literature" means any written communication distributed or made generally available to customers or the public that does not meet the foregoing definition of "advertisement." Sales literature includes, but is not limited to, circulars, research reports, market letters, performance reports or summaries, form letters, standard forms of option worksheets, seminar texts, and reprints or excerpts of any other advertisement, sales literature, or published article.]

[(b) Approval and Recording]

[(1) Each item of advertising and sales literature shall be approved by signature or initial, prior to use, by a registered principal (or designee) of the member.]

[(2) A separate file of all advertisements and sales literature, including the name(s) of the person(s) who prepared them and/or approved their use, shall be maintained for a period of three years from the date of each use.]

[(c) Filing Requirements and Review Procedures]

[(1) Members shall file advertisements for review with Association's Advertising Regulation Department as follows:]

[(A) Advertisements concerning government securities (as defined in Section 3(a)(42) of the Securities Exchange Act of 1934) other than collateralized mortgage obligations shall be filed by members with the Association's Advertising Department for review within 10 days of first use or publication; and]

[(B) advertisements concerning collateralized mortgage obligations shall be filed with the Association's Advertising Regulation Department for review at least 10 days prior to use (or such shorter period as the Department may allow in particular circumstances) for approval and, if changed or expressly disapproved by the Association, shall be withheld from publication or circulation until any changes specified by the Association have been made or, in the event of disapproval, until the advertisement has been refiled for, and has received, Association approval.]

[(2) Each member of the Association that has not previously filed advertisements with the Association shall file its initial advertisement concerning government securities with the Association's Advertising Department at least 10 days prior to use and shall continue to file its advertisements concerning government securities at least 10 days prior to use for a period of one year.]

[(3) Notwithstanding the foregoing provisions, any District Business Conduct Committee of the Association, upon review of a member's government securities advertising and/or sales literature, and after determining that the member will again depart from the standards of this section, may require that such member file all government securities advertising and/or sales literature, or the portion of such member's material that is related to any specific types or classes of securities or services, with the Association's Advertising Department and/or the District Committee, at least 10 days prior to use.]

[The Committee shall notify the member in writing of the types of material to be filed and the length of time such requirement is to be in effect. The requirement shall not exceed one year, however, and shall not take effect until 30 days after the member receives the written notice, during which time the member may request a hearing

before the District Business Conduct Committee, and any such hearing shall be held in reasonable conformity with the hearing and appeal procedures of the Code of Procedure.]

[(4) In addition to the foregoing requirements, every member's government securities advertising and sales literature shall be subject to a routine spot-check procedure. Upon written request from the Association's Advertising Department, each member shall promptly submit the material requested. Members will not be required to submit material under this procedure that has been previously submitted pursuant to one of the foregoing requirements.]

[(5) The following types of material are excluded from the foregoing filing requirements and spot-check procedure:]

[(A) Advertisements of sales literature solely related to changes in a member's name, personnel, location, ownership, offices, business structure, officers or partners, telephone or teletype numbers, or concerning a merger with, or acquisition by, another member;]

[(B) Advertisements or sales literature that do no more than identify the member and/or offer a specific security at a stated price;]

[(C) Material sent to branch offices or other internal material that is not distributed to the public;]

[(6) Material that refers to government securities solely as part of a listing products and/or services offered by the member, is excluded from the requirements of paragraph (c)(1) of this section.]

[(d) Standards Applicable to Communications With the Public]**[(1) General Standards]**

[(A) All member communications with the public shall be based on principles of fair dealing and good faith and should provide a sound basis for evaluating the facts in regard to any particular security or securities or type of security, industry discussed, or service offered. No material fact or qualification may be omitted if the omission, in light of the context of the material presented, would cause the advertising or sales literature to be misleading.]

[(B) Exaggerated, unwarranted, or misleading statements or claims are prohibited in all public communications of members. In preparing such literature, members must bear in mind that inherent in investment are the risks of fluctuating prices and the uncertainty of dividends, rates of return, and yield, and no member shall, directly or

indirectly publish, circulate, or distribute any public communication that the member knows or has reason to know contains any untrue statement of a material fact or is otherwise false or misleading.]

[(C) When sponsoring or participating in a seminar, forum, radio, or television interview, or when otherwise engaged in public appearances or speaking activities that may not constitute advertisements, members and persons associated with members shall nevertheless follow the standards of paragraph (d) of this section.]

[(2) Specific Standards]

[In addition to the foregoing general standards, the following specific standards apply:]

[(A) Necessary Data: Advertisements and sales literature shall contain the name of the member, the person or firm preparing the material, if other than the member, and the date on which it is first published, circulated, or distributed (except that, in advertisements, only the name of the member need be stated; and except also that, in any so-called "blind" advertisement used for recruiting personnel, the name of the member may be omitted). If the information in the material is not current, this fact should be stated.]

[(B) Recommendations: In making a recommendation, whether or not labeled as such, a member must have a reasonable basis for the recommendation made and must disclose the price at the time the recommendation is made, as well as any of the following situations which are applicable:]

[(i) that the member usually makes a market in the securities being recommended, or in the underlying security if the recommended security is an option, and/or that the member or associated persons will sell to or buy from customers on a principal basis;]

[(ii) that the member and/or its officers or partners own options, rights, or warrants to purchase any of the securities of the issuer whose securities are recommended, unless the extent of such ownership is nominal;]

[(iii) that the member was manager or co-manager of a public offering of any securities of the recommended issuer within the last three years.]

[The member shall also provide, or offer to furnish upon request, available investment information supporting the recommendation.]

[A member may use material referring to past recommendations if it sets forth all recommendations as to the same type, kind, grade, or classification of securities made by a member within the

last year. More years may be covered if they are consecutive and include the most recent year. Such material must also name each security recommended and give the date and nature of each recommendation (e.g., whether to buy or sell), the price at the time of the recommendation, the price at which or the price range within which the recommendations was to be acted upon, and the general market conditions during the period covered.]

[Also permitted is material that does not make any specific recommendation but offers to furnish a list of all recommendations made by a member within the past year or over more consecutive years, including the most recent year, if this list contains all the information specified in the previous paragraph. Neither the list of recommendations, nor material offering such list, shall imply comparable future performance. Reference to the results of a previous specific recommendation, including such a reference in a follow-up research report or market letter, is prohibited if the intent or the effect is to show the success of a past recommendation, unless all of the foregoing requirements with respect to past recommendations are met.]

[(C) Claims and Opinions: Communications with the public must not contain promises of specific results, exaggerated, or unwarranted claims or unwarranted superlatives, opinions for which there is no reasonable basis, or forecasts of future events that are unwarranted or that are not clearly labeled as forecasts.]

[(D) Testimonials: In testimonials concerning the quality of a firm's investment advice, the following points must be clearly stated in the communication:]

[(i) the testimonial may not be representative of the experience of other clients;]

[(ii) the testimonial is not indicative of future performance or success;]

[(iii) if more than a nominal sum is paid, the fact that it is a paid testimonial must be indicated;]

[(iv) if the testimonial concerns a technical aspect of investing, the person making the testimonial must have knowledge and experience to form a valid opinion.]

[(E) Offers of Free Service: Any statement to the effect that any report, analysis, or other service will be furnished free or without any charge must not be made unless such report, analysis, or other service actually is or will be furnished entirely free and without condition or obligation.]

[(F) Claims for Research Facilities: No claim or implication may be made for

research or other facilities beyond those that the member actually possesses or has reasonable capacity to provide.]

[(G) Hedge Clauses: No cautionary statements or caveats, often called "hedge clauses," may be used if they are misleading or inconsistent with the content of the material.]

[(H) Recruiting Advertising: Advertisements in connection with the recruitment of sales personnel must not contain exaggerated or unwarranted claims or statements about opportunities in the investment banking or securities business and should not refer to specific earnings figures or ranges that are not reasonable under the circumstances.]

[(I) Periodic Investment Plans: Communications with the public should not discuss or portray any type of continuous or periodic investment plan without disclosing that such a plan does not assure a profit and does not protect against loss in declining markets. In addition, if the material deals specifically with the principles of dollar cost averaging, it should point out that since such a plan involves continuous investment in securities regardless of fluctuating price levels of such securities, the investor should consider his financial ability to continue his purchases through periods of low price levels.]

[(J) References to Regulatory Organizations: Communications with the public shall not make any reference to membership in the Association or to registration or regulation of the securities being offered, or of the underwriter, sponsor, or any member or associated person, that could imply endorsement or approval by the Association or any federal or state regulatory body.]

[References to membership in the Association or the Securities Investor Protection Corporation shall comply with all applicable by-laws and rules pertaining thereto].

[(K) Identification of Sources: Statistical tables, charts, graphs, or other illustrations used by members in advertising or sales literature should disclose the source of the information if not prepared by the member.]

[Availability to Customers of Certificate, By-Laws, Rules, and Code of Procedure]

[Sec. 9. Every member of the Corporation shall keep in each office maintained by him, in the form to be supplied by the Board of Governors, a copy of the Certificate of Incorporation, By-Laws, Government Securities Rules, and Code of Procedure of the Corporation, and of all additions and amendments from time to time made

thereto, and of all interpretative rulings made by the Board of Governors, all of which shall be available for the examination of any customer who makes requests therefore.]

[Complaints]

[Sec. 10.]

[Complaints by public against members]

[(a) Any person feeling aggrieved by any act, practice, or omission of any member or any person associated with a member of the Corporation, which such person believes to be in violation of the Securities Exchange Act of 1934, the rules and regulations thereunder including the rules of the Treasury Department or these Government Securities rules, may, on the form to be supplied by the Board of Governors, file a complaint against such member or such persons associated with a member in regard thereto with any District Business Conduct Committee of the Corporation, and any such complaint shall be handled in accordance with the Code of Procedure of the Corporation.]

[Complaints by District Business Conduct Committees]

[(b) Any District Business Conduct Committee which, on information and belief, is of the opinion that any act, practice, or omission of any member of the Corporation or any person associated with a member is in violation of the Securities Exchange Act of 1934, the rules and regulations thereunder including the rules of the Treasury Department or these Government Securities rules may, on the form to be supplied by the Board of Governors, file a complaint against such member or such person associated with a member in regard thereto with itself or with any other District Business Conduct Committee of the Corporation, as the necessities of the complaint may require, and any such complaint shall be handled in accordance with the Code of Procedure and in the same manner as if it had been filed by an individual or member.]

[Complaints by the Board of Governors]

[(c) The Board of Governors shall have authority, when on the basis of information and belief, it is of the opinion that any act, practice, or omission of any member of the Corporation or of any person associated with a member is in violation of the Securities Exchange Act of 1934, the rules and regulations thereunder including the rules of the Treasury Department or these Government Securities rules, to file a complaint against such member or such person

associated with a member in respect thereto or to instruct any District Business Conduct Committee to do so, and any such complaint shall be handled in accordance with the Code of Procedure.]

[Reports and Inspection of Books for Purpose of Investigating Complaints]

[Sec. 11. For the purpose of any investigation, or determination as to filing of a complaint, or any hearing of any complaint against any member of the Corporation or any person associated with a member made or held in accordance with the Code of Procedure, any District Business Conduct Committee, or the Board of Governors, or any duly authorized agent or agents of any such Committee or Board shall have the right to:]

[(1) require any member of the Corporation or person associated with a member to report orally or in writing with regard to any matter involved in any such investigation or hearing; and]

[(2) to investigate the books, records and accounts of any such member with relation to any matter involved in any such investigation or hearing.]

[No member or person associated with a member shall refuse to make any report as required in this Section, or refuse to permit any inspection of books, records, and accounts as may be validly called for under this Section.]

[Sanctions for violation of the Rules]

[Sec. 12. Any District Business Conduct Committee, Market Surveillance Committee, or the Board of Governors, in the administration and enforcement of the Securities Exchange Act of 1934, the rules and regulations thereunder including the rules of the Treasury Department or these Government Securities rules, and after compliance with the Code of Procedure, may:]

[(1) censure any member or person associated with a member; and/or]

[(2) impose a fine upon any member or person associated with a member; and/or]

[(3) suspend the membership of any member or suspend the registration of a person associated with a member, if any, for a definite period; and/or]

[(4) expel any member or revoke the registration of any person associated with a member, if any; and/or]

[(5) suspend or bar a member or person associated with a member from association with all members; or]

[(6) impose any other fitting sanction deemed appropriate under the circumstances, for each or any violation of such provisions by a member or person associated with a member or for

any neglect or refusal to comply with any orders, directions, or decisions issued by any District Business Conduct Committee, Market Surveillance Committee, or by the Board of Governors in the enforcement of these rules, including any interpretation made by the Board of Governors, as any such Committee or Board, in its discretion, may deem to be just;]

[provided, however, that no such sanction imposed by any District Business Conduct Committee or Market Surveillance Committee, shall take effect until the period for appeal therefrom or review has expired, as provided in Article III, Section 1 of the Code of Procedure; and provided, further, that all parties to any proceeding resulting in a sanction shall be deemed to have assented to or to have acquiesced in the imposition of such sanction unless any party aggrieved thereby shall have made application to the Board of Governors for review pursuant to the Code of Procedure, within fifteen (15) days after the date of such notice.]

