NASD

Notice To Members

National Association of Securities Dealers, Inc. November 1992

Number 92-56

Suggested Routing:*

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

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

MAIL VOTE

Subject: Proposed Recision of the Guidelines Regarding Communications With the Public About Investment Companies and Variable Contracts (Guidelines) and Proposed Amendments to Article III, Section 35 of the Rules of Fair Practice to Incorporate Items From the Guidelines; Last Voting Date: December 21, 1992

EXECUTIVE SUMMARY

The NASD® invites members to vote on a proposal to rescind the Guidelines and to amend Article III, Section 35 of the Rules of Fair Practice to include items that were contained in the Guidelines and would apply to advertisements for all types of investment products. The text of the proposed amendments and a copy of the Guidelines follow this Notice.

BACKGROUND AND DESCRIPTION OF PROPOSAL

The Guidelines were adopted by the NASD in 1982 following the Securities and Exchange Commission's (SEC) 1979 repeal of its Statement of Policy on Investment Company Sales Literature and are set forth at ¶5286 of the *NASD Manual*. When the SEC amended Rule 482 under the Securities Act of 1933 and adopted Rule 34b-1 under the Investment Company Act of 1940 relating to the communication of investment company performance to the public, many of the provisions of the Guidelines became obsolete. Accordingly, the NASD is proposing to rescind the Guidelines and amend Article III, Section 35 of the Rules of Fair Practice by adding those provisions of the Guidelines that imposed general standards for communications and certain of the Guidelines' specific standards for communications concerning claims of tax-free or tax-exempt returns, comparisons, and predictions and projections would become part of Article III, Section 35. The amended provisions would apply to advertisements for all types of investments, whereas the application of the Guidelines was restricted to investment company and variable contract products.

Proposed new Subsection 35(d)(1)(D) would incorporate the entire provision set forth as "General Considerations," which is currently included in the first section of the Guidelines, under the provision contained in Section 35 that imposes general "Standards Applicable to Communications With the Public." The first standard under new paragraph 35(d)(1)(D)(i) relates to the overall context of a statement and would require members to consider that a statement may be misleading in one context while being perfectly appropriate in an-

other context. The principal test of this standard is whether the statement adequately balances the potential risks with the potential benefits. The proposed rule language is identical to that currently contained in the Guidelines.

The standard set forth in proposed new paragraph 35(d)(1)(D)(ii) relates to the importance of the target audience as a factor in evaluating the communication. The provision would require varying levels of explanation or detail in a communication depending on the audience and the member's ability to restrict the communication to the intended audience. Members are required to consider the likelihood that the communication could be received by persons for whom the explanations or information are inadequate or misleading. The proposed rule language is identical to that currently contained in the Guidelines.

The standard set forth in new paragraph 35(d)(1)(D)(iii) would require that all statements in communications be made clearly and cautions against complex or overly technical explanations and the inclusion of material information in legends or footnotes. The proposed rule language is identical to that currently contained in the Guidelines.

New Subsections 35(d)(2)(L), (M), and (N) would incorporate concepts contained in the Guidelines into the requirements set forth in Section 35 as "Specific Standards" for communications with the public. Subsection 35(d)(2)(L) would prohibit members from calling an investment "tax free" or "tax exempt" if tax liability is merely postponed or deferred, and requires that if there are references to tax-free/tax-exempt current income or if taxes are payable on redemption, those facts and any applicable taxes must be adequately disclosed. The rule language of this provision is drawn from the last paragraph of the section in the Guidelines titled "4. Specific Considerations in Presenting Yield Data or Illustrations."

Subsection 35(d)(2)(M) would require members, when using comparisons, to ensure that the comparisons are clear, fair, balanced, and include any material differences between the subjects of the comparison such as liquidity, safety, investment objectives, and fees, among others. The rule language of this provision is drawn from the first three paragraphs of the section in the Guidelines titled "5. Considerations Regarding Comparisons."

Subsection 35(d)(2)(N) would prohibit members from predicting or projecting future performance on any basis, including past performance. Hypothetical illustrations of mathematical principles such as dollar-cost averaging, however, are not considered projections of performance. The rule language of this provision is based on that included in the section in the Guidelines titled "Adequacy of Information Concerning the Relevance of Results Illustrated to Probable Future Results."

Comments Received on Proposed Amendments

The NASD published the proposed amendments to Subsections 35 (d)(2)(L), (M), and (N) for comment in *Notice to Members 91-79* (December 1991). The NASD received five comment letters with four favoring the proposal and one opposed to one provision. In response, the Board of Governors (Board) has approved a number of changes to the original version of the amendments to Article III, Section 35 as published for comment.

In one instance, the Board amended the original proposal to add new Subsection 35(d)(1)(D) relating to "General Standards" to incorporate matters from the Guidelines that the commenter believed are not expressly covered elsewhere in Section 35. The Board also modified proposed Subsection 35(d)(2)(L) relating to tax-free/tax-exempt claims to specify that adequate disclosure would require disclosure of which taxes apply or which do not (as opposed to disclosure of both).

The Board also modified proposed Subsection 35(d)(2)(M) covering comparisons to include a specific reference to differences in the safety of investments and to clarify that the requirement to disclose material differences may include those listed in the subsection thus distinguishing between differences that, although listed, may not be material. The Board, however, did not as suggested modify Subsection 35(d)(2)(M) to only require disclosure of "relevant" material differences on the basis that the terms "material" and "relevant" are synonymous.

Rejecting another recommendation, the Board retained proposed Subsection 35(d)(2)(N) to prohibit all predictions or projections of performance because such projections are likely to be speculative and, therefore, misleading under the antifraud provisions of the federal securities laws. The Board believes the proposed subsection addresses specific forms of communication, while the antifraud provisions are general in nature. Another sug-

gestion called for modifying the subsection to permit statements relating to results from zero coupon bond portfolios and hypothetical illustrations (such as dollar-cost averaging or tax-free compounding charts). The Board rejected the suggestion regarding zero coupon bond portfolios because of the variety of zero coupon bond funds and because of the changes in expectations if the shares are liquidated; however, the Board agreed with the recommendation regarding hypothetical illustrations of mathematical principles. The Board also deleted the first reference to "future" in this subsection on grounds of redundancy.

REQUEST FOR VOTE

The Board believes that it is appropriate to rescind the Guidelines and amend Article III, Section 35 to incorporate and make applicable to all investment products standards that were previously applicable only to investment company/variable contract products. In addition to eliminating redundancies by rescinding the Guidelines, the incorporation of general and specific standards previously only applicable to investment company/variable contract products would consolidate the regulations under one rule. The Board considers the proposed amendments necessary and appropriate and recommends that members vote their approval.

The text of the proposed amendments to Article III, Section 35 that requires member vote is below. The text of the Guidelines which are proposed to be deleted in their entirety follow the amendments to Article III, Section 35. Please mark the attached ballot according to your convictions and mail it in the enclosed, stamped envelope to The Corporation Trust Company. Ballots must be postmarked **no later than December 21, 1992.** The amendment will not be effective until it is filed with and approved by the SEC.

Questions concerning this Notice should be directed to R. Clark Hooper, Vice President, Advertising, at (202) 728-8330, or Elliott R. Curzon, Senior Attorney, Office of General Counsel (202) 728-8451.

PROPOSED AMENDMENT TO ARTICLE III, SECTION 35 OF THE RULES OF FAIR PRACTICE REQUIRING MEMBER VOTE

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

ARTICLE III

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Communications With The Public

Sec. 35.

