

submissions should refer to File Number SR-NASD-95-27 and should be submitted by July 19, 1995.

For the Commission, by the Division of Market Regulation, pursuant to the delegated authority.<sup>3</sup>

**Margaret H. McFarland,**

*Deputy Secretary.*

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[Release No. 34-35877; File No. SR-NASD-95-28]

**Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Regarding Trading in Anticipation of the Issuance of a Research Report**

June 21, 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 May 25, 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 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**

Pursuant to the provisions of Section 19(b)(1) of the Act, the NASD hereby proposes to amend Article III, Section 1 of the NASD Rules of Fair Practice<sup>1</sup> by adding a new Interpretation regarding a prohibition against purposeful trading that affects a member firm's inventory position in a given security prior to the firm's issuance of a research report in that same security. Below is the text of the proposed rule change. Proposed new language is in italics.

**Trading Ahead of Research Reports Interpretation to Article III, Section 1 of the NASD Rules of Fair Practice**

*The Board of Governors, under its statutory obligation to protect investors and enhance market quality, is issuing an Interpretation to the Rules of Fair Practice regarding a member firm's trading activities that occur in anticipation of a firm's issuance of a research report regarding a security. The Board of Governors is concerned with*

*activities of member firms that purposefully establish or adjust firm's inventory position in Nasdaq-listed securities, an exchange-listed security traded in the OTC market, or a derivative security based primarily on a specific Nasdaq or exchange-listed security in anticipation of the issuance of a research report in that same security. For example, a firm's research department may prepare a research report recommending the purchase of a particular Nasdaq-listed security. Prior to the publication and dissemination of the report, however, the trading department of the member firm might purposefully accumulate a position in that security to meet anticipated customer demand for that security. After the firm had established its position, the firm would issue the report, and thereafter fill customer orders from the member firm's inventory positions.*

*The NASD believes that such activity is conduct which is inconsistent with just and equitable purposes of trade, and not in the best interests of investors. Thus, this Interpretation prohibits a member from purposefully establishing, creating or changing the firm's inventory position in a Nasdaq-listed stock, and exchange-listed stock traded in the third market, or a derivative security related to the underlying equity security, in anticipation of the issuance of a research report regarding such security by the member firm.*

*Article III, Section 1 of the Rules of Fair Practice states that:*

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

*In accordance with Article VII, Section 1(a)(2) of the NASD By-laws, the NASD Board of Governors has approved the following Interpretation of Article III, Section 1:*

*Trading activity purposefully establishing, increasing, decreasing, or liquidating a position in a Nasdaq security, an exchange-listed security traded in the over-the-counter market, or a derivative security based primarily upon a specific Nasdaq or exchange-listed security, in anticipation of the issuance of a research report in that security is inconsistent with just and equitable principles of trade and is a violation of Article III, Section 1 of the Rules of Fair Practice.*

*For the purposes of this Interpretation, a "purposeful" change in the firm's inventory position means any trading activities undertaken with the intent of altering a firm's position in a security in anticipation of accommodating investor interest once*

*the research report has been published. Hence, the Interpretation does not apply to changes in an inventory position related to unsolicited order flow from a firm's retail or broker-dealer client base or to research done solely for in-house trading and not in any way used for external publication.*

*Under this Interpretation, the Board recommends, but does not require, that member firms develop and implement policies and procedures to establish effective internal control systems and procedures that would isolate specific information within research and other relevant departments of the firm so as to prevent the trading department from utilizing the advance knowledge of the issuance of a research report. Firms that choose not to develop "Chinese Wall" procedures bear the burden of demonstrating that the basis for changes in inventory positions in advance of research reports was not purposeful.*

**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*

(a) Background

At times, broker-dealers that have research departments prepare research reports that recommend that customers take certain actions with respect to certain identified securities. The research reports may advise the firm's customers to buy or sell the security that is the subject of the research report. For instance, prior to publication of a research report, some firms would intentionally establish a proprietary position in the security that was to be the subject of a report in anticipation of meeting expected customer demand in response to the research report. Once the firm had accumulated stock, it would issue the research report and commence solicitation of orders, expecting to fill customer orders from the inventory position it had accumulated.

<sup>3</sup> 17 CFR 200.30-3(a)(12).

<sup>1</sup> NASD Manual, Rules of Fair Practice, Art. III, Sec. 1 (CCH) ¶ 2151.

In 1991, the New York Stock Exchange ("NYSE"), in NYSE Information Memo 91-8, issued a policy statement regarding stock accumulations by a NYSE member organization in advance of that member's issuance of research reports. NYSE Information Memo 91-8 stated that where an NYSE member organization intended to purposefully acquire a position in an NYSE-listed security in contemplation of its issuance of a favorable research report, the NYSE would find such conduct to be inconsistent with just and equitable principles of trade.