[Sec. 13. All fines imposed pursuant to Section 12 of these rules shall be paid to the Treasurer of the Corporation and shall be used for the general corporate purposes. Any member that fails promptly to pay any fine imposed pursuant to Section 12 of these rules, or any costs imposed pursuant to Section 12 of these rules, or any costs imposed pursuant to Section 14 of these rules after such fine or costs have become finally due and payable, may after seven (7) days' notice in writing be summarily suspended or expelled from membership on the Corporation. A member may also be summarily suspended or expelled from membership in the Corporation if the member fails to immediately terminate the association of any person who fails to pay promptly any fine imposed pursuant to Section 12 of these rules or any costs imposed pursuant to Section 14 of these rules after such fine or costs have become finally due and payable after seven (7) days' notice in writing. The registration of a person associated with a member, if any, may be summarily revoked if such person fails to pay promptly any fine imposed pursuant to Section 12 of these rules, or any costs pursuant to Section 14 of these rules after such fine or costs have become finally due and payable after seven (7) days' notice in writing.]

[Cost of proceedings]

[Sec. 14. Any member or person associated with such member disciplined pursuant to Section 12 of

these rules shall bear such part of the costs of the proceedings as the District Business Conduct Committee or the Board of Governors deems fair and appropriate in the circumstances.]

Code of Procedure

Article I

No change.

Article II

Disciplinary Actions by District Business Conduct Committees, the Market Surveillance Committee and Others

* * * * *

Acceptance, Waiver and Consent, Minor Rule Violations, and Summary Complaint Procedures

Sec. 10. A Committee, may, prior to issuance of a complaint under Section 1 of this Article, impose disciplinary penalties pursuant to the procedures set forth under this Section 10.

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Appendix

Violations Appropriate For Disposition Under The Minor Rule Violations Plan

* * * * *

- Article III, Subsections 35 (b) and (c) and 35A (b) and (c) of the Rules of Fair Practice [and Subsections 8 (b) and (c) of the Government Securities Rules]—Failure to have advertisements and sales literature approved by a principal prior to use, failure to maintain separate files of advertisements and sales literature containing required information, and failure to file advertisements with the Association within the required time limits.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the NASD included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The NASD has prepared summaries, set forth in Sections (A), (B), and (C) below, of the most significant aspects of such statements.

(A) *Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change*

1. *Purpose*

Application of the Rules of Fair Practice to Exempted Securities Except Municipals and Merger of Government Securities Rules

The Government Securities Act Amendments of 1993 ("Government Securities Amendments") were signed into law on December 13, 1993, and eliminated the statutory limitations on the NASD's authority to regulate the sales practices of exempted securities, including government securities transactions, other than municipals.⁴

In order to implement the expanded sales practice authority granted to the NASD pursuant to the Government Securities Amendments, the NASD is proposing to delete the NASD Government Securities Rules and apply the NASD Rules of Fair Practice, where applicable, to exempted securities, including government securities other than municipals.⁵ The Government Securities Rules, therefore, are being deleted in their entirety and certain of these rules are proposed to be merged into the Rules of Fair Practice.

Set forth below is a description of the amendments proposed to the Rules of Fair Practice that would apply the Rules of Fair Practice to exempted securities (except municipals) and would merge certain provisions of the Government Securities Rules. This is followed by a chart depicting the applicability of the Rules of Fair Practice to transactions in exempted securities (except municipals).

Article I of the Rules of Fair Practice

Section 4. The NASD proposes to amend Article I, Section 4 of the Rules of Fair Practice to replace the term "exempted" with the term "municipal" in order to make the Rules of Fair Practice applicable, as appropriate, to exempted securities, including government securities other than municipals.

Section 5. The NASD proposes to amend Article I, Section 5(a) of the Rules of Fair Practice by deleting the phrase "other than those members registered with the Securities and Exchange Commission solely under the provisions of Section 15C of the Act and persons associated with such members" in order to expand the application of the

Rules of Fair Practice to members involved in the government securities business pursuant to Section 15C of the Act.

Article III of the Rules of Fair Practice: Primary Amendments

Section 1: Prompt Receipt and Delivery Interpretation. Paragraph (b)(2)(a) of the Interpretation of the Board of Governors—Prompt Receipt and Delivery and Securities under Article III, Section 1 of the Rules of Fair Practice exempts "transactions in corporate debt securities" from the NASD requirement that a member cannot accept a "short" sale order for any customer in any security unless the member can make an affirmative determination that the member will receive the security from the customer or that the member can borrow the security on behalf of the customer for delivery by settlement date. Paragraph (b)(2)(b) under this Interpretation similarly exempts "transactions in corporate debt securities" from the NASD requirement that a member cannot effect a "short sale" for any customer or its own account in any security unless the member or person associated with a member makes an affirmative determination that the member can borrow the securities or otherwise provide for delivery of the securities by the settlement date.

The regulatory rationale for exempting transactions in corporate debt securities from the Prompt Receipt and Delivery Interpretation is that many short-selling transactions in the corporate debt market are "for the purpose of risk reduction and market liquidity and to ensure their availability for bona fide purposes."⁶ The NASD believes that short-selling transactions provide similar risk reduction and market liquidity in all debt markets. The NASD therefore, proposes to delete the term "corporate" from both paragraphs (b)(2)(a) and (b) of the Interpretation of the Board of Governors—Prompt Receipt and Delivery of Securities, under Article III, Section 1 of the Rules of Fair Practice to expand the short-sale exemptions under those provisions to all debt.

Section 1: Free-Riding and Withholding Interpretation. The NASD has determined that the Interpretation of the Board of Governors—Free-Riding and Withholding under Article III, Section 1 of the Rules of Fair Practice may apply to certain arrangements necessary for the distribution of

government securities, *i.e.*, that members may be considered to purchase government securities for their own account. The NASD, however, is not aware of any situation which would indicate that there are abuses in the distribution practices related to government securities that requires the application of the Interpretation. The NASD, therefore, proposes to amend the Interpretation to clarify that it does not apply to transactions in government securities in order to ensure that normal distribution practices in government securities are not adversely affected by this rule.

Section 21(b)(i): "Marking of Customer Order Ticket" Rule. Corporate debt is exempted from Article III, Section 21(b)(i) of the Rules of Fair Practice, which requires that a person associated with a member indicate on the memorandum for sale of a security whether the order is "long" or "short." The NASD has determined that Section 21(b)(i) to Article III of the Rules of Fair Practice should not be applicable to the market for any debt securities, where short sales are not known to raise the investor protection concerns that are associated with transactions in equity securities. In particular, with respect to the market for mortgage-backed securities, the concern exists that the application of Section 21(b)(i) would create confusion for brokers selling securities that have been purchased but not yet received because of this market's extended settlement periods. The NASD, therefore, proposes to amend Section 21(b)(i) to exempt all debt securities, other than municipals from the "marking of customer order ticket" rule.

Section 25: Transactions in Exempted Securities. Section 25 to Article III of the Rules of Fair Practice prohibits NASD members from dealing with a non-member broker/dealer except at the same prices and on the same terms afforded the general public. At Section 25 to Article III of the Rules of Fair Practice is the Interpretation of the Board of Governors—Transactions Between Members and Non-Members. This Interpretation, under Part 2—Transactions in "Exempted Securities" reminds members that the Rules of Fair Practice do not apply to transactions, whether between members or between members and non-members, in "exempted securities" pursuant to Article I, Section 4 of the Rules of Fair Practice.

In light of the proposed rule change to Article I Section 4 of the Rules of Fair Practice that reflects the NASD's expanded authority over exempted securities, the Association is proposing

⁴ *Id.*

⁵ The terms exempted securities, government securities and municipal securities are defined in Sections 3(a)(12), 3(a)(42) and 3(a)(29) of the Act.

⁶ Securities Exchange Act Release No. 27409 (October 31, 1989), 54 FR 46665 (November 6, 1989).

to amend Part 2 to the above Interpretation to state that Section 25 of Article III of the Rules of Fair Practice shall not apply to "exempted securities." The NASD has determined that the provisions of Section 25 should continue to not apply to transactions in exempted securities in order to permit foreign non-member broker/dealers to continue to purchase exempted securities, including government securities, without compliance with Article III, Section 25(c). Section 25(c) requires a foreign non-member broker/dealer to agree in writing to conform to the requirements of Section 25 when making any sales to purchasers within the U.S. of securities acquired as a result of a transaction with the member. The NASD believes it would difficult at this time to accurately determine the potential adverse effects to the government securities markets if the NASD required members to obtain such

agreements from foreign non-member broker/dealers that purchase government securities from NASD members.

Amendments Merging Government Securities Rules into Rules of Fair Practice

The NASD proposes to merge certain provisions contained solely under the Government Securities Rules into corresponding sections of the Rules of Fair Practice in order to provide NASD members with one set of sales practice rules that will reflect the NASD's expanded authority under the Government Securities Amendments. The NASD specifically proposes to add provisions of the Government Securities Rules into Article III, Section 21(c)(3), 38, and 39; Article IV, Sections 1 to 4; and Article V, Section 1 of the Rules of Fair Practice. The NASD also proposes to move provisions contained under Section 6 of the Government Securities

Rules into a new Section 38A to Article III of the Rules of Fair Practice. The NASD also proposes to add references, where appropriate, to Section 402.2(c) of the rules of the Treasury Department. To effect these amendments, the NASD has reorganized and renumbered a number of the provisions contained in the above-referenced sections of the Rules of Fair Practice.

Set forth below is a table identifying the provisions of the Government Securities Rules and the corresponding provisions of the Rules of Fair Practice into which the Government Securities Rules have been merged by amendment to those provisions. In addition, the table indicates the corresponding section of the Rules of Fair Practice for each Government Securities Rule where no rule language change is necessary because of the expanded authority under Article I, Section 5 of the Rules of Fair Practice.

GOVERNMENT SECURITIES RULES MERGED INTO THE RULES OF FAIR PRACTICE

Government Securities Rules Merged Into Rules of Fair Practice

Sec. 1 Adoption of Rules	Article I, Sec. 1—No change.
Sec. 2 Applicability: Subsection (a)	Subsection (b).
Sec. 3 Definitions in By-Laws and Rules of Fair Practice	Article I, Sec. 4 and 5(a). Article I, Sec. 5(b) and (c)—No change. Article II, Sec. 1 and 2—No change.
Sec. 4 Books and Records	Article III, Sec. 21.
Sec. 5 Supervision	Article III, Sec. 27—No change.
Sec. 6 Regulation of Activities of Members Experiencing Financial and/or Operational Difficulties. Explanation of Board of Governors—Restrictions on a Member's Activity.	Article III, Sec. 38 and 38A.
Sec. 7 Approval of Change in Exempt Status under SEC Rule 15c3-3	Article III, Sec. 39.
Sec. 8 Communications with the Public	Article III, Sec. 35—No change.
Sec. 9 Availability to Customers of Certificate, By-Laws, Rules, and Code of Procedure.	Article IV, Sec. 1—No change.
Sec. 10 Complaints: Subsection (a) Complaints by Public Against Members	Article IV, Sec. 2.
Subsection (b) Complaints by District Business Conduct Committees.	Article IV, Sec. 4.
Subsection (c) Complaints by the Board of Governors	Article IV, Sec. 4.
Sec. 11 Reports and Inspection of Books for Purpose of Investigating Complaints Resolution of Board of Governors—Suspension of Members for Failure to Furnish Information Duly Requested.	Article IV, Sec. 5—No change.
Sec. 12 Sanctions for Violation of the Rules	Resolution of Board of Governors—Suspension of Members for Failure to Furnish Information Duly Requested—No change. Article V, Sec. 1.
Sec. 13 Payment of Fines or Costs	Article V, Sec. 2—No change.
Sec. 14 Cost of Proceedings	Article V, Sec. 3—No change.

Conforming References

The NASD proposes to make conforming changes to NASD By-Laws, Schedules to the By-Laws, the Rules of Fair Practice, and the Code of Procedure by eliminating references to provisions of the Government Securities Rules or the terms "exempted security" or "exempted securities" and replacing these terms, where applicable, with the

appropriate Rules of Fair Practice or the term "municipal" securities, respectively. The conforming changes regarding such references are made to Section (o) to Article I of the By-Laws; Section 13 to Schedule A of the By-Laws; Part VI, Section 1 Schedule C to the By-Laws; Article III, Section 35 of the Rules of Fair Practice; and the Appendix entitled "Violations Appropriate For Disposition Under the

Minor Rule Violations Plan" under Article II, Section 10 of the Code of Procedure.