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(d) Standards Applicable to Communications with the Public

(1) General Standards

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(D) In judging whether a communication, or a particular element of a communication may be misleading several factors should be considered, including, but not limited to:

(i) The Overall Context in Which the Statement or Statements Are Made: A statement made in one context may be misleading even though such a statement could be perfectly appropriate in another context. An essential test in this regard is the balance of treatment of risks and potential benefits.

(ii) The Audience to Which the Communication Is Directed: Different levels of explanation or detail may be necessary depending on the audience to which a communication is directed, and the ability of the member given the nature of the media used, to restrict the audience appropriately. If the statements made in a communication would be applicable only to a limited audience, or if additional information might be necessary for other audiences, it should be kept in mind that it is not always possible to restrict the readership of a particular communication.

(iii) The Overall Clarity of the Communication: A statement or disclosure made in an unclear manner obviously can result in a lack of understanding of the statement, or in a serious misunderstanding. A complex or overly technical explanation may be worse than too little information. Likewise material disclosure relegated to legends or footnotes realistically may not enhance the reader's understanding of the communication.

(2) Specific Standards

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

* * * * *

(L) Claims of Tax-Free/Tax-Exempt Returns: Income or investment returns may not be characterized as tax free or exempt from income tax where tax liability is merely postponed or deferred. If taxes are payable upon redemption, that fact must

be disclosed. References to tax-free/tax-exempt current income must indicate which taxes apply or which do not unless income is free from all applicable taxes. For example, if income from an investment company investing in municipal bonds may be subject to state or local income taxes, this should be stated, or the illustration should otherwise make it clear that income is free from federal income tax.

(M) Comparisons: In making a comparison, either directly or indirectly, the member must make certain that the purpose of the comparison is clear and must provide a fair and balanced presentation, including any material differences between the subjects of comparison. Such differences may include investment objectives, sales and management fees, liquidity, safety, guarantees or insurance, fluctuation of principal and/or return, tax features, and any other factors necessary to make such comparisons fair and not misleading.

(N) Predictions and Projections: Investment results cannot be predicted or projected. Investment performance illustrations may not imply that gain or income realized in the past will be repeated in the future. However, for purposes of this rule, the following types of information are not considered projections of performance; hypothetical illustrations of mathematical principles, (e.g., illustrations designed to show the effects of dollar-cost averaging, tax-free compounding, or the mechanics of variable annuity contracts or variable life policies).

(**Note:** Entire text is proposed to be deleted.)

[GUIDELINES REGARDING COMMUNICATIONS WITH THE PUBLIC ABOUT INVESTMENT COMPANIES AND VARIABLE CONTRACTS

1. General Considerations

In judging whether a communication, or a particular element of a communication, may be misleading, several factors should be considered, including, but not limited to:

The Overall Context in Which the Statement or Statements Are Made

A statement made in one context may be misleading even though such a statement could be perfectly appropriate in another context. An essential test in this regard is the balance of treatment of risks and potential benefits.

The Audience to Which the Communication is Directed

Different levels of explanation or detail may be necessary depending on the audience to which a communication is directed, and the ability of the member, given the nature of the media used, to restrict the audience appropriately. If the statements made in a communication would be applicable only to a limited audience, or if additional information might be necessary for other audiences, it should be kept in mind that it is not always possible to restrict the readership of a particular communication.

The Overall Clarity of the Communication

A statement or disclosure made in an unclear manner obviously can result in a lack of understanding of the statement, or in a serious misunderstanding. A complex or overly technical explanation may be worse than too little information. Likewise, material disclosure relegated to legends or footnotes realistically may not enhance the reader's understanding of the communication.

2. Special Considerations in Presenting Investment Results

Presentations of investment results require special care to insure that they are not misleading. While it is not possible to prevent every reader of a communication which illustrates investment results from attributing unwarranted predictive value to the data, adequate consideration of certain basic principles can reduce this risk. Among these basic principles are:

Investment Objectives and Policies as Related to Data Provided

Generally speaking, illustrations of investment results should be designed to illustrate the relationship of investment performance to stated investment objectives over meaningful periods. If material changes in objectives, policies, management, or other characteristics have occurred during or since the time period illustrated, these changes should be described.

Appropriateness and Fairness of the Time Periods Illustrated

In general, the appropriate time periods for illustrations of results are those which are of sufficient duration that the relevance of the data to the investment objectives can be determined. Thus yield or performance data may cover a variety of different periods for different types of investments.

The selection of a specific time period solely for the purpose of illustrating performance "at its best" is likely to mislead. Illustrations should generally include the last full calendar or fiscal year, or the last twelve months.

Adequacy of Information Concerning the Relevance of Results Illustrated to Probable Future Results

Investment results cannot be predicted or projected and historical illustrations should reflect this. Presentations of investment results should be made in a context that makes clear that within the longer periods illustrated there have been short term fluctuations, often counter to the overall trend of investment results, and that no single period of any length is to be taken as "typical" of what may be expected in future periods. This is a simple principle, and not one which should require a great deal of boiler plate language but rather a simple, straightforward explanation.

The Clarity of a Chart or Table Format

In selection of a format for illustration of investment results in either chart or table form, consideration should be given not only to the completeness and accuracy of the data, but also to the clarity and meaningfulness of the overall presentation. Careful consideration should be given to the overall visual impact of data presented in chart form, since the reader may not go beyond a scanning of the "trend" shown by a chart. It should be recognized that the reader who is confused by having been buried in masses of unclear, although statistically relevant, data may be misled just as badly as the reader who is given too little information.

The Adequacy of Summary Results and the Need for Supporting Data

While a summary of investment results is often necessary in order to make sales literature readable and understandable, it must be recognized that the reader may not look beyond the summary data presented. Consequently, the preparer of such illustrations should take into account that the summary data must be fair in all respects and not likely to mislead, either directly or by distracting the reader from other necessary information. Generally speaking, all summary data covering periods longer than one year should be supported by full year-by-year data over the same or longer periods and should include reference to that supporting data. If supporting data is not included in the same piece of sales literature, members should carefully consider supplying the data in another document.

Inclusion of Relevant Charges and Expenses

Illustrations of income and/or capital results should reflect the results which would have been achieved by the reader for whom the illustration is designed. Actual sales charges, account charges or deductions, and any other relevant expenses which would have been applicable should be taken into account in the illustration, unless such current charges are different, in which case the current charges should be described. Illustrations of gross investment results may be appropriate under certain limited circumstances, but such illustrations should normally be accompanied by an explanation of how such results would be affected by all applicable charges and expenses.

3. Specific Considerations in Presenting Capital Results or Total Return Illustrations

Application of the foregoing principles to illustrations involving capital results, either alone or as part of a "total return" illustration, results in the following specific considerations.

Capital results illustrations, including "total return" data, should generally cover a period long enough to reflect variations in value through different market conditions. A period of ten years, or if shorter, the life of the company or account, is the recommended minimum illustration period, with periods longer than ten years being in five-year increments. In illustrations of other periods, particularly shorter periods, members should consider whether to include with such illustration an explanation of the reason for selecting such period and whether data for the recommended ten-year or life minimum period should be included with such illustration or in another specifically referenced document, such as a prospectus or shareholder report. Generally, data for full calendar or fiscal years should be reflected. A discussion of the general trends of relevant securities prices during the period may be desirable to lend proper perspective to such illustrations. Illustrations dealing solely with capital results should explain the relative significance of income.