At that time, the NASD also considered the issue of trading activity in anticipation of the issuance of research reports but determined to address the issue on a case-by-case basis. Thus, in response to individual member firm requests for a position on the issue, the NASD staff informally had taken the position that trading based upon material, non-public market information could be considered a violation of just and equitable principals of trade. In 1994, however, the NASD solicited member comment in Notice To Members 94-40 ("NTM 94-40") on the development of a formal policy that clearly would state that trading in anticipation of a research report would be deemed a violation of Article III, Section 1 of the Rules of Fair Practice. The NASD Board, in proposing this new Interpretation, also sought comment on a policy to recommend, but not require, that member firms develop and implement "Chinese Wall" restrictions that would isolate research and trading activities within individual departments of the firm.

#### (b) Comments Received

In response to its proposal on trading ahead of research reports, the NASD received eleven comments that were fairly evenly split between support of and opposition to the proposed policy. Three firms either fully supported the proposal or suggested very minor changes. These firms believed that the proposed Interpretation would: (1) Clarify a member firm's obligations in Nasdaq and third market securities; (2) promote consistency among self-regulatory organization rules; (3) ease the compliance burden on the firms; and (4) engender greater investor confidence that the investor will not be disadvantaged by the professional.<sup>2</sup> Two other firms<sup>3</sup> supported the proposed

policy in part, but expressed certain reservation. For example, A.G. Edwards believed that it was important that an Interpretation be developed to address issues related to a firm's unfair trading in advance of a research report. The firm also believed that any Interpretation should be extended to third Market trading in advance of research report on NYSE-listed companies. However, Edwards was concerned that the proposal could harm small capitalized issues with limited liquidity and it could undercut a firm's interest in developing research reports, especially with low liquidity stocks. J.P. Morgan's letter raised similar concerns.

Finally, six comments<sup>4</sup> opposed the adoption of the proposed Interpretation. These comments expressed two principle concerns with the proposal: (1) It would adversely affect the liquidity and pricing of Nasdaq SmallCap stocks because firms would not be able to develop a readily available inventory in such stock to meet investor demand after the issuance of the report; and (2) member firms likely would diminish their research efforts because their own customers would not be able to benefit from securities that the firm had been able to secure at advantageous prices.

#### (c) Discussion

As noted above, the NASD has carefully examined its policies regarding the trading practices for member firms in anticipation of the issuance of a firm's research reports. The NASD believes that purposeful inventory adjustments made in anticipation of customer trading activity as a result of the firm's research report could appear to, and at times would, conflict with the firm's fiduciary duties toward its customers. The NASD, after weighing the issues related to the matter, has determined that in the interests of investor protection, it would be deemed a violation of just and equitable principles of trade if a member firm purposefully adjusts its inventory position in a Nasdaq security, in an exchange listed security that is traded in the third market, or in a derivative product of any such securities in anticipation of the issuance of a research report in that security. At the least, such purposeful activity creates an appearance of impropriety that harms the perception of the marketplace and could lead to a loss of investor confidence. The NASD notes that it is important that investors understand that

they will not be disadvantaged by professionals, and accordingly, it seeks to further enhance its rules and policies that promote the fair treatment of investors and maintain the confidence of such investors. This new policy should enhance the overall perception of Nasdaq and the third market and encourage investors to participate in those markets, thereby promoting liquidity. In addition, because the NASD believes that the proposed Interpretation is consistent with the policy found in NYSE Information Memorandum 91-8, this clear statement of NASD policy will promote consistency among self-regulatory organizations and help to alleviate compliance burdens for member firms that operate in multiple markets.

After considering the comments on the proposal in NTM 94-40, the NASD Board determined to refine the proposal slightly to incorporate comments recommending that the proposed Interpretation address third market trading in listed securities that are the subject of a firm's research report. The NASD believes it important from an investor protection viewpoint to clearly state that it would be a violation of just and equitable principles of trade if a member firm trading in the third market in anticipation of the issuance of a research report were to establish, increase, or decrease a position in an exchange-listed security. Without the inclusion of exchange-listed securities traded in the third market, there could be a significant gap in customer protection rules on this issue. Similarly, the NASD has amended its policy as proposed in NTM 94-40 to clarify that it would also be a violation if the firm were to decrease or liquidate its position in a security because it was about to issue a negative research report. This amendment to the proposed policy also closed a potential gap in the policy and clarified the intent of the NASD.