Other Technical Amendments

The NASD proposes to modify references to SEC Rules 15c3-1 and 15c3-3 to reflect amendments by the SEC to those rules. Such technical changes are made under Part II, Section 2(b)(iv) of Schedule C to the By-Laws

and under Article III, Sections 38, and 39 of the Rules of Fair Practice.

Applicability of the Rules of Fair Practice

The NASD intends that the proposed rule change would apply the Rules of Fair Practice, where appropriate, to activities involving exempted securities, pursuant to the proposed changes

described above under Article I, Sections 4 and 5 to the Rules of Fair Practice. The NASD, therefore, has reviewed all Rules of Fair Practice, as well as Interpretations and Policies thereunder, to determine their applicability or non-applicability to exempt securities. To clarify the application of specific rules, interpretations and policies of the Rules

of Fair Practice under the proposed rule change, the NASD intends to provide by publication in a Notice to Members (upon approval of the proposed rule change by the Commission) the following summary of applicable and non-applicable rules, interpretations and policies of the Rules of Fair Practice.

APPLICABILITY OF THE RULES OF FAIR PRACTICE TO EXEMPTED SECURITIES, INCLUDING GOVERNMENT SECURITIES (EXCEPT MUNICIPALS)

Article III

Section 1	Business Conduct of Members Interpretations of the Board of Governors— Execution of Retail Transactions in the Over-the-Counter Market Prompt Receipt and Delivery Forwarding of Proxy and Other Materials Free-Riding and Withholding Interpretation on Limit Order Protection Front Running Policy	Applicable. Applicable. Applicable. Not Applicable. Amending to be Not Applicable. Not Applicable. Applicable.
Section 2	Recommendations to Customers Policy of the Board of Governors—Fair Dealing With Customers Policy	Applicable. Applicable.
Section 3	Charges to Customers	Applicable.
Section 4	Fair Prices and Commission Interpretation of the Board of Governors—NASD Mark-Up Policy	Applicable. Applicable. ⁷
Section 5	Publication of Transactions and Quotations Interpretation of the Board of Governors—Manipulative and Deceptive Quotations	Applicable. Applicable.
Section 6	Offers at Stated Prices Policy of the Board of Governors—Policy With Respect to Firmness of Quotations	Applicable. Applicable.
Section 7	Disclosure of Prices in Selling Agreements	Applicable only to traditional underwriter arrangements.
Section 8	Securities Taken in Trade Interpretation of the Board of Governors—Safe Harbor and Presumption of Compliance	Not Applicable. Not Applicable.
Section 9	Use of Information Obtained in Fiduciary Capacity	Applicable.
Section 10	Influencing or Rewarding Employees of Others	Applicable.
Section 11	Payment Designed to Influence Market Prices, Other than Paid Advertising	Applicable.
Section 12	Disclosure on Confirmations	Not Applicable; superseded by SEC rules.
Section 13	Disclosure of Control	Not Applicable.
Section 14	Disclosure of Participation or Interest in Primary or Secondary Distribution	Applicable.
Section 15	Discretionary Accounts	Applicable.
Section 16	Offers "At the Market"	Not Applicable.
Section 17	Solicitation of Purchases on an Exchange to Facilitate a Distribution of Securities	Applicable.
Section 18	Use of Fraudulent Devices	Applicable.
Section 19	Customers Securities or Funds	Applicable.
Section 20	Installment or Partial Payment Sales	Applicable.
Section 21	Books and Records	Applicable, except for proposed amendments to Subsection (b)(i).
Section 22	Disclosure of Financial Condition	Applicable.
Section 23	Net Prices to Persons Not in Investment Banking or Securities Business	Applicable.
Section 24	Selling Concessions Interpretation of the Board of Governors—Services in Distribution	Not Applicable. Not Applicable.
Section 25	Dealing with Non-Members Interpretation of the Board of Governors—Transactions Between Members and Non-members.	Amending to be Not Applicable. Not Applicable.
Section 26	Investment Companies	Not Applicable.
Section 27	Supervision	Applicable.
Section 28	Transactions for or by Associated Persons	Applicable.
Section 29	Variable Contracts of an Insurance Co	Not Applicable.
Section 30	Margin Accounts	Applicable.
Section 31	Securities Failed to Receive and Failed to Deliver	Not Applicable.
Section 32	Fidelity Bonds	Applicable.
Section 33	Options	Not Applicable.
Section 34	Direct Participation Programs Appendix F	Not Applicable.
Section 35	Communications With the Public	Applicable.
Section 35A	Options Communications With the Public	Applicable.
Section 36	Transactions with Related Persons Interpretations of the Board of Governors—Transactions With Related Persons	Not Applicable. Not Applicable.
Section 37	Operating Rules for ITS/CAES and CAES	Not Applicable.

APPLICABILITY OF THE RULES OF FAIR PRACTICE TO EXEMPTED SECURITIES, INCLUDING GOVERNMENT SECURITIES
(EXCEPT MUNICIPALS)—Continued

Section 38	Regulation of Activities of Members Experiencing Financial and/or Operational Difficulties	Applicable.
Section 39	Approval of Change in Exempt Status under SEC Rule 15c3-3	Applicable.
Section 40	Private Securities Transactions	Applicable.
Section 41	Short-Interest Reporting	Not Applicable.
Section 42	Prohibition on Transactions During Trading Halts	Not Applicable.
Section 43	Outside Business Activities	Applicable.
Section 44	The Corporate Financing Rule	Not Applicable.
Section 45	Customer Account Statements	Applicable.
Section 46	Adjustment of Open Orders	Not Applicable.
Section 47	Clearing Agreements	Applicable.
Section 48	Short Sale Rule	Not Applicable.
Section 49	Primary Nasdaq Market Maker Standards	Not Applicable.

Article IV—Complaints

Section 1	Availability to Customers of Certificate, by-laws, Rules and Code of Procedures	Applicable.
Section 2	Complaints by Public Against Members for Violations of Rules	Applicable.
Section 3	Complaints by District Business Conduct Committee	Applicable.
Section 4	Complaints by Board of Directors	Applicable.
Section 5	Reports and Inspection of Books for Purpose of Investigating Complaints	Applicable.

Article V

Section 1	Sanctions for Violations of Rules	Applicable.
Section 2	Interpretation of the Board of Governors—The Effect of a Suspension or Revocation of the Registration, if any, of a Person Associated with a Member or the Barring of a Person from further Association with any Member. Payment for Fines, Other Monetary Sanctions, or Costs	Applicable.
Section 3	Posts of Proceedings	Applicable.

⁷ Article III, Section 4 of the Rules of Fair Practice and the NASD Mark-Up Policy currently apply to transactions in equity and corporate debt securities. The NASD is developing an Interpretation of the Mark-Up Policy with respect to exempt securities and other debt securities. Therefore, the current application of Article III, Section 4 of the Rules of Fair Practice and the NASD Mark-Up Policy will not apply to transactions in exempt securities until adoption of the proposed Interpretation of the NASD Mark-Up Policy with respect to all debt securities. However, current Article III, Section 4 of the Rules of Fair Practice and the Mark-Up Policy remain in full force and effect for all equity and corporate debt transactions. See letter from Elliott R. Curzon, Assistant General Counsel, NASD, to Mark P. Barracca, Branch Chief, Division of Market Regulation, SEC, dated October 17, 1995 (Amendment No. 1 to the proposed rule change).

Interpretation of the Board of Governors—Suitability Obligations to Institutional Customers

The NASD is proposing to adopt an Interpretation of the Board of Governors—Suitability Obligations to Institutional Customers under Article III, Section 2 of the Rules of Fair Practice (“Suitability Interpretation”). The NASD intends the proposed Suitability Interpretation to clarify that the NASD’s suitability rule under Article III, Section 2(a) of the Rules of Fair Practice is applicable to institutional customers, while recognizing that generally, a member’s relationship with an institutional customer is different than the member relationship with retail customers.

The first paragraph of the proposed Suitability Interpretation acknowledges that the Association’s broadened authority, pursuant to the Government Securities Amendments, was the initial impetus for the Association’s decision to provide further guidance to members on their suitability obligations when making recommendations to institutional customers. The first

paragraph clarifies, however, that the Board intends the proposed Suitability Interpretation to be applicable to all debt and equity securities, except municipals.

The second paragraph of the proposed Suitability Interpretation states that the suitability rule is fundamental to fair dealing and is intended to promote ethical sales practices and high standards of professional conduct. This paragraph further states that members’ responsibilities include having a reasonable basis for recommending a particular security or strategy, as well as reasonable grounds for believing the recommendation is suitable for the customer to whom it is made. This paragraph further clarifies that members are expected to meet the same high standards of competence, professionalism, and good faith regardless of the financial circumstances of the customer.

The proposed Suitability Interpretation clarifies that it is intended to provide guidance to members in fulfilling only their customer-specific suitability obligations. The third paragraph of the proposed

Suitability Interpretation states that the Interpretation concerns only the manner in which a member determines that a recommendation is suitable for a particular customer and that the manner in which a member fulfills this suitability obligation will vary depending on the nature of the customer and the specific transaction. This paragraph further states that the Interpretation deals only with guidance regarding how a member may fulfill such “customer-specific suitability obligations” under Article III, Section 2(a) of the Rules of Fair Practice. This third paragraph of the Suitability Interpretation contains a footnote to a Commission administrative decision that references a non-customer specific suitability obligation that is not addressed by the proposed Suitability Interpretation.

The proposed Suitability Interpretation and the factors contained therein are not intended either to create a safe harbor for members, or a burdensome evidentiary checklist for members. The fourth paragraph of the proposed Suitability Interpretation states that, while it is difficult to define

in advance the scope of a member's suitability obligation with respect to a specific institutional customer transaction recommended by a member, the Board has identified certain factors that may be relevant when considering compliance with Article III, Section 2(a) of the Rules of Fair Practice. This paragraph further states that factors are not intended to be requirements or the only factors to be considered, but are offered merely as a guidance in determining the scope of a member's suitability obligations.

The proposed Suitability Interpretation contains a subheading entitled "Considerations Regarding the Scope of Members' Obligations to Institutional Customers." Under this subheading, the proposed Suitability Interpretation states that the two most important considerations in determining the scope of a member's suitability obligations in making recommendations to an institutional customer are the customer's capability to evaluate investment risk independently, and the extent to which the customer intends to exercise independent judgment in evaluating a member's recommendation.

Presence of Customer Capability

The proposed Suitability Interpretation states that a member must determine, based on the information available to it, the customer's capability to evaluate investment risk. In some cases, the member may conclude that the customer is not capable of making independent investment decisions in general. In other cases, the institutional customer may have general capability, but may not be able to understand a particular type of instrument or its risk. The proposed Suitability Interpretation states that this latter case is more likely to arise with relatively new types of instruments, or those with significantly different risk or volatility characteristics than other investments generally made by the institution. The proposed Suitability Interpretation states that if a customer is either generally not capable of evaluating investment risk or lacks sufficient capability to evaluate the particular product, the scope of a member's customer-specific obligations under the suitability rule would not be diminished by the fact that the member was dealing with an institutional customer. On the other hand, the fact that an institutional customer initially needed help understanding a potential investment need not necessarily imply that the customer did not ultimately develop an understanding and make an independent investment decision.

Further guidance regarding the subject of customer capability is

provided when the proposed Suitability Interpretation states that a determination of the customer's capability to evaluate investment risk independently will depend on an examination of the customer's capability to make its own investment decisions including the resources available to the customer to make informed decisions. The proposed Suitability Interpretation states that relevant considerations could include:

- The use of one or more consultants, investment advisers or bank trust departments;
- The general level of experience of the institutional customer in financial markets and specific experience with the type of instruments under consideration;
- The customer's ability to understand the economic features of the security involved;
- The customer's ability to independently evaluate how market developments would affect the security; and
- The complexity of the security or securities involved.

Presence of Independent Investment Judgment

The proposed Suitability Interpretation states that a member may conclude that an institutional customer intends to exercise independent judgment if the customer's investment decision will be based on its own independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations. The proposed Suitability Interpretation clarifies that a member's determination that a customer is making independent investment decisions will depend on the nature of the relationship that exists between the member and the customer. Relevant considerations could include:

- Any written or oral understanding that exists between the member and the customer regarding the nature of the relationship between the member and the customer and the services to be rendered by the member;
- The presence or absence of a pattern of acceptance of the member's recommendations;
- The use by the customer of ideas, suggestions, market views and information obtained from other members or market professionals, particularly those relating to the same type of securities; and
- The extent to which the member has received from the customer current comprehensive portfolio information in connection with discussing recommended transactions or has not

been provided important information regarding its portfolio or investment objectives.