Illustrations of "total return" (i.e. illustrations which reflect the combined results of capital and income) should reflect dollar and/or percentage changes for each year covered by the illustration, as well as for the total period. The illustration should, except for variable contracts, show the

breakdown of the income and capital components at least for the total period covered. Where such a breakdown for the total period would not adequately convey the significance of annual variations in the components, consideration should be given to including annual income and capital data. If dividends are assumed to have been reinvested, the illustration should reflect the actual frequency and results of such reinvestments during the period. Illustrations of performance results in chart form may be misleading because of the scale on which they are displayed. Generally, if an illustration of capital results or of total return is in chart form, a semi-log (ratio) format is recommended.

4. Specific Considerations in Presenting Yield Data or Illustrations

Application of the foregoing general principles to income or yield illustrations results in the following specific considerations.

Any illustration or statement of yield should be accompanied by an explanation of how the yield is computed, along with any additional information necessary to fairly evaluate the yield, including reference to such risks as may be involved in ownership of the security. Depending on the circumstances, one or more of the following may be appropriate:

- a statement concerning the variability of income;
- a statement of the variability of capital value, e.g., the net asset value at the beginning and end of the previous calendar or fiscal year, or during a recent market advance or decline;
- information about the general characteristics of the portfolio and any material portfolio changes which are anticipated.

Historic yields should be calculated by dividing the company's annual dividends from net investment income by the maximum offering price of the company's shares, using either the average price during the year or the price at the beginning or end of the year.

Current yields should generally be calculated by dividing the company's dividend income for the previous twelve months by the current maximum offering price. However, annualized yields based on periods of less than one year may be appropriate in some cases, e.g., money market funds, funds with less than a full year's history, and funds where the current rate of dividend income varies significantly from the dividends paid in the previous twelve months. Such annualized yield should be based on the company's gross income less actual expenses for the period.

Yields or income should not be characterized as tax sheltered or as free or exempt from income tax where tax liability is merely postponed or deferred. Unless income is free from all income taxes, references to tax exemption should indicate which taxes apply or specify which taxes do not apply. For example, if income from an investment company investing in municipal bonds may be subject to state or local income taxes, this should be stated, or the illustration should otherwise make it clear that income is free from federal income tax.

5. Considerations Regarding Comparisons

Comparisons of investment products or services may be valuable or useful to investors but care must be taken to insure that comparisons are fair and balanced. Comparisons generally should include an explanation of the purpose of the comparison and explanation of any material differences between the subjects of the comparison.

Comparisons involving investment companies and variable contracts are often related to yield or performance, but may also relate to structure, fees, tax features and other matters. It is essential that a comparison be as complete as practicable and that no fact be omitted which, if disclosed, would likely alter materially the conclusions reasonably drawn or implied by the comparison. This point is particularly important with respect to selection of time periods for comparison of investment results. Data for each subject of the comparison should also be presented on the same basis, i.e., for the same period in terms of both aggregate and year by year data.

Comparisons with alternative investment or savings vehicles should explain clearly any relevant differences in guarantees, fluctuations of principal and/or return, insurance, tax features, and any other factors necessary to make such comparisons fair and not misleading.

A comparison of investment performance with a market index or average generally should, if appropriate in view of the nature of the comparison, include a clear indication of the purpose of the comparison and the reason or purpose for selection of the index or average, and a description of the index and the fact that it is unmanaged. The extent

of the explanation necessary will vary, depending upon the degree of general recognition of the particular index. If there are material differences between the composition of the index and the composition of the portfolio, this should be pointed out. If the comparison is not on a total return basis, the relative impact of differences in income or capital changes, whichever is applicable, should also be explained.

Unless the comparison clearly explains the material relevant differences, a comparison with an index, average, or group of investment companies or accounts should relate to an index, average, or group of investment companies or accounts with investment objectives similar to that of the company compared. Where possible, it is advisable to use an independently prepared and published index, average or group. The smaller or less widely recognized the group or category selected, the greater the importance of explaining the reason for the selection. Since overall investment company industry averages generally include diverse portfolios and objectives, comparisons with such averages should generally not be used.]

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MAIL VOTE

Subject: Proposed Amendments to Schedule E to the NASD By-Laws Regarding Potential Conflicts of Interest; Last Voting Date: December 21, 1992

EXECUTIVE SUMMARY

The NASD invites members to vote on proposed changes to Schedule E that would require compliance with its provisions if a member participating in a distribution of a public offering of debt or equity securities has a conflict of interest with the issuer. A conflict of interest would be deemed to exist if the member or its affiliates own an aggregate of 10 percent or more of the outstanding subordinated debt, 10 percent or more of the common equity or the preferred equity of a corporation; or 10 percent or more of the distributable profits or losses through a general, limited, or special partnership interest. The NASD is also proposing to adopt an exception to the requirement that a qualified independent underwriter provide a pricing opinion where the member affiliated with the issuer or a member that has a conflict of interest with the issuer is participating as a financial advisor in a restructuring or recapitalization. The text of the amendments follows the discussion below.

BACKGROUND

In 1972, the NASD adopted Schedule E to the By-Laws (Schedule E) to regulate the potential conflicts of interest that exist when a member participates in the public distribution of its own securities or the securities of an affiliate. The presumptions contained within Schedule E used to determine affiliation are generally either voting control through ownership of equity securities or common control of management through interlocking officerships or directorships. Schedule E addresses the conflicts by requiring a qualified independent underwriter to render an opinion on the price of the securities offered, conduct due diligence, and participate in the preparation of the registration statement, in the absence of an investment-grade rating for debt securities or a bona fide independent market for equity securities. The qualified independent underwriter also assumes underwriter's liability for the offering. The NASD has relied on the objectivity and independence of the qualified independent underwriter to resolve the conflicts of interest present when a member distributes its own securities or those of an affiliate.

PUBLICATION FOR COMMENT

In June 1990, the NASD published *Notice to Members 90-39* (June 1990) requesting membership comment on proposed amendments to Schedule E to address the conflicts of interest that exist when a member participates in a public offering of an issuer while the member owns debt, preferred equity, or non-voting common equity of the issuer. The NASD is concerned regarding such offerings because members and their affiliates often become holders of risky, less-than-investment-grade debt securities as a result of their participation in leveraged buy-out transactions. This could influence the independence of members' pricing and due diligence functions in any subsequent related public offering.

COMMENTS RECEIVED

The NASD received 19 comment letters on the amendments to Schedule E published for comment in *Notice to Members 90-39*. None of the comments fully supported the proposed amendments as published for comment. The commenters were particularly concerned with the concept of expanding Schedule E to include certain types of offerings that have heretofore been excluded from the provisions of Schedule E and argued that the 10 percent threshold that would trigger the application of Schedule E is too low. Commenters also argued that ownership of debt and non-voting preferred and common stock does not permit members or their affiliates to control an issuer and does not affect the member's ability to independently perform pricing and due diligence in a public offering. Commenters also pointed out the practical difficulty of determining when debt and preferred securities are owned since such securities may have been acquired in the normal course of business and are being held in trading or investment accounts.

Questions were also raised regarding the impact of the proposed amendments on NASD members affiliated with banks or bank holding companies, since banks are most likely to act as a corporate lender, and the difficulties that members affiliated with banks would experience in complying with the provisions of Schedule E which require (1) that a majority of the members of the Board of Directors of the member have five years experience in the securities business; and (2) if the member intends to manage the underwriting, that the member have been involved in the securities business at least five years.