Fulfillment of the Suitability Obligation

The proposed Suitability Interpretation states that the factors contained therein are merely guidelines that will be utilized to determine whether a member has fulfilled its suitability obligations with respect to a specific institutional customer transaction and that the inclusion or absence of any of these factors is not dispositive of the determination of suitability. Such a determination can only be made on a case-by-case basis taking into consideration all the facts and circumstances of a particular member/customer relationship, assessed in the context of a particular transaction.

The Association believes it is important to further clarify when a member may consider its suitability obligations fulfilled pursuant to the guidance provided by the proposed Suitability Interpretation. The proposed Suitability Interpretation, therefore, states that where the broker-dealer has reasonable grounds for concluding that the institutional customer is making independent investment decisions and is capable of independently evaluating investment risk, then a member's obligation to determine that a recommendation is suitable for a particular customer is fulfilled.

Application of Proposed Suitability Interpretation to Delegated Agents

The NASD believes it is important to clarify the application of the Suitability Rule to transactions wherein the institutional customer has delegated decision-making authority to an agent. The proposed Suitability Interpretation states that where a customer has delegated decision-making authority to an agent, such as an investment advisor or a bank trust department, this Interpretation shall be applied to the agent.

Definition of Institutional Customer

For purposes of the proposed Suitability Interpretation, the NASD believes that the term "institutional customer" should not be arbitrarily defined by referencing a threshold of institutional asset size, portfolio size, or by referencing various statutory designations. The proposed Suitability Interpretation, therefore, states that for purposes of this Interpretation, an institutional customer shall be any entity other than a natural person.

The proposed Suitability Interpretation does not intend the size

of the institutional customer's securities portfolio to be a dispositive consideration in determining the member's fulfillment of its suitability obligation under Article III, Section 2(a) of the Rules of Fair Practice. The proposed Suitability Interpretation, however, does state that in determining the applicability of this Interpretation to an institutional customer, the NASD will consider the dollar value of the securities that the institutional customer has in its portfolio and/or under management. The proposed Suitability Interpretation also states that, while this Interpretation is potentially applicable to any institutional customer, the guidance contained herein is more appropriately applied to an institutional customer with at least \$10 million invested in securities in the aggregate in its portfolio and/or under management. The NASD intends this reference to "\$10 million invested in securities" to be a non-dispositive factor that may be considered along with the other considerations contained in the proposed Suitability Interpretation.

The NASD believes that the proposed rule change will clarify that the NASD's suitability rule under Article III, Section 2(a) of the Rules of Fair Practice is applicable to institutional customers, while recognizing that a member's relationship with an institutional customer is different than with retail customers in those situations where the institutional customer is able to, and in fact does, make an independent investment decision. It is believed that the proposed Suitability Interpretation will provide important guidance to members regarding their suitability obligations to institutional customers by clarifying the type of considerations that should be part of the member's decision-making process in determining its suitability obligations. In providing such guidance, the NASD also believes that the proposed Suitability Interpretation furthers the goals of the Government Securities Amendments to expand the Association's sales practice rules to exempted securities by clarifying that the suitability rule under Article III, Section 2(a) of the Rules of Fair Practice applies to members' transactions in all debt and equity securities, including government and other exempted securities, except for municipals.

Amendment to Article III, Section 2(b) of the Rules of Fair Practice

The NASD is proposing to amend Article III, Section 2(b) to clarify that the definition of a "non-institutional customer" for purposes of the account records requirement of that provision

shall mean a customer that does not qualify as an "institutional account" under Article III, Section 21(c)(4) of the Rules of Fair Practice. The NASD believes this provision will clarify that the definition of "institutional customer" contained in the Suitability Interpretation does not apply to Article III, Section 2(b) of the Rules of Fair Practice.

Effectiveness of Rule Change

The NASD proposes that the rule change would be effective and applicable upon approval by the Commission with the following exceptions. Article III, Sections 21, 27, and 32 of the Rules of Fair Practice will be implemented within three months after the effective date of the rule change to provide members sufficient time to change their internal procedures to comply with such rules.⁸

2. Statutory Basis

The NASD believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,⁹ as amended, which requires that the rules of the Association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest in that the rule change will implement the Association's expanded sales practice authority over exempted securities, except for municipals, by creating one set of sales practice rules for members by merging the Government Securities Rules into the Rules of Fair Practice and applying, where applicable, the Rules of Fair Practice to those members registered with the SEC solely under the provisions of Section 15C of the Act and to transactions in exempted securities, including government securities, except municipals. The proposed rule change will also further the above-purposes of the Act, as amended, by adopting a new Interpretation of the Board of Governors—Suitability Obligations to Institutional Customers under Article III, Section 2 of the Rules of Fair Practice to: (i) Apply the NASD's suitability rule under Article III, Section 2(a) of the Rules of Fair Practice to transactions in exempted securities including government securities, except

municipals; and (ii) provide guidance to members on their suitability obligations when making recommendations to institutional customers, of which the government securities markets has a particularly broad institutional component. The proposed rule change will also further the above-purposes of the Act, as amended, by: (i) making clarifying amendments to certain sections and Interpretations under Articles III and IV of the Rules of Fair Practice relating to the government securities business; (ii) making technical changes to NASD By-Laws, Schedules of the By-Laws, the Rules of Fair Practice, and the Code of Procedure to replace references to provisions of the Government Securities Rules with references to the appropriate Rules of Fair Practice, and to delete the terms "exempted security" or "exempted" securities, or, replace these terms with the term "municipal securities," as applicable; and (iii) modifying references to SEC Rules 15c3-1 and 15c3-3 to reflect SEC amendments to those rules.

(B) Self-Regulatory Organization's Statement on Burden on Competition

The NASD believes that the proposed Suitability Interpretation contained in the proposed rule change is consistent with the intent of the Act as amended by the Government Securities Amendments.¹⁰ The proposed Suitability Interpretation expands the suitability rule contained under Article III, Section 2(a) of the Rules of Fair Practice to all securities transactions, including transactions in exempted securities, except for municipals. While the proposed Suitability Interpretation acknowledges that a member's relationships with institutional customers may be different from the normal member/retail customer relationship, it does not unfairly discriminate against such institutional customers. The proposed rule change applies the suitability rule under Article III, Section 2 of the Rules of Fair Practice to both retail and institutional customers in connection with all securities transactions, other than municipals. The proposed Suitability Interpretation provides members with an appropriate analysis of their suitability obligations to institutional customers based on the institutional customer's capability to evaluate investment risk independently and the

⁸ See letter from Elliott R. Curzon, Assistant General Counsel, NASD, to Mark P. Barracca, Branch Chief, Division of Market Regulation, SEC, dated October 17, 1995 (Amendment No. 1 to the proposed rule change).

⁹ 15 U.S.C. § 78o-3.

¹⁰ The Association received one comment letter that argued that the proposed Suitability Interpretation distinguished between institutional and retail customers and, therefore, was contrary to the intent of the Government Securities Amendments. See Letter No. 10, *infra* note 19.

extent to which the customer intends to exercise independent judgment in evaluating the member's recommendation.¹¹

On the basis of the foregoing, the NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act, as amended.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

A draft of the proposed Suitability Interpretation contained in the proposed rule change was first published for comment in Notice to Members 94-62 (August 1994) ("NTM 94-62").¹² Fifteen comments were received from fourteen commentors in response thereto.¹³ Of the fourteen commentors providing comments in response to NTM 94-62, one commentor supported without significant change;¹⁴ eleven

¹¹ See H.R. 103-225, 103rd Cong., 1st Sess. (September 23, 1993).

¹² A copy of the NTM 94-62 is included in File No. SR-NASD-95-39 as Exhibit 2 thereto.

¹³ The NASD received letters regarding NTM 94-62 from the following: (1) Brian C. Underwood, Director of Compliance, A.G. Edwards & Sons, Inc., dated September 29, 1994; (2) Alan S. Kramer, Senior Managing Director, Bear Sterns & Co. Inc., dated October 17, 1994; (3) Marjorie E. Gross, Senior Vice President & Associate General Counsel, Chemical Bank, dated September 29, 1994; (4) Marjorie E. Gross, Senior Vice President & Associate General Counsel, Chemical Bank, dated October 14, 1994; (5) F. Smith, President, Freeman Securities Company, Inc., dated September 30, 1994; (6) Wendy R. Beer, Compliance Counsel, Furman Selz, dated October 31, 1994; (7) Betsy Dotson, Assistant Director, Federal Liaison Center, Government Finance Officers Association, dated September 30, 1994; (8) Kathryn S. Reimann, Senior Vice President and Director of Fixed Income Compliance, Lehman Brothers Inc., dated October 17, 1994; (9) Larry Forrester, Senior Vice President, Lyn-Hayes Financial, Inc., dated August 23, 1994; (10) Marguerite C. Willenbacher, Vice President and Senior Counsel, Debt and Equity Markets Group, Merrill Lynch, Pierce, Fenner & Smith Inc., dated October 17, 1994; (11) Ken deRegt, Managing Director, Morgan Stanley & Co. Incorporated, dated October 14, 1994; (12) letter from Prudential Insurance Company of America, dated October 31, 1994; (13) letter from Marianna Maffucci, Senior Vice President and General Counsel, Public Securities Association, dated October 17, 1994; (14) William A. McIntosh, Managing Director and Co-head of U.S. Fixed Income, Salomon Brothers Inc., dated September 30, 1994; and (15) Robert F. Price, Chairman, Federal Regulation Committee, and Mark T. Commander, Chairman, Self-Regulation and Supervisory Practice Committee, Securities Industry Association, dated October 17, 1994. A copy of the comment letters listed above is included in File No. SR-NASD-95-39 as Exhibit 3 thereto. These letters will be referred to hereinafter by their number as indicated in this footnote. The two comment letters submitted by Chemical Bank will be referred to as No. 3 for the purpose of this discussion.

¹⁴ Letter No. 14, *supra* note 13.

commentors supported with changes;¹⁵ one commentor was opposed;¹⁶ and one commentor addressed issues in NTM 94-62 other than the proposed Suitability Interpretation.¹⁷

The proposed Suitability Interpretation published in NTM 94-62 was revised, and a second draft was published for comment in Notice to Members 95-21 (April 1995) ("NTM 95-21").¹⁸ Sixteen comments were received in response thereto.¹⁹ Of the sixteen comment letters received in response to NTM 95-21, nine commentors supported the proposal with changes;²⁰ three commentors considered the proposal either unworkable or insufficient and requested greater protection for either the member or the

¹⁵ Letter Nos. 1, 2, 3, 5, 6, 8, 10, 11, 12, 13, and 15, *supra* note 13.

¹⁶ Letter No. 7, *supra* note 13.

¹⁷ Letter No. 9, *supra* note 13. Notice to Members 94-62 also requested comment on the proposed NASD Board Interpretation regarding the NASD Mark-Up Policy to Transactions in Government and other debt securities. The proposed Mark-Up Interpretation is not included in this rule filing.

¹⁸ A copy of NTM 95-21 is included in File No. SR-NASD-94-39 as Exhibit 4 thereto.

¹⁹ The NASD received letters regarding NTM 95-21 from the following: (1) Allen Weintraub, Chairman and Chief Executive Officer, The Advest Group, Inc., dated May 5, 1995; (2) Brian C. Underwood, Director of Compliance, A.G. Edwards & Sons, Inc., dated May 15, 1995; (3) Michael S. Caccese, Esq., Senior Vice President, General Counsel, and Secretary, Association for Investment Management and Research; (4) Marjorie E. Gross, Senior Vice President & Associate General Counsel, Chemical Bank, dated May 17, 1995; (5) Michael J. Wilk, Managing Director, Comerica Securities, dated May 12, 1995; (6) Douglas E. Harris, Senior Deputy Comptroller for Capital Markets, Comptroller of the Currency, dated May 17, 1995; (7) Lawrence Jacob, Senior Vice President, Assistant Secretary and Director of Compliance, Daiwa Securities America Inc., dated May 16, 1995; (8) James A. Brickley, President and CEO, Federal Farm Credit Banks Funding Corp., dated May 17, 1995; (9) Mitchell Delk, Vice President Government and Industry Relations, Freddie Mac, dated June 1, 1995; (10) Betsy Dotson, Assistant Director, Federal Liaison Center, Government Finance Officers Association, dated May 17, 1995; (11) Matthew Lee, Executive Director, Inner City Press/Community on the Move, dated May 15, 1995; (12) Matthew Elderfield, Assistant Director, London Investment Banking Association, dated June 13, 1995; (13) Linda D. Edwards, Vice President Compliance, Llama Company, dated May 9, 1995; (14) Scott H. Rockoff, Managing Director, Director of Compliance, and Assistant General Counsel, Nomura Securities International, Inc., dated May 17, 1995; (15) Robert D. Mc.Knew, Chairman, Public Securities Association, dated May 18, 1995; and (16) Robert F. Price, Chairman Federal Regulation Committee, Richard O. Scribner, Chairman Self-Regulation and Supervisory Practices Committee, and Zachary Snow, Chairman OTC Derivative Products Committee, Securities Industry Association, dated June 7, 1995. A copy of the comment letters listed above is included in File No. SR-NASD-95-39 as Exhibit 5 thereto. These letters will be referred to hereinafter by their number as indicated in this footnote.

²⁰ Letter Nos. 1, 3, 4, 7, 8, 9, 12, 15 and 16, *supra* note 19.

investor;²¹ three commentors opposed the proposal;²² and one commentor did not express an opinion.²³

The Association's statements on the comments in response to the drafts of the proposed Suitability Interpretation contained in NTM 94-62 and NTM 95-21 are as follows.

Notice to Members 94-62

The NASD published NTM 94-62 to request member comment on the proposed Suitability Interpretation. The proposed Suitability Interpretation published for comment in NTM 94-62 stated that a member's obligation to an institutional customer would be fulfilled if, at the time of the specific transaction, the member has reasonable grounds for determining that the customer: (1) has developed resources and procedures to make its own investment decisions; (2) is not relying on the member's recommendation on the specific transaction; and (3) is capable of understanding the product and its risks and of making an independent investment decision. Several examples were in the proposed Suitability Interpretation to provide guidance to members regarding these determinations.

Comments Regarding the General Purpose of the Proposed Suitability Interpretation

Eleven commentors supported the proposed Suitability Interpretation's general intent to clarify the application of a member's obligations to institutional customers pursuant to the suitability rule under Article III, Section 2 of the Rules of Fair Practice.²⁴ These commentors, however, raised substantial and numerous issues regarding the proposed considerations and supporting factors underlying a member's suitability determination to an institutional customer. In response to these and other comments, the Association significantly revised and clarified the proposed Suitability Interpretation, as described below. One commentor argued that Congress, when adopting the Government Securities Act

²¹ Letter Nos. 6, 10, and 14, *supra* note 19.

²² Letter Nos. 2, 9, and 13, *supra* note 19.

²³ Letter No. 11, *supra* note 19. In addition, the NASD received a letter from the Honorable Edward J. Markey, Chairman of U.S. House of Representatives, Subcommittee on Telecommunications and Finance dated October 7, 1994, commenting on the proposed Suitability Interpretation published in Notice to Members 94-62 (August 1994). The letter from Congressman Markey and the NASD's response thereto dated November 4, 1994, are contained at Exhibit 6 of the rule filing.

²⁴ Letter Nos. 1, 2, 3, 5, 6, 8, 10, 11, 12, 13, and 15, *supra* note 19.

Amendments of 1993, intended the NASD's suitability rule under Article III, Section 2 of the Rules of Fair Practice to apply equally to all customers without distinction.²⁵ The commentor opposed the Suitability Interpretation's intent to clarify the applicability of a member's suitability obligations to institutional customers.

The NASD believes that the Suitability Interpretation contained in NTM 94-62 appeared to create a safe harbor because of the unintended mechanical nature of the suggested list of factors for member consideration. The Association revised the Suitability Interpretation to eliminate the mechanical nature of the examples of factors for consideration. The Suitability Interpretation contained in the proposed rule change states that members are reminded that the factors are merely guidelines that will be utilized to determine whether a member has fulfilled its suitability obligations with respect to a specific institutional customer transaction and that the inclusion or absence of any of these factors is not dispositive of the determination of suitability. The NASD believes the Suitability Interpretation as drafted in the proposed rule change is consistent with the intent of the Act, as amended by the Government Securities Amendments. The Association believes the proposed rule change expands the suitability obligations under Article III, Section 2 of the Rules of Fair Practice to all securities, except municipals and to all members in connection with their dealings with all customers. The NASD believes that the Suitability Interpretation contained in the proposed rule change does not unfairly discriminate against institutional customers, but does provide guidance to members to help them fulfill their suitability obligations under Article III, Section 2 of the Rules of Fair Practice to all institutional investors.

One commentor supported the proposed Suitability Interpretation's underlying notion that NASD members should recommend to their customers only financial products that meet their customers' needs and investment objectives.²⁶ The commentor, however, believes that this obligation arises under Article III, Section 1 of the Rules of Fair Practice, which states that members, in the conduct of their business, shall observe high standards of commercial honor and just and equitable principles of trade. The commentor argued that the Association's discussion regarding the Suitability Standard under Article III,

Section 2 of the Rules of Fair Practice with reference to the institutional marketplace is misguided and should be guidance regarding the proper business conduct of member firms under Article III, Section 1 of the Rules of Fair Practice.

The NASD agrees that members have significant obligations under Article III, Section 1 of the Rules of Fair Practice. Such obligations are, in some cases, distinct from the suitability obligation arising under Article III, Section 2 and in other cases appear to overlap. The Association, however, believes that a member's Suitability Obligations to institutional customers have been more specifically set forth in Article III, Section 2(a) of the Rules of Fair Practice and that it would be contrary to the mandate of the Act, as amended, to limit the application of Article III, Sec. 2(a) to non-institutional customers or in any manner provide a "suitability" safe harbor to members when dealing with institutional customers.

Definition of Institutional Customer

The proposed Suitability Interpretation published for comment in NTM 94-62 defined the term "institutional customer" to mean the term "institutional account" under Article III, Section 21(c)(4) of the Rules of Fair Practice.²⁷ Two commentors suggested that the term "institutional customer" be expanded to include non-U.S. institutions such as foreign investment companies and foreign investment advisers subject to their home country regulation.²⁸ The commentors stated that without this change, members under the proposed Suitability Interpretation would have suitability responsibilities for foreign investors with professional managers having less than \$50 million in assets. One commentor concluded that such foreign investors consequently would have greater protection under Article III, Section 2 of the Rules of Fair Practice than domestic investors.²⁹ The Suitability Interpretation contained in the rule change does not distinguish between U.S. and non-U.S. institutions and is not intended to be limited solely to domestic institutions.

One commentor stated that the \$50 million asset threshold set forth in

Article III, Section 21(c)(4) of the Rules of Fair Practice that is applicable to Article III, Section 2(a) of the Rules of Fair Practice, was too high and the list of institutions referenced under provisions (i) and (ii) contained therein was too narrow.³⁰ The commentor submitted a list of institutions to include under the definition of institutional customer. The NASD revised the definition of "institutional customer" to not reference Article III, Section 21(c)(4), the asset threshold test therein, or any specific institutional types. The Suitability Interpretation contained in the proposed rule change would define an institutional customer to mean any entity other than a natural person. One commentor argued that state and local governments should not be classified as institutional customers by reference to the asset test under Article III, Section 21(c)(4) of the Rules of Fair Practice.³¹ The commentor stated that government units may have assets of at least \$50 million in buildings, land and other facilities, as well as significant amounts of money to invest from revenues derived primarily from tax receipts, but be unable to afford highly skilled investment experts to handle their funds. As indicated above, the NASD has determined not to rely on the asset test in Article III, Section 21(c)(4) for purposes of defining the term "institutional customer" with respect to the proposed Suitability Interpretation. The Association disagrees, moreover, with the commentor's suggestion that state and local governments be excluded from the definition of institutional customer. The Suitability Interpretation contained in the proposed rule change provides guidance regarding factors and considerations that may (or may not) be applicable to any institutional customer. The Suitability Interpretation provides guidance to members on the relevant considerations that should be examined by a member in fulfilling its suitability obligations to all institutional customers and does not unfairly discriminate between institutional customers based on asset size, portfolio size, or institutional type. The Association believes this regulatory approach is in furtherance of the Act, as amended.

One commentor suggested that the proposed Suitability Interpretation apply to retail customers who are capable of making independent investment decisions.³² The NASD believes that the proposed Suitability Interpretation and the considerations

²⁷ The term "institutional account" under Article III, Section 21(c)(4) of the Rules of Fair Practice means: (i) a bank, savings and loan association, insurance company, or registered investment company; (ii) an investment adviser registered under Section 203 of the Investment Advisers Act of 1940; or (iii) any other entity (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least \$50 million.

²⁸ Letter Nos. 3 and 11, *supra* note 13.

²⁹ Letter No. 3, *supra* note 13.

³⁰ Letter No. 5, *supra* note 13.

³¹ Letter No. 7, *supra* note 13.

³² Letter No. 10, *supra* note 13.

²⁵ Letter No. 7, *supra* note 13.

²⁶ Letter No. 12, *supra* note 13.

contained therein are not generally applicable to retail customers as a class. The NASD further believes that members already have guidance in the form of NASD administrative decisions that clarify the application of a member's suitability obligation to retail customers under Article III, Section 2 of the Rules of Fair Practice.

One commentator stated that the reference to customer "sophistication" in the discussion part of NTM 94-62, appeared to create an assumption that institutional customers, as defined by the term "institutional account" under Article III, Section 21(c)(4) of the Rules of Fair Practice, are sophisticated and entitled to a lesser standard of care from members.³³ The Association has revised the Suitability Interpretation contained in the proposed rule change to eliminate any appearance that customer "sophistication" is automatically linked to the term "institutional account." The Association has deleted the reference to sophistication in discussing the proposed Suitability Interpretation and revised the definition of "institutional customer" to mean any entity other than a natural person. The NASD believes that such revision eliminates the unintended appearance that an institutional customer, as defined in the proposed Suitability Interpretation, is entitled to any lesser standard of care from members.

Presence of Customer Capability: Resources and Procedures

The proposed Suitability Interpretation in NTM 94-62 suggested that a member consider whether the institutional customer has developed resources and procedures (or "capability") for the purpose of making independent investment decisions. Three commentators supported the consideration of the customer's capability and suggested it be the primary basis for determining if a member has fulfilled the suitability obligations.³⁴ The Association has modified the Suitability Interpretation contained in the proposed rule change to provide that the member's considerations regarding the customer's capability and whether the customer intends to make an independent investment decision are equally important.³⁵

One commentator stated that the reference to the customer's "procedures" was confusing and could

imply that the member is required to review the investment procedures of the customer.³⁶ The commentator stated that many institutional customers will not share their investment procedures with their broker/dealers. In response to these comments, the Suitability Interpretation contained in the proposed rule change was revised to require consideration of the "customer's capability to evaluate investment risk independently" rather than the "customer's resources and procedures to make independent investment decisions."

Absence of Customer Reliance on the Member's Recommendations

The proposed Suitability Interpretation published in NTM 94-62 stated that, even if the institutional customer has developed resources and procedures to make independent investment decisions, factors should be present that provide reasonable grounds for the belief that the institutional customer is not relying on the member's recommendations in connection with a particular transaction or market product.

Six commentators supported the member consideration regarding the absence of customer "reliance" and argued that it should be the primary consideration in determining whether the member has fulfilled its suitability obligation in connection with a customer transaction.³⁷ The Association determined that the term "reliance" might incorporate unintended case law and imply that the member's suitability obligations under Article III, Section 2(a) of the Rules of Fair Practice are only triggered by customer reliance rather than acting as an ongoing obligation. Further, the "reliance" consideration required a member to determine the absence of customer reliance on a member's recommendation. The NASD has, therefore, deleted the term "reliance" and replaced it with language that would require the member to affirmatively consider the extent to which the "customer intends to exercise independent judgment in evaluating a member's recommendation." The Association believes the revised language contained in the proposed Suitability Interpretation continues, nonetheless, to address the independent nature of the institutional customer, which concept was strongly supported by the above commentators.

In response to the comments stating that "reliance" should be the primary

consideration, the NASD, as noted above, has revised the Suitability Interpretation contained in the proposed rule change to clarify that neither the customer's capability nor the customer's intent to exercise independent judgment should be given priority in determining whether a member's suitability obligations have been fulfilled. Both considerations are considered equally important under the Suitability Interpretation contained in the proposed rule change.

Four commentators stated that many institutional accounts, such as banks, insurance companies and registered investment companies, are subject to various regulatory and investment restrictions at the state and federal level and, in the case of foreign entities, are also subject to additional foreign strictures.³⁸ Commentors suggested that members should have reduced suitability obligations to such regulated institutional customers because such customers are in the best position to ensure that their investments are appropriate. The NASD acknowledges the existence of various regulatory and investment restrictions imposed on various domestic and foreign institutions but emphasizes that such restrictions do not supersede or waive the regulatory responsibilities that the NASD's Rules of Fair Practice impose on members in furtherance of the rules and regulations of the Act, as amended.

Many commentators supporting the proposal contained in NTM 94-62 argued that if a client uses outside expertise such as investment professionals (whether employees, third-party money managers, bank trustees, etc.) to manage its accounts, then the client must bear the responsibility for the investment decisions made by such professionals. The NASD acknowledges that a member/institutional customer relationship changes when the customer uses outside expertise to manage its accounts. The Association believes, however, that the use of investment professionals does not eliminate a member's suitability obligations.