NASD REVIEW

The NASD has reviewed the comments received in response to *Notice to Members 90-39*. The NASD continues to believe that a member is subject to conflicts of interest in pricing an offering of securities and performing due diligence that require compliance with the provisions of Schedule E when the member owns at least 10 percent of the debt and non-voting preferred and common stock of an issuer. The NASD recognizes that the incidences of such ownership have decreased since the issue was first considered. A number of changes have been made to the proposed amendments to Schedule E that the NASD believes will address the most significant objections of commenters. Because of the negative comments generated by publication for comment of the original version of the proposed amendments to Schedule E, the NASD has published a revised proposal for member vote.

SUMMARY OF PROPOSED AMENDMENTS

Set forth below is a summary of the amendments proposed to each section of Schedule E. In each case, a description is provided of any modifications to the rule language as published in *Notice to Members 90-39*.

Section 1 — General

The NASD is proposing a new introductory paragraph to Schedule E that sets forth the applicability of Schedule E to conflict-of-interest situations by prohibiting members and their associated persons from participating in the distribution of a public offering of debt or equity securities if the member and/or its associated persons, parent, or affiliates have a conflict of interest with the company. No modifications have been made to the rule language of this provision as published in *Notice to Members 90-39*.

Section 2 — Definitions

Four new definitions are proposed to be added to the definitions section and one definition is proposed to be amended.

■ **Common Equity** — A new definition of "common equity" is proposed to include the total number of shares of common stock outstanding without regard to class, voting rights, or other dis-

tinguishing characteristics as reflected on the consolidated financial statements of the company. No modifications have been made to the rule language of this provision as published in *Notice to Members 90-39*.

■ **Conflict of Interest** — The principal new definition is that of "conflict of interest." Significant modifications have been made to the rule language of this provision as published in *Notice to Members 90-39* to address the comments received which are reflected in this provision and the related definitions for "preferred equity" and "subordinated debt." The provision has been modified to exclude ownership of the common equity, preferred stock, or debt of the *parent* of the issuer. A conflict of interest will be deemed to exist if the member and/or its associated persons, parent, or affiliates in the aggregate beneficially own 10 percent or more of the:

(1) outstanding subordinated debt of a company;

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

(3) preferred equity of a company. In addition, a conflict of interest will be deemed to exist if the member and/or its associated persons, parent, or affiliates beneficially owns a general, limited, or special partnership interest in 10 percent or more of the distributable profits or losses of a company.

The calculation of the 10 percent threshold would be based on all securities of the issuer beneficially owned by the member at the time of the filing of the offering documents, including proprietary trading accounts and other fluctuating positions, regardless of whether any of the securities are sold prior to effectiveness of the offering.

A new paragraph has been added to this provision to set forth a number of exclusions from the definition of "conflict of interest" in response to the requests of commenters. Exclusions would be available for: (1) offerings by not-for-profit and charitable organizations; (2) investment companies registered under the Investment Company Act; (3) "separate accounts" as defined in the Investment Company Act of 1940; (4) real estate investment trusts; (5) direct participation programs; (6) financing-instrument-backed securities that are rated investment grade; (7) equity securities for which a bona fide independent market exists; and (8) debt securities rated investment grade.[1]

■ **Preferred Equity** — The term "preferred equity" is proposed to be the same as that published in *Notice to Members 90-39* and would include the aggregate capital invested by all persons in the preferred securities outstanding without regard to class, voting rights, or other distinguishing characteristics as reflected on the consolidated financial statements of the company.

■ **Subordinated Debt** — In response to comments, the NASD has modified the proposal published for comment, which included a definition of the term "debt" that would have provided that a conflict exists based on at least a 10 percent beneficial interest in the short- and long-term debt of a company. On review of the comments received, the NASD believes that the proposed amendments should not (and were not intended to) apply to banks or lending institutions that make loans to companies in the normal course of business. Since it is subordinated debt that is often issued in a leveraged buy-out and restructuring transactions, the NASD has determined that these are the transactions of greatest concern. As a result, all senior debt, whether secured or unsecured, and all short-term with a maturity at issuance of less than one year would be excluded from the application of the proposed amendments.[2]

In place of the prior proposed definition of the term "debt," the NASD is proposing to adopt a definition of "subordinated debt" to include debt of an issuer that is expressly subordinate in right of payment to, or with a claim on assets subordinate to, any existing or future debt of such issuer and all debt that is specified as subordinated at the time of issuance. The language of the definition specifically excludes short-term debt, as well as secured debt and bank debt not specified as subordinated debt at the time of issuance.

■ **Qualified Independent Underwriter** — A conforming amendment is proposed to subparagraph (6) of the definition of "qualified independent underwriter" currently included in Subsection 2(l) to Schedule E. Subsection 2(l) sets forth the re-

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

[2]The calculation of the 10 percent threshold would be applicable to an issuer's entire subordinated debt outstanding. Senior and short-term debt would, therefore, be excluded when calculating the percentage of debt that would trigger application of the proposed amendments.

quirement that a qualified independent underwriter not be an affiliate of the issuer and not beneficially own 5 percent or more of the outstanding voting securities of the issuer. The provision is proposed to be modified also to prohibit ownership of 5 percent or more of the common equity, preferred equity, or subordinated debt of the issuer.

Section 3 — Participation in Distribution of Securities of Member or Affiliate

Subsection 3(a) — It is proposed that Section 3 be retitled "Participation in Distribution of Securities." Subsection 3(a) has been modified by the addition of a prohibition on any member underwriting or participating as a member of the underwriting syndicate or selling group or otherwise assisting in the distribution of a public offering of securities of a company with which the member or its associated persons, parent, or affiliates have a conflict of interest unless the member complies with Subsection 3(b) and Subsection 3(c). No modifications have been made to the rule language of this provision as published in *Notice to Members 90-39*.

Subsection 3(b) — The NASD is not proposing any changes to Subsection 3(b) which requires that the majority of the Board of Directors of the member that is deemed to have a conflict with the issuer must have been actively engaged in the investment banking or securities business for at least five years and, if the member intends to manage the underwriting, that the member have been involved in the securities business at least five years. With respect to the concerns of commenters that are bank-affiliated members, the NASD believes that if the members of the Board and the firm can demonstrate sufficient appropriate experience, the Corporate Financing Department has some flexibility in applying the provision and that exceptions, as appropriate, may be granted pursuant to Section 16 of Schedule E by a hearing subcommittee or by the Chairman of the Corporate Financing Committee in consultation with the Director of the Department on a case-by-case basis.

Subsection 3(c) — The NASD is proposing to amend Subsection 3(c) to indicate that if a member proposes to underwrite, participate as a member of the underwriting syndicate or selling group, or otherwise assist in the distribution of a public offering of securities of a company with which it or its associate persons, parent, or affiliate have a conflict, the offering must be made in compliance with paragraph 3(c)(1), which requires a qualified independent underwriter to participate in the preparation of the offering document, exercising the usual standards of due diligence with respect thereto, and issue an opinion on the pricing of the offering. As stated above, the definition of "conflict of interest" would specifically exclude the application of Schedule E to conflict-of-interest situations where the offering comports with the alternative forms of Schedule E compliance set forth in paragraphs 3(c)(2) and (3), which require either a bona fide independent market (in the case of an equity offering) or an investment-grade rating (in the case of a debt offering).