Comments Regarding Customer Reliance Factors

Investment Guidelines. One of the factors provided in NTM 94-62 regarding the consideration of customer reliance was whether the member's investment recommendation is consistent with the customer's explicit investment guidelines. One commentator suggested that a member should be encouraged to become familiar with

³³ Letter No. 7, *supra* note 13.

³⁴ Letter Nos. 1, 3, and 15, *supra* note 13.

³⁵ This latter consideration replaces the "reliance" consideration proposed in NTM 94-62 (August 1994) and NTM 95-21 (April 1995).

³⁶ Letter No. 3, *supra* note 13.

³⁷ Letter Nos. 2, 8, 10, 11, 13, and 14, *supra* note 13.

³⁸ Letter Nos. 6, 10, 13, and 15, *supra* note 13.

customer investment guidelines, but not be obliged to assure compliance with customer investment guidelines because, in practice, members cannot do so effectively and should not be required to assume monitoring functions that can be better carried out by the customer.³⁹ Another commentator argued that any consideration of customer's investment guidelines for purposes of determining the absence of customer "reliance" would only discourage institutional customers from sharing their investment guidelines with members.⁴⁰ The commentator also argued that the member's fulfillment of its suitability obligations should not be determined only on information received prior to the transaction, but should also be determined after the transaction if the member receives notice that the transaction was contrary to the jurisdiction's investment guidelines. The commentator expressed concern that, as a result, a customer's rights would be negatively affected under the applicable statute of limitations. The NASD has determined to delete the factor regarding investment guidelines from the proposed Suitability Interpretation. With regard to the commentator's latter statements regarding the timing of the member's suitability determination and its effect on the customer's rights under statute of limitations, the NASD believes that a member's suitability determination is intended by Article III, Section 2(a) to be made prior to a recommendation and a member's satisfaction of its suitability obligation is determined based on information it knows or should have known at the time of the transaction. Thus, the NASD does not believe that an institutional customer's rights under an applicable statute of limitations would be negatively affected.

Affirmative Statement of Reliance. One of the suggested factors regarding customer reliance in NTM 94-62 was the existence of "affirmative statements" made by the customer at the time of the transaction that it is relying on the member's recommendations. One commentator opposed this affirmative statements factor, arguing that unless the broker/dealer requires a written statement of non-reliance (which, the commentator argued, would be a waiver of duty for the broker/dealer), this standard would be impossible to confirm after the fact.⁴¹ One commentator also argued that the "customer reliance" factor is flawed if based solely on the customer's affirmative statements

because sophisticated investors will be encouraged to make an "affirmative statement" regarding reliance on the member in order to preserve a cause of action if the investment fails.⁴²

In response to both commentators, the NASD believes that written and oral statements are useful considerations in determining whether a member has fulfilled its suitability obligations. The NASD acknowledges that the factor, as published in NTM 94-62, may have unintentionally appeared to be dispositive, and the NASD has revised this factor to eliminate this appearance. The factor in the proposed rule change is revised to state that a member may consider "any written or oral understanding that exists between the member and the customer regarding the nature of the relationship between the member and the customer and the services to be rendered by the member" in determining whether the customer intends to exercise independent judgment in evaluating the member's recommendation.

Pattern of Acceptance of Member's Recommendation. The proposed Suitability Interpretation published in NTM 94-62 stated that one of the factors that may be considered regarding customer reliance is a "pattern of acceptance" by the customer of the member's advice through the execution of all or nearly all of the recommended transactions. One commentator opposed this factor and argued that no conclusion can be drawn from a simple look at how frequently a customer follows the recommendations of an individual broker/dealer.⁴³ The commentator further stated that while government finance officers are authorized to carry out investing for a jurisdiction, they must consider a number of factors in their decision, and advice from a broker/dealer is not the sole factor. The NASD believes that a customer's pattern of acceptance of a member's recommendations is a useful consideration in determining whether the member has fulfilled its suitability obligations under the proposed Suitability Interpretation. The NASD believes, however, that the proposed Suitability Interpretation contained in NTM 94-62 may have appeared to make this factor dispositive regarding the issue of fulfilling a member's suitability obligation. The NASD agrees that making this factor dispositive of the issue would be inappropriate and has revised the Suitability Interpretation contained in the proposed rule change to eliminate this appearance. The

proposed Suitability Interpretation clarifies that all the factors are merely guidelines and that the inclusion or absence of any of these factors is not dispositive of the determination of suitability.

Customer Relationships with Other Broker/Dealers. The proposed Suitability Interpretation published in NTM 94-62 stated that another factor that may be considered regarding customer reliance is whether the customer maintains substantive relationships with a number of members. One commentator opposed this consideration and argued that this consideration would automatically shift the suitability responsibility to all institutional investors because all responsible institutions rely on multiple broker/dealers.⁴⁴ The NASD believes that an institutional customer's relationships with other members, particularly in regard to the same type of security, is a useful consideration in determining whether the member has fulfilled its suitability obligations. As noted above, the NASD has revised the proposed Suitability Interpretation contained in NTM 94-62 to clarify that such factors are only guidelines and that the inclusion or absence of any of these factors is not dispositive of whether a member has fulfilled its suitability obligations to an institutional customer. The NASD also has revised the above factor in the Suitability Interpretation contained in the proposed rule change to state that a member's consideration of whether the customer intends to exercise independent judgment in evaluating the member's recommendation may include the "use by the customer of ideas, suggestions, market views and information obtained from other members or market professionals, particularly those relating to the same type of securities."

Transactions in Connection with "New" Products. The proposed Suitability Interpretation published in NTM 94-62 stated that, in the case of a new product, or a security with significantly different risk or volatility characteristics than other investments generally made by the institution, the member should ascertain whether the institutional customer is relying on the member to explain the product and its risk(s) or is relying on other sources. One commentator stated that the NASD's Policy regarding Fair Dealings with Customers under Article III, Section 2 of the Rules of Fair Practice already imposes on the dealer a responsibility to ensure that adequate disclosure and information is made available to all

³⁹ Letter No. 11, *supra* note 13.

⁴⁰ Letter No. 7, *supra* note 13.

⁴¹ Letter No. 7, *supra* note 13.

⁴² Letter No. 3, *supra* note 13.

⁴³ Letter No. 7, *supra* note 13.

⁴⁴ Letter No. 7, *supra* note 13.

customers institutional or otherwise, in the case of derivative products or new financial products.⁴⁵ The NASD believes it is appropriate for the NASD to provide additional guidance in the proposed Suitability Interpretation regarding member's suitability obligations to institutional investors in connection with new products or products with significantly different risk or volatility characteristics. Such guidance would be in addition to the general guidance regarding new products contained in the NASD's Policy regarding Fair Dealings with Customers under Article III, Section 2 of the Rules of Fair Practice. As revised, the Suitability Interpretation contained in the proposed rule change states that the institutional customer may have general capability, but may not be able to understand a particular type of instrument of its risk. The proposed Suitability Interpretation states that this situation is more likely to occur with relatively new types of instruments, or those with significantly different risk or volatility characteristics, other than investments generally made by the institution.

Another commentator raised concerns that the Suitability Interpretation created a higher standard of duty for the member in connection with a "new" product, but did not define the term "new."⁴⁶ The NASD believes that the term "new" should not be defined in the context of the member's suitability obligation. The determination of whether the product is "new" must be considered on a case-by-case basis in the context of the member/dealer relationship and considering the prior investments generally made by the institution.

Member Knowledge That The Customer Is Incapable Of Understanding the Product or its Risks or Making an Independent Investment Decision. The Suitability Interpretation published in NTM 94-62 stated that a member would not be considered to be fulfilling its suitability obligations if, prior to the transaction, the member knows or can reasonably conclude, based on information available to it, that the customer is not capable of understanding the product or its risks, or of making an independent investment decision. One commentator requested that this provision be clarified to reflect that it is the institutional customer's investment professional, and not the senior officer of the institutional customer, who must be capable of understanding the investment

decision.⁴⁷ The NASD believes the structure of institutional customers may vary and, therefore, particular staff or professionals who provide the customer with capability to evaluate investment risk independently must be considered on a case-by-case basis. The proposed Suitability Interpretation contained in the proposed rule change, therefore, references only the institutional customer as an entity and does not reference any particular staff. Moreover, the proposed Suitability Interpretation discusses this issue within a broader context in the first paragraph following the heading "Considerations Regarding the Scope of Member's Obligations to Institutional Customer."

Transaction-by-Transaction Determinations

The proposed Suitability Interpretation published in NTM 94-62 stated that member compliance is to be determined on a transaction-by-transaction basis. Three commentators recommended replacing the proposed transaction-by-transaction analysis in favor of product-by-product determinations and argued there is no time in the case of normal institutional transactions to perform such transaction-by-transaction "due diligence."⁴⁸ The NASD recognizes that, while the suitability rule imposes an ongoing obligation, it may not be necessary for a member to make the determination on a transaction-by-transaction basis in order to fulfill its suitability obligation. The NASD believes it is appropriate for a member to determine when additional due diligence is necessary in order to fulfill its suitability obligations. The Suitability Interpretation contained in the proposed rule change states that a determination that a member has fulfilled its suitability obligations can only be made on a case-by-case basis taking into consideration all the facts and circumstances of a particular member/customer relationship, assessed in the context of a particular transaction.

One commentator suggested that if a transaction-by-transaction analysis was required, it should be limited to certain narrowly-defined categories of products. The Association has determined that such narrowly defined categories would not be appropriate in the context of determining a member's suitability obligation because what may be understood by one customer, may not be understood by another customer.

Notice to Members 95-21

In response to the comments to NTM 94-62, the NASD published a revised proposed Suitability Interpretation in Notice to Member 95-21. The revised proposed Suitability Interpretation clarified that it merely provided guidelines to determine whether a member has fulfilled its suitability obligations to institutional customers with respect to transactions in all equity or debt securities, except municipals. The NASD also emphasized in the discussion part of NTM 95-21 that the proposed Suitability Interpretation was not intended to be a safe harbor.

The proposed Suitability Interpretation published for comment in NTM 95-21 provided that the manner in which a member fulfills its suitability obligation in making a recommendation to a customer will vary depending on the nature of the customer and the specific transaction. It stated that, while it is difficult to define in advance a member's suitability obligation with respect to a specific institutional customer transaction recommended by a member, the Board has identified certain factors that are considered when the NASD conducts its reviews for compliance with Article III, Section 2(a) of the Rules of Fair Practice. It also stated the factors were not intended to be requirements or the only factors to be considered but are offered merely as guidance in determining a member's suitability obligation. The proposed Suitability Interpretation published for comment in NTM 95-21 emphasized that a member must determine, based on the information available to it, the customer's capability to evaluate investment risk. In discussing this first obligation, the proposed Suitability Interpretation contrasted situations where a member concludes the customer is not capable (in general or with respect to the particular type of instrument) of making an independent investment decisions with other situations where the customer ultimately can make an independent investment decision without relying on the member.

The primary consideration in determining a member's suitability obligation under the proposed Suitability Interpretation published for comment in NTM 95-21 was whether the customer was relying on the member's judgement as reflected in a recommendation rather than making an investment decision based on its own independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations. It

⁴⁵ Letter No. 2, *supra* note 13.

⁴⁶ Letter No. 10, *supra* note 13.

⁴⁷ Letter No. 3, *supra* note 13.

⁴⁸ Letter Nos. 3, 11, and 6, *supra* note 13.

stated that a determination regarding such customer's reliance would depend on (i) the nature of the relationship that exists between the member and the customer; and (ii) the customer's capability to make its own investment decisions including the resources available to the customer to make informed decisions.

Four relevant factors were provided to help the member determine the nature of the relationship that exists between the member and the customer. The first factor suggested that the member consider any written or oral agreement between the member and the customer regarding the customer's reliance on the member for recommendations. The second factor suggested that the member consider the presence or absence of a pattern of acceptance of the member's recommendations by the institutional customer. The third factor suggested that the member consider the use by the customer of ideas, suggestions, market views, and information obtained from other members or market professionals, particularly those relating to the same type of securities. The fourth factor suggested that the member consider the extent to which the customer provided the member with current comprehensive portfolio information in connection with discussing recommended transactions or did not provide important information about its portfolio or investment objectives.

Four relevant factors were also provided to help the member consider the customer's capability to make independent investment decisions, including the resources available to the customer to make informed decisions. The first factor suggested that the member consider whether the customer had use of one or more investment advisers or bank trust departments. The second factor suggested that the member consider the general level of experience of the staff of the institutional customer in financial markets and specific experience with the type of instruments under consideration. The third and fourth factors suggested that the member consider the customer's ability to independently evaluate how market developments would affect the security and the complexity of the security or securities involved.

Members were reminded that the factors were merely guidelines which would be utilized to determine whether a member had fulfilled its suitability obligations and that the inclusion or absence of any of these factors was not dispositive of the determination of suitability. It clarified that such a determination could only be made on a case-by-case basis taking into

consideration all the facts and circumstances of a particular member/customer relationship, assessed in the context of a particular transaction.

The definition of the term "institutional customer" was also revised to mean any entity other than a natural person. It stated that in determining the applicability of this Interpretation to an institutional customer, the NASD would consider the dollar value of the securities that the institutional customer has in its portfolio and under management. It also stated that while the Interpretation was potentially applicable to any institutional customer, the guidance contained therein should at a minimum be applied to an institutional customer with at least \$10 million invested in securities in the aggregate in its portfolio and under management.

General Comments

Four commentors stated that the factors contained in the proposed Suitability Interpretation should not be a checklist for NASD compliance purposes.⁴⁹ One commentor stated that it is not practical for members to make on-going assessments of many of the factors and noted, for example, that members cannot monitor the experience level of client's staff.⁵⁰ One commentor argued that the factors, in general, should not be considered an evidentiary checklist which would require additional bookkeeping by the member.⁵¹ The NASD did not intend that the proposed Suitability Interpretation create an evidentiary checklist that required additional bookkeeping. The NASD, therefore, eliminated the appearance that the factors create an evidentiary checklist for NASD compliance review by replacing the phrase "the Board has identified certain factors which are considered when the NASD conducts its reviews for compliance" in the fourth paragraph of the Suitability Interpretation contained in the proposed rule change, with the phrase "the Board has identified certain factors which may be relevant when considering compliance."

One commentor stated that, while not asking for a safe harbor, it believed that the proposed Suitability Interpretation should clarify procedures that create a "clear rebuttable assumption" that suitability of the recommendation has been established.⁵² The NASD believes that a member's suitability obligation

under Article III, Section 2(a) of the Rules of Fair Practice remains with the member until fulfilled, and that, therefore, the creation of "clear rebuttable presumption" through fulfillment of certain procedures would not be appropriate. One commentor recommended that the proposed Suitability Interpretation should only be applicable to relatively new types of instruments and not to "basic securities" because it would be too expensive for some firms to capture the proposed information on the customer and provide such information to its registered representatives for all such basic securities.⁵³ The NASD believes that Article III, Section 2 of the Rules of Fair Practice imposes suitability obligations on members when making recommendations regardless of the type of security, except for municipals. The NASD, therefore, believes that the scope of the proposed Suitability Interpretation in the proposed rule change must include all such securities, except municipals, regardless of whether the security is relatively basic or complex. In addition, the NASD believes that the term "basic securities" is not amenable to definition, as what is a basic security to one customer may not be basic to another.

One commentor stated that the proposed Suitability Interpretation, as a whole, is unworkable for members because of its complexity. The commentor believes the proposed Suitability Interpretation would provide little relief from the Suitability Rule under Article III, Section 2 of the Rules of Fair Practice for members dealing with institutional customers. The commentor proposed that the NASD adopt a two-part test based on portfolio size and the existence of a written agreement. Under the test, a member could assume that the suitability rule would not apply to institutional customers with an investment portfolio of \$10 million or more if there were a written agreement on point stating that the customer was not relying on the member for recommendations.⁵⁴ The NASD does not believe it is appropriate to create a safe harbor for members' suitability obligations nor to change or reduce members' obligations under the suitability rule in Article III, Section 2 of the Rules of Fair Practice, as recommended by the commentor. The NASD believes the Suitability Interpretation, as contained in the proposed rule change, provides important guidance to members in fulfilling their suitability obligations

⁴⁹ Letter Nos. 1, 2, 15, and 16, *supra* note 19.

⁵⁰ Letter No. 2, *supra* note 19.

⁵¹ Letter No. 15, *supra* note 19.

⁵² Letter No. 14, *supra* note 19.

⁵³ Letter No. 1, *supra* note 19.

⁵⁴ Letter No. 6, *supra* note 19.

under Article III, Section 2(a) of the Rules of Fair Practice to institutional customers.

Definition of Institutional Customer

One commentator argued that the statement in the proposed Suitability Interpretation that the guidance contained therein "should at a minimum be applied to an institutional customer with at least \$10 million invested in securities in the aggregate in its portfolio and/or under management" is contrary to Congressional intent, under the Government Securities Act Amendments of 1993, to not distinguish between customers based on portfolio size.⁵⁵ The commentator also argued that if the proposed definition of institutional customer is used, further clarification is needed regarding: (i) the issue of aggregating government units that contain sub-units; (ii) the period to be reviewed for determining whether \$10 million is invested in securities in its portfolio and under management; and (iii) the definition of the term "under management." Another commentator argued that portfolio size should not matter in connection with the definition of institutional customer.⁵⁶ Another commentator requested clarification on whether the NASD intended by its discussion regarding the above \$10 million threshold, to create a presumption of applicability either above or below the \$10 million threshold.⁵⁷ The NASD agrees that portfolio size is not dispositive of a member's suitability obligations, but believes it is appropriate for the NASD to consider the portfolio size of the customer in determining the applicability of the proposed Suitability Interpretation. The NASD believes that there is a greater likelihood that the member can apply the proposed Suitability Interpretation to an institutional customer with at least \$10 million invested in securities in the aggregate in its portfolio and/or under management, but the NASD has no intent to create a presumption either above or below that aggregate dollar amount that the Interpretation will, in fact, apply to a particular institutional customer. In connection with concerns regarding the NASD's method of calculating the \$10 million test, the NASD intends to look for guidance for such calculations to SEC Rule 144A.⁵⁸

One commentator recommended that the phrase "\$10 million invested in securities and under management" be

changed to "\$10 million invested in securities in the aggregate in its portfolio or under management" in order to recognize securities in the customer's portfolio that are not actively managed.⁵⁹ Upon review, the NASD agrees with this recommendation and changed the word "and" to "and/or" to make it clear that the \$10 million that is applied to the total of securities that are: (1) beneficially owned by the institutional customer; and (2) in any accounts of other investors that are managed by the customer. As set forth above, the type of securities to be included in the calculation and the method of calculation will be determined by reference to SEC Rule 144A.

Presence of Customer Capability

One commentator noted that guidance regarding the consideration of the customer's capability to make its own investment decisions was referenced twice in the proposed Suitability Interpretation published for comment in NTM 95-21 and questioned whether this was intentional.⁶⁰ The NASD has modified the proposed Suitability Interpretation to clarify this discussion of customer capability under the heading "Considerations Regarding the Scope of Members' Obligations to Institutional Customers."

Two commentators recommended that the proposed Suitability Interpretation should state that a rebuttable presumption exists that institutions are capable of making their own independent investment decisions if the institutions: (i) are engaged in the financial industry or in the business of managing their own or others investments; (ii) have in-house or outside investment professionals charged with the responsibility for recommending or making investment decisions on behalf of the institution; or (iii) independently adopt an investment guideline and provide explicit investment guidelines to the member.⁶¹ As discussed above, it is the position of the NASD that rebuttable presumptions are not appropriate under Article III, Section 2 of the Rules of Fair Practice and that the factors are merely guidelines.

One commentator recommended that the party that the member may consider "capable" be clarified to mean the "institutional customer" rather than the "staff of the institutional customer" as set forth in NTM 95-21.⁶² One

commentor similarly recommended that the party that the member may consider "capable" be defined as "all of the staff of the institutional customer" and not just one staff person.⁶³ The NASD believes it is difficult to define the particular staff responsible for the investment decision of the institutional customer. The NASD has modified the proposed Suitability Interpretation contained in the proposed rule change to delete the reference to the institutional customer's "staff."

Absence of Customer Reliance

One commentator stated that the primary focus on customer reliance or the absence of customer reliance on a member's recommendation in NTM 95-21 appeared to permit a broker/dealer to make a recommendation to an institutional customer without having reasonable grounds for believing that the recommendation is suitable for the customer.⁶⁴ The commentator argued that a determination that the customer is not relying on the member's recommendation should not relieve the member of the responsibility to have reasonable grounds, based on some information about the customer, for believing that the recommendation is suitable for that customer. Upon review of this comment and others discussed above with respect to NTM 94-62, the NASD acknowledges that the term "reliance" leads to confusion regarding the status of the member's suitability obligation. The term "reliance" has, therefore, been eliminated from the proposed Suitability Interpretation contained in the proposed rule change. It has been replaced with language that would require the member to affirmatively consider the extent to which the "customer intends to exercise independent judgment in evaluating a member's recommendation."

One commentator recommended that the proposed Suitability Interpretation state that members are not guarantors and that the governing body of the institutional customer is responsible for the amount of risk the institution should undertake.⁶⁵ The NASD acknowledges that members are not guarantors of the customer's investment. The proposed Suitability Interpretation contained in the proposed rule change is not intended to imply such responsibility. To the contrary, the proposed Suitability Interpretation seeks to clarify the circumstances under which a member has fulfilled its suitability obligations to an institutional customer

⁵⁵ Letter No. 10, *supra* note 19.

⁵⁶ Letter No. 3, *supra* note 19.

⁵⁷ Letter No. 14, *supra* note 19.

⁵⁸ See 17 CFR 230.144A (1994).

⁵⁹ Letter No. 4, *supra* note 19.

⁶⁰ Letter No. 16, *supra* note 19.

⁶¹ Letter Nos. 12 and 16, *supra* note 19.

⁶² Letter No. 15, *supra* note 19.

⁶³ Letter Nos. 4, *supra* note 19.

⁶⁴ Letter No. 9, *supra* note 19.

⁶⁵ Letter No. 4, *supra* note 19.

based on the member's consideration of the customer's capability to evaluate investment risk independently and the extent to which the customer intends to exercise independent judgment in evaluating the member's recommendation.

One commentator argued that the proposed considerations regarding customer reliance are unworkable because a member is not in a position to second-guess the qualifications or knowledge of an institutional customer.⁶⁶ The commentator opposed the suggestion that members may consider oral or written agreements and stated that referencing such oral or written agreements is not practical as the member/customer relationship is subject to continual change. The commentator stated that the fact that an institutional account is managed should be dispositive that the client is not relying on the member's recommendations. The Association believes that a member in an ongoing member/customer relationship will often gain knowledge of factors pertaining to the customer's capability to independently evaluate investment risk, as well as whether the customer intends to and is making independent investment judgments. Where the member does not gain such knowledge regarding a specific customer, the Association acknowledges that the Suitability Interpretation is not applicable to the member's relationship with the customer.

One commentator stated that Article III, Section 2 of the Rules of Fair Practice and the related Policy of the Board of Governors—Fair Dealing with Customers set forth adequate suitability guidelines for retail and institutional customers, and for new products.⁶⁷ The commentator argues that, given the adequacy of such rules, the only purpose of the proposed Suitability Interpretation is to establish a detailed determination of the customer's reliance upon the members' investment recommendations. The commentator further states that this determination is an obligation of an investment advisor and not a broker/dealer's obligation under Article III, Section 2 of the Rules of Fair Practice. The commentator argues that members who continue to merely make investment recommendations based on the existing guidelines for suitability should not be required to assume the responsibility of investment advisors. As noted above, the proposed Suitability Interpretation, published in NTM 95-21, was revised to eliminate

consideration regarding reliance by the customer on the member's recommendation. The NASD believes that the Suitability Interpretation in the proposed rule change addresses relevant issues for members to consider in fulfilling their suitability obligations to institutional customers and that the obligations discussed therein are separate from the obligations of an investment advisor under the Investment Advisers Act of 1940.

One commentator recommended that if an institutional customer provides a document or affirmative statement that it is not relying on the member's recommendations, then the member would not have a reason to evaluate any of the proposed Suitability Interpretation's factors or any other factors in order to fulfill its suitability obligation to that client.⁶⁸ One commentator submitted a draft Trading Authorization form that would require representations by the institutional customer that the customer: (i) has the resources and procedures to make its own investment decisions; (ii) will not rely solely on the firms recommendations for investment decisions; and (iii) is capable of understanding the products and risks as presented.⁶⁹

The NASD believes that the Suitability Interpretation contained in the proposed rule change is clear that it does not provide any safe harbor from the suitability obligations under Article III, Section 2 of the Rules of Fair Practice. Earlier versions of the proposed Suitability Interpretation were revised to eliminate any appearance that it provided a mechanical method by which a member could fulfill its suitability obligation under Article III, Section 2 of the Rules of Fair Practice. While the Suitability Interpretation contained in the proposed rule change continues to provide factors for the member to consider in making its suitability determination, these examples are not dispositive. The Suitability Interpretation contained in the proposed rule change states that members are reminded that these factors are merely guidelines that will be utilized to determine whether a member has fulfilled its suitability obligations with respect to a specific institutional customer transaction and that the inclusion or absence of any of these factors is not dispositive of the determination of suitability.