No modifications have been made to the rule language of Subsection 3(c) as published in *Notice to Members 90-39*. In response to comments, however, the NASD proposes to clarify the applicability of the requirements of paragraph 3(c)(1) to recapitalizations and restructurings where an NASD member offering securities of an affiliate or subject to the application of Schedule E because of a conflict of interest is acting as a financial advisor rather than an underwriter. In this event, the NASD believes that it is appropriate to recognize that the more limited functions of the member acting as a financial adviser would not require the qualified independent underwriter to provide a pricing opinion where the financial adviser has not been engaged to opine on the price or the exchange value. The NASD is, therefore, proposing to amend paragraph 3(c)(1) to set forth this exception in a parenthetical statement.

Section 4 — Disclosure

Subsection 4(b) — This Subsection of Schedule E is proposed to be amended to require the disclosure in the offering document if the offering is by an issuer with which a member has a conflict of interest. The provision currently requires that the offering document disclose that the offering is being made pursuant to the provisions of Schedule E, the name of the qualified independent underwriter and that such member is assuming the responsibilities of acting as a qualified independent underwriter. In the case of an offering subject to the conflict-of-interest provisions, the provision would require disclosure that the member or its associated persons, parent, or affiliates own the common stock, preferred stock, or subordinated debt of

the company.

Members currently subject to Schedule E are only required to disclose whether the offering is being made by a member of its own securities or those of an affiliate and are not required to disclose that the member has a conflict of interest with the issuer. In response to comments received on the proposed amendments, the NASD has determined to delete the language originally included in *Notice to Members 90-39* that would have required disclosure that the member is subject to a conflict of interest. Moreover, the NASD has long held the position that the application of Schedule E is not a determination that a conflict of interest actually exists, but is necessary to prevent at least the appearance of a conflict of interest.

Corporate Financing Filing Requirements

The filing requirements of the Corporate Financing Rule are contained in Section (b) to Article III, Section 44 of the NASD Rules of Fair Practice (Corporate Financing Rule). Paragraph (b)(6)(C) requires that members filing an offering subject to the filing requirements of the Rule or Schedule E[3] submit a statement that is intended to elicit information on whether any member or person associated with a member has acquired any debt or equity securities of the issuer. The provision currently requires a statement of the association or affiliation with any member of any debt or equity securityholder of an issuer in an initial public offering. Where the offering is not an initial public offering, the same information is requested to any securityholder of five percent or more of any class of the issuer's securities. The provision sets forth the details of the information regarding such securityholdings that must be submitted in the statement.

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

REQUEST FOR VOTE

The NASD Board of Governors believes that the proposed amendments to Schedule E are necessary to address the potential conflicts of interest that are present when a member (its associated persons, parent, or affiliates) participating in a debt or equity public offering owns 10 percent or more of the subordinated debt, preferred stock, or common equity of a company. The Board considers the proposed amendments necessary and appropriate and recommends that members vote their approval. The amendments will not be effective until filed with and approved by the Securities and Exchange Commission. Please mark the attached ballot according to your convictions and mail it in the enclosed stamped envelope to The Corporation Trust Company. Ballots must be postmarked **no later than December 21, 1992.**

Questions concerning this Notice should be directed to Charles L. Bennett, Director, NASD Corporate Financing Department, at (202) 728-8253.

Schedule E to the NASD By-Laws

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

Distribution of Securities of Members and Affiliates — Conflicts of Interest

Section 1 — General

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

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

Section 2 — Definitions

* * * * *

(e) **Common Equity** — the total number of

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

shares of common stock outstanding without regard to class, whether voting or non-voting, convertible or non-convertible, exchangeable or non-exchangeable, redeemable or non-redeemable, as reflected on the consolidated financial statements of the company.

* * * * *

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

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

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

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

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

(a) an offering of securities exempt from registration with the Securities and Exchange Commission under Section 3(a)(4) of the Securities Act of 1993;

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

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

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

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

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

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

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

* * * * *

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

* * * * *

[l]o **Qualified independent underwriter* —** a member which:

*

*

*

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

* * * * *

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

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

(a) No member shall underwrite, participate as a

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

member of the underwriting syndicate or selling group, or otherwise assist in the distribution of a public offering of an issue of debt or equity securities issued or to be issued by the member of an affiliate of the member, or of a company with which the member or its associated persons, parent or affiliates have a conflict of interest, unless the member is in compliance with subsection 3(b) and subsection 3(c) below.

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

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

(1) the price at which an equity issue or the yield at which a debt issue is to be distributed to the public is established at a price no higher or yield no lower than that recommended by a qualified independent underwriter, (except that in the case of an exchange offer or other transaction relating to a recapitalization or restructuring of a company, a qualified independent underwriter is not required to provide a recommendation on the price or yield at which a security shall be distributed if the member that is affiliated with the issuer or with which the member or its associated persons, parent or affiliates have a conflict of interest is not obligated to and does not provide a recommendation or opinion with respect to the price, yield, or exchange value of the transaction), which shall also participate in the preparation of the registration statement and prospectus, offering circular, or similar document and which shall exercise the usual standards of "due diligence" in respect thereto; provided, however, that an offering of securities by a member which has not been actively engaged in the investment banking or securities business, in its present form or as a predecessor broker/dealer, for at least the five years immediately preceding the filing of the registration statement shall be managed by a qualified independent underwriter;

* * * * *

Section 4 — Disclosure

(a) Unchanged.

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

* * * * *

Section 11 — Suitability

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

Section 12 — Discretionary Accounts

Notwithstanding the provisions of Article III, Section 15 of the Corporation's Rules of Fair Practice, or any other provisions of law, a transaction in securities issued by a member or an affiliate of a

member, or by a company with which a member has a conflict of interest shall not be executed by any member in a discretionary account without the prior specific written approval of the customer.

NASD

Notice To Members

National Association of Securities Dealers, Inc. — November 1992

Number 92-58

Suggested Routing:*

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

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

Subject: SEC Approval of Amendment to Section 13, Schedule E to the NASD By-Laws Effective October 1, 1992

EXECUTIVE SUMMARY

The Securities and Exchange Commission (SEC) has approved an amendment to Section 13 of Schedule E to the NASD By-Laws (Schedule E). The amendment permits NASD members to sell securities issued by an entity that wholly owns the member to their employees and other associated persons. The text of the amendment follows this Notice.

BACKGROUND

Section 13 provides an exemption from the NASD Free-Riding and Withholding Interpretation (Interpretation) and permits NASD members to sell securities of the member or those of its parent to its employees. Section 13 was part of the original amendments to the NASD By-Laws governing the distribution of securities of an NASD member. The NASD Board of Governors (Board) recognized the fact that employees of members would naturally desire to have an ownership interest in their employer. The Board also believed such an investment was beneficial for both the employee and employer.

The Interpretation is based on 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 a secondary market. This obligation applies regardless of whether such securities are acquired by the member and an underwriter, as a selling group member, or from a member participating in the distribution as an underwriter or selling group member, or otherwise. The NASD believes that 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 at which the security trades in the secondary market. Thus, failure to make a bona-fide distribution, 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.