One commentator recommended that the NASD adopt the standards for suitability determinations set forth in

the Municipal Securities Rulemaking Board ("MSRB") Rule G-19 as the NASD suitability standard for all securities, other than municipals.⁷⁰ The commentator stated that the MSRB Rule G-19 prohibits a transaction unless the member, after reasonable inquiry, has reasonable grounds to believe that the recommendation is suitable for a customer in light of its financial background, investment experience and investment objectives; and has no reasonable grounds to believe the recommendation is unsuitable. This commentator also argued that if reliance by the customer on the member's recommendation is to be the test, then an affirmative duty should be imposed on the member to request "material relevant to a particular transaction," and to inform the customer of the instrument's characteristics, including behavior under different market conditions and valuation information. The NASD acknowledges the parallel regulatory function that MSRB Rule G-19 serves in the municipal securities business. It is believed that differences between the municipal securities business and the general securities business, which involves many different types of securities of greater or lesser complexity, have resulted in different suitability standards adopted by the NASD and MSRB. The NASD believes that Article III, Section 2 of the Rules of Fair Practice has served as a key regulation to further investor protection and the public interest under the Act, as amended, and continues to be the most appropriate suitability standard for the securities business, except municipals.

Other Comments

One commentator recommended that all the Rules of Fair Practice be reviewed to ensure consistency and uniformity of treatment for securities having similar risk characteristics.⁷¹ The NASD has reviewed the Rules of Fair Practice to ensure consistency and uniformity of treatment in the application of the Rules of Fair Practice to debt securities having similar characteristics. The proposed rule change includes a chart that clarifies the applicability of the Rules of Fair Practice to exempted securities.

One commentator requested that the proposed Suitability Interpretation provide a definition of the term "recommendation" under Article III, Section 2 of the Rules of Fair Practice and the proposed Suitability

⁶⁶ Letter No. 2, *supra* note 19.

⁶⁷ Letter No. 5, *supra* note 19.

⁶⁸ Letter No. 16, *supra* note 19.

⁶⁹ Letter No. 13, *supra* note 19.

⁷⁰ Letter No. 10, *supra* note 17.

⁷¹ Letter No. 9, *supra* note 19.

Interpretation.⁷² One commentator was concerned that a rule that is triggered by the occurrence of a recommendation will result in a debate as to what is a "recommendation."⁷³ Article III, Section 2 of the Rules of Fair Practice has been applicable to members' recommendations since the inception of the NASD. A significant amount of case law has been developed as a result of NASD disciplinary actions with respect to this provision, which is available as guidance to the membership. The NASD believes that defining the term "recommendation" raises many complex issues in the absence of the specific facts of a particular case. Finally, the NASD believes that the requested definition is not required in order to provide the guidance to members that is intended by the proposed Suitability Interpretation.

One commentator was concerned that the proposed Suitability Interpretation would lead investment practitioners to err on the side of conservatism in dispensing investment advice.⁷⁴

The commentator recommended that the NASD clarify that "suitable investment advice" shall not mean "the most conservative advice." The NASD does not believe that the proposed Suitability Interpretation contained in the proposed rule change addresses the appropriate level of investment advice. Rather, the focus of the proposed Suitability Interpretation is on clarifying the relationship of a member to its institutional customer when making a recommendation in connection with a securities transaction.

One commentator raised concerns regarding the general regulatory environment of the derivatives markets and urged the NASD to investigate a U.S. bank's activities in the derivatives markets.⁷⁵ The NASD intends the proposed rule change to further enhance the regulatory environment of the derivatives markets to the extent that exempted securities, including government securities other than municipals, are part of such markets. The NASD does not have jurisdiction to investigate a banking institution.

One commentator requested clarification that the proposal will not be vitiated or affected by the draft Principles and Practices for Wholesale Finance Market Transactions ("Draft Principles").⁷⁶ The commentator noted that the Draft Principles provide that, absent a written agreement to the

contrary, no communications (including ideas or suggestions regarding potential transactions) by a member should be construed as recommendations or investment advice.

On August 17, 1995, the final version of the Principles was issued by a committee consisting of representatives of the Emerging Markets Traders Association, the Foreign Exchange Committee of the Federal Reserve Bank of New York, the International Swaps and Derivatives Association, the New York Clearing House Association, the Public Securities Association, and the Securities Industry Association. The Principles are a voluntary industry standard. The position on suitability set forth in the final version of the Principles, as stated in the cover memorandum thereto issued by the Federal Reserve Bank of New York, is that the investor is encouraged to take responsibility for its own decisions regarding securities transactions. As set forth in Section 4.2.2. of the Principles, the investor is required to assume that the member is acting at arm's length for its own account and that any communications are not

recommendations or investment advice on which the investor may rely unless a written agreement or applicable law is to the contrary. The Principles go on to recognize, however, that certain rules or regulations expressly provide that the facts and circumstances of a relationship alone may give rise to "an advisory or fiduciary relationship"—even in the presence of a written agreement purporting to negate such a relationship. Additionally, Section 4.2.1. of the Principles focuses on whether the investor has the capability to understand and make independent investment decisions. In comparison, the Suitability Interpretation contained in the proposed rule change focuses on the customer's capability to evaluate investment risk independently and the extent to which the customer intends to exercise independent judgment in evaluating a member's recommendation—somewhat similar concepts.

The proposed Suitability Interpretation clarifies that the NASD's fundamental standard of suitability contained in Article III, Section 2(a) of the Rules of Fair Practice applies to all recommendations by a member to an institutional customer and recognizes that the manner in which a member fulfills this suitability obligation will vary depending on the nature of the customer and the specific transaction. The proposed Suitability Interpretation does not, however, provide definitive guidance on what constitutes a

recommendation, leaving to the facts and circumstances of each case the determination of exactly when the suitability obligation imposed by Article III, Section 2(a) is triggered. Thus, under the NASD's suitability rule, whenever a recommendation is made, a member is responsible for the suitability of its recommendations to institutional customers in all cases, but will be deemed to have met its customer-specific suitability obligations if the member determines with respect to a transaction that a customer has the capability to evaluate investment risk independently and intends to exercise independent judgement in evaluating the member's recommendation. The Suitability Interpretation contained in the proposed rule change is not modified or superseded by the Principles as adopted. Rather, a member of the NASD will remain subject to Article III, Section 2(a), regardless of any different position on an issue set forth in the Principles.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

A. by order approve such proposed rule change, or

B. institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be

⁷² Letter No. 2, *supra* note 19.

⁷³ Letter No. 10, *supra* note 19.

⁷⁴ Letter No. 3, *supra* note 19.

⁷⁵ Letter No. 11, *supra* note 19.

⁷⁶ Letter No. 8, *supra* note 19.

available for inspection and copying at the principal office of the NASD. All submissions should refer to the file number in the caption above and should be submitted by November 14, 1995.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.⁷⁷

Jonathan G. Katz,

Secretary.

[FR Doc. 95-26231 Filed 10-23-95; 8:45 am]

BILLING CODE 8010-01-P

[Release No. 34-36385; File No. SR-OCC-95-10]

Self-Regulatory Organizations; The Options Clearing Corporation; Order Approving a Proposed Rule Change to Enhance Saturday Expiration Date Processing Procedures

October 18, 1995.

On July 11, 1995, The Options Clearing Corporation ("OCC") filed with the Securities and Exchange Commission ("Commission") a proposed rule change (File No. SR-OCC-95-10) pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act").¹ Notice of the proposal was published in the Federal Register on August 31, 1995.² No comment letters were received. For the reasons discussed below, the Commission is approving the proposed rule change.

I. Description of the Proposal

Under the rule change, OCC is enhancing its Saturday expiration processing cycles by instituting a single real-time procedure for the updating of expiring positions of its clearing members. Prior to the amendment, OCC's Saturday expiration processing procedure for index and equity options did not provide real-time updates to clearing members on their expiring positions. Accordingly, two processing cycles, a preliminary and a final cycle, were necessary to reflect the results of post-trade activity (e.g., reconciliation of unmatched trades) affecting expiring positions and to give clearing members the opportunity to edit their preliminary exercise instructions in response to updated reports from OCC.

OCC previously has implemented an expiration processing system for options expiring on business days³ that

provides real-time updates to clearing members on their expiring positions. Such real-time updates eliminate the need for a preliminary and final processing cycle. OCC now will employ this same real-time system for its Saturday expirations in order to reduce Saturday expiration processing to one cycle.

To accomplish the enhancement to Saturday expiration processing, certain changes have been made to OCC's by-laws and rules. The rule change eliminates references to preliminary and final processing cycles and reports. The rule change also amends OCC's by-laws and rules to reflect that the expiration exercise procedure is carried out utilizing an on-line transmission of instructions and reports to and from clearing members instead of by physical delivery of hard copy reports. The rule change also makes it clear that expiration processing cannot be extended beyond the normal expiration time except when the following day is not a business day and provides for emergency automatic exercises not only when OCC is unable to issued exercise reports but also when it is unable to receive exercise instructions properly submitted by clearing members.

Specifically, a new defined term, "Expiration Exercise Report," which refers to the on-line exercise reports (including intraday updates) that OCC will make available to its clearing members has been added to Article I, Section 1 of OCC's by-laws. Technical and conforming changes have been made to Interpretations and Policies .02 under Article VI, Section 1.

Article VI, Section 18 has been amended to allow exercise processing to continue into the day after the expiration date only when that day is not a business day.⁴ The purpose is to avoid the abuses that might result from allowing post-expiration exercise instructions to be given at times when U.S. markets were open. Section (a) of Article I, Section 18 now requires a clearing member to submit exercise

instructions to OCC within such times as OCC shall prescribe.⁵

Section (b) of Article VI, Section 18 provides a "backstop" automatic exercise procedure in cases where OCC is unable to produce the reports required for expiration exercise processing within applicable deadlines. The rule change provides for automatic exercise not only in those cases but also in cases where OCC is unable to receive properly submitted exercise instructions within applicable deadlines. Cases of the latter type are currently covered by Section (c), which is being deleted.⁶

Rule 805, which specifies the exercise processing procedures for Saturday expirations, provides expressly for on-line processing and covers weekday as well as Saturday expirations. OCC has deleted from the rule references to preliminary and final exercise reports. OCC will utilize its on-line C/MACS system to make the Expiration Exercise Reports available to clearing members.⁷ The Expiration Exercise Report will list all of the clearing member's expiring positions. Once the Expiration Exercise Report is made available, clearing members can submit exercise instructions in response to such report on separate C/MACS report screens. The response screens will be updated on a real-time basis.

Paragraph (b) of Rule 805 has been amended to reflect a change in the deadline for submitting exercise instructions. Previously, responses to the preliminary exercise report had to be submitted by 9:00 a.m. Central Time, and responses to the final report had to be submitted by 4:00 p.m. Central Time. Under the new system, clearing members are required to submit exercise instructions in response to the Expiration Exercise Report before such time as OCC shall specify.⁸

⁵ Prior to approval of this proposed rule change, a clearing member had to respond within two hours of receiving a report.

⁶ Section (c) of Article VI, Section 18 previously provided that if a preliminary or final exercise report is made available by OCC to a clearing member and if OCC cannot keep any of its offices open until the time prescribed for the return of such report, OCC will reopen its offices to receive such report which shall then be deemed to have been filed on a timely basis.

⁷ OCC will specify in its Operations Manual the deadline for making Expiration Exercise Reports available to clearing members. Initially, OCC proposes to specify as the deadline 7:00 a.m. Central Time on the expiration date, which is the current deadline for issuing preliminary exercise reports.

⁸ OCC will specify this deadline in its Operations Manual. Initially, the deadline will be 1:00 p.m. Central Time. This new cut-off time will allow OCC to begin its critical expiration processing earlier and should reduce the amount of time clearing members will be required to maintain staff on expiration Saturdays.

⁷⁷ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. § 78s(B)(1) (1988).

² Securities Exchange Act Release No. 36149 (August 23, 1995), 60 FR 45507.

³ Some examples of such options include flexibly structured options, Quarterly-Index Expiration Options or QIXs, and foreign currency option contracts.

⁴ This limitation is not new. It was imposed when options expiring on business days were first introduced. Securities Exchange Act Release No. 23004 (March 19, 1986), 51 FR 9563 [File No. SR-OCC-85-18] (order approving amendments to OCC by-laws and rules to accommodate the issuance, clearance, and settlement of European-style Treasury bill options). However, the limitation was deleted as part of a number of related OCC rule changes in 1993. Securities Exchange Act Release No. 33158 (November 4, 1993), 58 FR 60229 [File No. SR-OCC-93-8] (order approving amendments to OCC by-laws and rules to accommodate the clearance and settlement of Quarterly-Index Expiration Options to be traded on the New York Stock Exchange).