Prior to 1988, Section 13 permitted sales to employees of an affiliated member. *Notice to Members 86-28* requested comments to modify major sections of Schedule E, including a proposal specifically to exclude sales to affiliates. *Notice to Members 88-33* adopted those modifications and, as a result, Section 13 was narrowed to restrict the exemption from the Interpretation to sales to employees of the member or its parent. To permit sales to

employees of affiliates of NASD members was believed to be too broad and permissive in scope. Sales to employees of the member or its parent was the original intent of the exemption from the Interpretation. The NASD and the SEC now believe that certain sales to special purpose affiliates may be appropriate. The view is now that the modifications may have been too restrictive and may have disenfranchised persons that should have been permitted to invest in the securities of their employer's holding company.

AMENDMENT

Section 2(h) of Schedule E defines the term "parent" for purposes of Section 13 as any entity affiliated with the member from which the member derives 50 percent or more of its gross revenues or in which it employs 50 percent or more of its assets. Large diversified holding companies cannot meet this definition of a parent of a member because the activities of the broker/dealer are only a small part of their business. Employees and other associated persons of NASD member firms owned by such large holding companies, therefore, could not rely on the Section 13 exemption to the Interpretation to purchase shares of their respective holding company in a public offering.

Section 13 now allows employees and other associated persons of NASD members wholly owned by large holding companies to purchase the securities offered by such entities even though the holding company does not come within the Schedule E definition of a parent. It is the NASD's belief that enabling such persons to purchase shares of their respective holding company in a public offering is consistent with the policy of permitting employees of members to have an ownership interest in their member-employers.

EFFECTIVE DATE

The amendment became effective on October 1, 1992. Therefore, NASD members may sell securities to their employees and associated persons when the securities are issued by an entity that wholly owns the NASD member.

Questions concerning this Notice can be directed to Carl R. Sperapani, Assistant Director, or the staff of the Corporate Financing Department, at (202) 728-8258.

AMENDMENT TO SCHEDULE E TO THE BY-LAWS

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

Section 13 — Sales to Employees — No Limitations

Notwithstanding the provisions of the Board of Governors' Interpretation With Respect To "Free-Riding and Withholding," a member may sell securities issued by a member, a parent of a member, an entity which wholly owns a member, or by an issuer treated as a member or parent of a member under Section 9 hereof to the member's employees; potential employees resulting from an intended merger, acquisitions, or other business combination of members resulting in one public successor corporation; persons associated with the member; and the immediate family of such employees or associated persons without limitation as to amount and regardless of whether such persons have an investment history with the member as required by that interpretation; provided, however, that in the case of an offering of equity securities for which a bona fide independent market does not exist, such securities shall not be sold, transferred, assigned, pledged, or hypothecated for a period of five months following the effective date of the offering.

NASD

Notice To Members

National Association of Securities Dealers, Inc. November 1992

Number 92-59

Suggested Routing:*

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

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

Subject: SEC Approval of Amendments Requiring Prefiling of Advertisements for Collateralized Mortgage Obligations

EXECUTIVE SUMMARY

On October 28, 1992, the Securities and Exchange Commission (SEC) approved an amendment to Article III, Section 35 of the Rules of Fair Practice and Section 8 of the NASD's Government Securities Rules requiring members to prefile advertisements relating to collateralized mortgage obligations (CMOs). The amendments take effect on November 16, 1992. The text of the new rule language follows this Notice.

BACKGROUND AND DESCRIPTION OF THE AMENDMENTS

On October 28, 1992, the SEC approved a rule change amending Article III, Section 35 of the Rules of Fair Practice and Section 8 of the NASD's Government Securities Rules requiring members to file advertisements concerning CMOs issued by a corporation or an agency of the United States government with the NASD prior to use. The requirement will be temporary, lasting for a period of one year until November 15, 1992. Before the end of the first year, the Association will evaluate the efficacy of the rule and determine whether to extend the rule, propose changes, or eliminate it.

The amendments reflect the NASD's increasing concern over misleading advertisements for CMOs and an increase in the number of complaints associated with such advertisements. The NASD believes that CMOs are extremely complex and require full and fair disclosure to assist the investor in understanding them. CMO advertisements generally are brief and emphasize high yields, safety, government guarantees (where applicable), and liquidity. The NASD has found, however, that it is difficult to distinguish between CMOs based on the content of such advertisements. Even though two CMOs have the same underlying collateral, they may differ substantially in their prepayment predictability or volatility. In particular, the terms "interest only" or "principal only" are generally inadequately explained.

As a result of these concerns, the NASD issued *Notice to Members 92-27* (May 1992) detailing the problems relating to CMO advertising and recommending that members' CMO advertisements comply with certain standards set forth in the Notice. For example, the NASD believes that an advertisement which includes the "yield" of a CMO is misleading without disclosure of the prepayment assumption used to calculate the yield and that the anticipated yield and average life of the security will fluctuate depending on the actual prepayment experience and current interest rates.

The NASD also recommended in *Notice to*

Members 92-27 (May 1992) that CMO advertisements not contain comparisons between CMOs and any other investment vehicles. The NASD is particularly concerned that advertising CMOs as alternatives to certificates of deposit (CDs) falsely implies that CMOs offer the same level of safety and guarantee of interest and principal as CDs.

In light of these concerns, the NASD has amended its rules to subject CMO advertisements to pre-use filing to provide NASD staff an opportunity to comment on the fairness and reasonableness of such advertisements prior to use and permit potentially misleading advertisements to be identified and withheld from publication.[1]

The new rule with respect to CMO advertising is set forth in new Subsection (c)(2) of Section 35 requires that all advertisements concerning corporate CMOs be filed with the NASD's Advertising Department at least 10 days prior to first use unless the Department permits a shorter period in particular circumstances. The advertisement must be approved before use. If changed or expressly disapproved by the NASD, it cannot be published or circulated until the member makes the changes specified by the Association. A disapproved advertisement must be refiled and receive Association approval prior to publication or circulation. The NASD also added a new Subsection 8(c)(1)(B) to its Government Securities Rules to require prefiling of advertisements relating to CMOs issued by an agency of the United States government. A technical amendment also deletes current Subsection 8(c)(2)(B) which applied to filing advertisements concerning government securities during the first year of the operation of the Government Securities Rules which were adopted by the NASD in 1989.

While the NASD believes that a pre-use filing requirement for CMO advertisements is appropriate, the NASD recognizes that it diminishes the flexibility of member firm advertising programs. Accordingly, the rule will be in effect for one year only. During that year, the NASD's Fixed Income Committee will review the rule's impact to determine the need for changes to ensure that CMO advertising is not misleading.

The NASD has also amended Article III, Section 35 of the Rules of Fair Practice to consolidate the current filing requirements for registered investment companies and public direct participation programs set forth in Subsections (c)(1) and (2), respectively, into new Subsection (c)(1). The requirements themselves are unchanged.

The amendments take effect on November 16, 1992. Questions concerning this Notice should be directed to R. Clark Hooper, Vice President, Advertising at (202) 728-8330, or Elliott R. Curzon, Senior Attorney, Office of General Counsel at (202) 728-8451.

TEXT OF AMENDMENTS TO ARTICLE III, SECTION 35 OF THE RULES OF FAIR PRACTICE

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

Communications With the Public

Sec. 35.

* * * * *

(c) Filing Requirements and Review Procedures

[(1) Advertisements and sales literature concerning registered investment companies (including mutual funds, variable contracts and unit investment trusts) shall be filed with the Association's Advertising Department within 10 days of first use or publication by any member. Filing in advance of use is recommended. Members are not required to file advertising and sales literature which have previously been filed and which are used without change.

(2) Advertising and sales literature concerning public direct participation programs as defined in Article III, Section 34 of the Rules of Fair Practice shall be filed with the Association's Advertising Department for review within 10 days of first use or publication. Filing in advance of use is recommended. Members need not file for review advertising and sales literature which has been filed by the sponsor, general partner or underwriter of the program or by another member.]

(1) Advertisements and sales literature concerning registered investment companies (including mutual funds, variable contracts and unit investment trusts) and public direct participation programs (as defined in Article III, Section 34 of the Rules of Fair Practice) shall be filed with the Association's Advertising Department within 10

[1] At present, advertisements concerning government securities must be filed with the NASD within 10 days of first use or publication. Additionally, advertisements and sales literature concerning registered investment companies and direct participation programs currently must be filed within 10 days of first use. Advertising and sales literature pertaining to options currently must be approved in advance of its use or publication.

days of first use or publication by any member. Filing in advance of use is recommended. Members are not required to file advertising and sales literature which have previously been filed and which are used without change.

(2) Advertisements concerning collateralized mortgage obligations registered under the Securities Act of 1933 shall be filed with the Association's Advertising 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 or sales literature has been refiled for, and has received, Association approval. This subsection (c)(2) shall remain in effect for one year from November 16, 1992 unless modified or extended prior thereto by the Board of Governors.

GOVERNMENT SECURITIES RULES

Communications With the Public
Sec. 8

* * * * *

(c) Filing Requirements And Review Procedures

(1) Members shall file advertisements for review with the Association's Advertising 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 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 or sales literature has been refiled for, and has received, Association approval. This subsection (c)(1)(B) shall remain in effect for one year from November 16, 1992 unless modified or extended prior thereto by the Board of Governors.

(2) [(A)] No change.

[(B) Each member that, on the effective date of this section, had been filing advertisements with the Association for a period of less than one year shall continue to file its advertisements concerning government securities at least 10 days prior to use, until the completion of one year from the date the first advertisement was filed with the Association.]

NASD

Notice To Members

National Association of Securities Dealers, Inc. November 1992

Number 92-60

Suggested Routing:*

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

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

Subject: SEC Approval of Amendments Relating to Periodic Account Statements

EXECUTIVE SUMMARY

On October 14, 1992, the Securities and Exchange Commission (SEC) approved an amendment adding new Section 45 to Article III of the Rules of Fair Practice requiring members to send account statements to customers at least quarterly. The amendments take effect on January 31, 1993. The text of the new rule language follows the discussion below.

BACKGROUND AND DESCRIPTION OF THE AMENDMENTS

On October 14, 1992, the SEC approved a rule change adding a new Section 45 to Article III of the NASD Rules of Fair Practice relating to periodic account statements. Under SEC Rule 15c3-2, broker/dealers have to notify customers every three months that the free credit balances in their accounts may either be used by the broker/dealers or paid on demand to the customers. The notification requirement, however, only applies if a customer has a free credit balance.

Because NASD members do not have to send periodic account statements to customers, some broker/dealers send only the free-credit-balance notice required by Rule 15c3-2. They do not send account statements of all securities positions, money balances, and account activity since the last statement. As a result, these customers are not advised of the current status of their accounts, regardless of any change in the status of those accounts.

The NASD believes that, in the interest of customer protection, customers should be more fully informed of the status of their accounts. The new rule requires members to send account statements at least once every quarter to customers having securities positions, funds, or any change in their account during the period since the previous statement was sent. The rule requires that the statement include a description of all securities positions, money balances, and account activity in the account during the period.

Subsection (a) of the rule requires each general securities member to send a statement of account describing all account activity to each customer at least once every quarter. Any account statements showing all account activity and sent more frequently than quarterly will satisfy the requirement.

Subsection (b) of the rule defines the term "account activity" to include all types of activity that may occur in a securities account with respect to "securities or funds in the possession or control of the member." Thus, this limitation exempts account activity relating to funds or securities not in control of the member. For example, direct participation program (DPP) securities are not covered

since, after the initial purchase through the distributing broker/dealer, the general partner communicates directly with investors.

Subsection (c) defines the phrase "general securities member" as a member that calculates its net capital under SEC Rule 15c3-1(a), except for paragraphs (a)(2) or (a)(3) — that is, a broker/dealer required to maintain at least $25,000 in net capital. Subsection (c) further defines "general securities member" to *exclude* members who do not carry customer accounts or hold customer funds or securities. Thus, members whose business is limited to variable contract insurance products, mutual funds, and unit trusts, among other products, or who neither carry accounts nor hold customer funds or securities, are exempt from the rule. In these cases, responsibility for complying with the rule falls on the member carrying the account or holding the funds or securities for those members.

Both subsections (b) and (c) exempt, from the periodic account statement requirement, members that neither carry customer accounts nor hold customer funds or securities. The NASD does not believe members, whether limited or general broker/dealers, should have to report information they may not be able to obtain or independently confirm on securities or funds not in their possession. In the case of DPPs and similar products, when a customer purchases DPP units through a member, the customers' funds go to the general partner (through an escrow account), the general partner confirms admission to the partnership directly to the purchaser, and all subsequent communications are usually between the general partner and the investor.

Subsection (d) of the rule permits the NASD's Operations Committee to exempt any member from the provisions of the rule upon a showing of good cause. This would permit the NASD under unusual circumstances to exempt a member if application of the rule would be unnecessarily burdensome given the type of business it conducts and the nature of the accounts, securities, or funds involved, and if the goal of customer protection and information could be met under alternative arrangements.

Following publication of the rule change for member vote, the NASD received several inquiries from members who conduct business with institutional or governmental clients on a "receipt-versus-payment/delivery-versus-payment" (RVP/DVP) basis. These members maintain accounts for their customers, but they represent that they hold funds or securities only for the few days necessary to complete the transactions. These members believe that firms that conduct such business (i.e., an RVP/DVP type of business for institutional or corporate clients) should be eligible for an exemption from the new rule under Subsection (d).

While the NASD does not intend to grant blanket exemptions, members may apply to the NASD's Operations Committee for exemptions tailored to their specific circumstances. An exemption, if granted by the Committee, would generally be account-specific and would not apply to all the accounts of each member. To apply for an exemption, a member should send its written request detailing the reason for its request and the type of business it conducts to the NASD Operations Committee, c/o Financial Responsibility Department, National Association of Securities Dealers, Inc., 1735 K Street, NW, Washington, DC 20006-1506.

The amendments take effect on January 31, 1992. Questions concerning this Notice should be directed to Thomas R. Cassella, Vice President, Financial Responsibility at (202) 728-8237, or Elliott R. Curzon, Senior Attorney, Office of General Counsel at (202) 728-8451.

TEXT OF AMENDMENTS TO SECTION 45, ARTICLE III OF THE RULES OF FAIR PRACTICE

(**Note:** All language is new.)

Customer Account Statements

Sec. 45

(a) Each general securities member shall, with a frequency of not less than once every calendar quarter, send a statement of account containing a description of any securities positions, money balances, or account activity to each customer whose account had a security position, money balance, or account activity during the period since the last such statement was sent to the customer.

(b) For purposes of this section, the term "account activity" shall include, but not be limited to, purchases, sales, interest credits or debits, charges or credits, dividend payments, transfer activity, securities receipts or deliveries, and/or journal entries relating to securities or funds in the possession or control of the member.

(c) For purposes of this section, the term "general securities member" shall refer to any member which conducts a general securities business and is required to calculate its net capital pursuant to the provisions of SEC Rule 15c3-1(a), except for paragraphs (a)(2) and (a)(3). Notwithstanding the foregoing definition, a member which does not carry customer accounts and does not hold customer funds or securities is exempt from the provisions of this section.

(d) The Association, acting through its Operations Committee, may, pursuant to a written request for good cause shown, exempt any member from the provisions of this section.

NASD

Notice To Members

National Association of Securities Dealers, Inc. November 1992

Number 92-61

Suggested Routing:*

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

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

Subject: Revised Form BD Goes Into Effect November 16, 1992

EXECUTIVE SUMMARY

The Securities and Exchange Commission (SEC) has approved changes to Form BD, the Uniform Application for Broker/Dealer Registration. The amendments, developed in consultation with the NASD, North American Securities Administrators Association (NASAA), and industry representatives, seek to clarify certain reporting requirements, including the definition of what "proceedings" are disclosable under Item 7(G). The scope of ownership disclosure required by the schedules to the Form BD has been changed to require that only 25 percent indirect owners and contributors be disclosed rather than the current 5 percent threshold. Additionally, the amendments update the disciplinary history reporting requirements to reflect changes implemented under the 1990 amendments to the Securities Exchange Act of 1934. The new form will be effective November 16, 1992. NASD members should begin to use the revised form when making their next Form BD amendment. The NASD will accept amendments on the old Form BD through January 10, 1993. After that date, amendments not filed on the revised Form BD cannot be accepted.

CHANGES TO FORM BD

The principal changes to the Form BD relate to Item 7 disclosures of disciplinary history of broker/dealers and their control affiliates. The requirements for disclosure of "proceedings" under Item 7 (G) represent the joint NASD, SEC, and NASAA interpretation first announced in *Notices to Members 91-81* (December 1991). That interpretation requires firms to report formal administrative and civil actions initiated by self-regulatory and governmental agencies and formal criminal charges, including felony indictments, felony criminal informations, and formal felony criminal charges equivalent to a criminal indictment or information, and any formal misdemeanor criminal information (or equivalent) involving matters listed in Item 7(A)(1) of Form BD.

The joint interpretation does not require reporting of criminal arrests effected in the absence of a formal written charge. Finally, the new definition does not require disclosure of informal investigations by regulators or pending private civil litigation.

Item 7(E)(2) has been amended to the extent that broker/dealers will no longer be required to disclose on Form BD any violation of a self-regula-

tory organization (SRO) rule deemed "minor" pursuant to a plan, approved by the SEC. To date, the American Stock Exchange, the Boston Stock Exchange, the Cincinnati Stock Exchange, the New York Stock Exchange, the Pacific Stock Exchange, the Philadelphia Stock Exchange, and the Chicago Board Options Exchange have approved plans on file. All other 7(E)(2) violations must be reported until the SRO bringing the action has its plan approved. The NASD has filed with the SEC its proposed minor violations reporting plan. To date, the plan has not been approved.

Other Item 7 amendments expand requirements to comply with the changes contained in the International Securities Enforcement Cooperation Act and the Securities Enforcement Remedies and Penny Stock Reform Act of 1990. Item 7(A) has been amended to require disclosure of similar convictions of the firm or its control affiliates by a foreign court. A new question, Item 7(c)(5), has been added to report fines or orders to cease and desist issued by the SEC or the Commodity Futures Trading Commission (CFTC). SEC Release Number 34-30958 requests that firms file an amendment on or promptly after November 16, 1992, if they determine additional Item 7 disclosures are appropriate.

The instructions for Item 10 have been revised to require that firms check all types of business activities, but exclude those which account for less than one percent of the applicant's securities related revenue. This *de minimis* exception will not apply to those activities that trigger specific SRO or SEC requirements, such as those involving municipal and government securities or options, which must be reported in Item 10 even if volume of activity is insignificant. Item 10 also was amended to include new categories of activity, including broker dealers selling corporate debt securities and interests in mortgages or other receivables, or selling tax shelters or limited partnerships in the secondary market.

Other less dramatic changes to the Form BD include an instruction in Item 1(C) requesting that firms doing business under other names disclose them on Schedule D and a clarifying instruction to Item 5 reminding firms that they should only supply successor details when reporting a succession on the current filing.

AMENDMENTS TO SCHEDULES AND ATTACHMENTS

Schedules for disclosure of the applicant's ownership have been totally redesigned, and requirements have been redefined. Existing schedules required firms to file an appropriate schedule based on their filing entity type. The revised schedules are not based on this categorical distinction. Schedule A will now be used to report executive officers, directors, or all general partners and 5 percent direct owners or limited partners contributing 5 percent or more of the partnership's capital. The SEC has revised the instructions to define beneficial stock ownership of an applicant to include securities owned by the immediate family living in the same residence.

Regardless of the filing entity type, Schedule B will be used for applicants to report their indirect ownership. For each direct owner not a person or public reporting company under Section 12 or 15 (d) of the Exchange Act reported on Schedule A, the applicant must disclose on Schedule B all 25 percent owners or contributors of (to) the direct owners. Instructions indicate that each successive 25 percent owner be disclosed until a person or public reporting company is reached. In determining beneficial ownership, the same attribution requirement applies to indirect owners that applied to direct owners. Schedule C has been completely revised to be used to report additions, deletions, and other changes to Schedules A and B. Approved NASD member firms should review their existing schedules to determine if an amendment is deemed appropriate. The approved firm should file the new Schedule A and B once, then submit all subsequent amendments on revised Schedule C. Applications for initial broker/dealer registration must now be made on the revised Form BD.

Other schedules, namely D and E, have also been revised, and a Form BD Disclosure Reporting Page (DRP) has been added. Schedule DRP for Form BD, modeled after the U-4 DRP, must now be used to provide details for Item 7 responses. For each new event or to update an event previously reported, a DRP must be filed. The DRP should be the only filing necessary; no attachments are necessary. Details to other Form BD items will continue to be reported on Schedule D.

Schedule E used to report branch office additions, deletions, or changes has been redesigned in a more structured format for required information.

The format change was undertaken to help facilitate the implementation of electronic Schedule E. Beginning November 16, 1992, Firm Access Query System (FAQS) subscribers will be able to file branch office additions, deletions, and changes via the ELECFILE command. The changes to the form will help insure that hard-copy filers include all relevant data about the branch location. Questions concerning this feature or other FAQS subscriber services should call the FAQS line at (301) 590-6862.

FILING INSTRUCTIONS

NASD members will not be required to file the amended form at any particular time. Member firms should, nevertheless, review their existing filing and determine whether an amendment is required due to this revision. If so, they should make their amended filing on the new form. If, as a result of the ownership disclosure changes, an amendment is necessary, a complete Schedule A and B (if applicable) should be filed. Thereafter, ownership and control changes will be made by filing the revised Schedule C.

If you determine an amendment is not necessary at this time, you would begin to use the revised form when an amendment was necessary. After January 10, 1993, only the revised Form BD will be accepted.

For additional details, refer to the revised Form BD (enclosed) or SEC Release Number 34-30959. To obtain copies or ask questions regarding the form or the instructions, call Member Services (301) 590-6500. Questions regarding this Notice should be directed to John F. Vaughn, Assistant Director, Membership, at (301) 590-6865 or Belinda Blaine, Attorney, at (202) 504-2418, Office of Chief Counsel, Division of Market Regulation (SEC).