Finally, the NASD, in reaction to a comment letter<sup>5</sup> decided to include in the proposed Interpretation a prohibition regarding a member firm's attempts to do indirectly what it is not permitted to do directly. Accordingly, the proposed Interpretation prohibits a member firm from purposefully establishing, increasing, decreasing or liquidating a derivative security position in anticipation of the firm's issuance of a research report on the security underlying the derivative position. The NASD's concern is, for example, that by trading in options on an underlying security that is to be the subject of a research report, the member

<sup>2</sup> See letters from Merrill Lynch; Lehman Bros.; and the Association for Investment Management and Research ("AIMR").

<sup>3</sup> See letters from J.P. Morgan Securities and A.G. Edwards.

<sup>4</sup> See letters from Kemper Securities, Inc.; Brown & Wood; Pacific Growth Equities; Conning & Co.; First Albany; and Rauscher Pierce Refsnes, Inc.

<sup>5</sup> See Lehman Bros. letter.

firm is doing by means of an economically equivalent transaction that which it would otherwise be prohibited from doing. Such activity would undermine the effectiveness of the proposed Interpretation.

The proposed Interpretation specifically notes that the intent of the prohibition is to cover situations where the member firm is "purposefully" altering its inventory position in anticipation of the issuance of a favorable or unfavorable research report. In accord with that intent, the proposed Interpretation is not intended to halt all of a firm's trading activity in that security. Even if the trading desk knows of a forthcoming research report on a particular security, the trading desk is fully permitted to continue to trade with its retail customers or with other broker-dealers if such trading arises from unsolicited order flow. Similarly, the proposed Interpretation would not apply to situations where the firm conducts research solely for in-house use and such research is not made available for external distribution.

In addition, the proposed Interpretation encourages but does not require firms to establish Chinese Wall procedures to control the flow of information between their research and trading departments. Such Chinese Wall procedures are risk management control adopted by securities firms that include physical and informational barriers between different departments of firms to enhance the likelihood that knowledge of upcoming events will be isolated within a single group and not disclosed to other groups that might trade on or otherwise benefit from the information. Because many firms today already use Chinese Wall restrictions between the research and trading departments of their firms, the NASD decided that the policy should encourage but not require the use of Chinese Walls as the preferred method of complying with the new policy.

While the NASD's proposed Interpretation would not require a member to develop Chinese Wall procedures, the NASD believes that Chinese Wall restrictions are the most effective means for a member firm to demonstrate that any trading activity before its issuance of a research report had not been in violation of the proposed Interpretation. Accordingly, if a member decides not to implement Chinese Wall procedures, it would carry the significantly greater burden of proving that stock accumulations or liquidations prior to the issuance of a research report had not been purposeful if an NASD investigation into the firm's buying or selling activity were initiated.

Chinese Wall procedures are therefore, the recommended and preferred approval, but members are allowed to analyze their own environments and determine where Chinese Wall procedures were appropriate for their firm.

While some commenters on NTM 94-40 objected to the proposed policy, the NASD notes that such comments were almost equally balanced by comments expressing strong support for the proposed policy. Indeed, even those commenters objecting to the proposal recognized that there were significant investor protection concerns that could arise when a firm adjusted its inventory positions in anticipation of its issuance of a research report. While not disregarding such investor protection issues, such commenters were more concerned about how they believed the proposed Interpretation would impact the liquidity of less well-capitalized stocks, and the potential dissemination of research into such smaller companies. Several firms raising this issue argued that they should be permitted to "passively" accumulate inventory positions and pass along the advantageous cost of acquisition to its customers when the research report was released.

Such comments, however, did not deal with two fundamental issues: (1) Trading ahead of customers based on non-public information; and (2) fair pricing in subsequent resales. Accordingly, because the practice of purposefully adjusting inventory in anticipation of research report issuance raises such significant potential for disadvantaging public investors, the NASD believes that the better practice is to prohibit such activity as violative of just and equitable principles of trade.<sup>6</sup> Accordingly, the NASD believes that the proposed rule change is consistent with Section 15A(b)(6) in that these proposed changes are designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to facilitate transactions in these securities, to remove impediments to and to perfect the mechanism of a free and open market and a national market system, and in general to protect investors and the public interest. The NASD believes that any potential negative effects of the policy will be significantly outweighed by the increased confidence of investors

<sup>6</sup>The issuance of research reports also may raise issues under the Securities Act of 1933 and the Act. See, e.g., Section 5 of, and Rules 137, 138 and 139 under, the Securities Act of 1933 and Rule 10b-6 under the Act.

and their corresponding willingness to trade with member firms.

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

The NASD believes that the proposed rule change will not 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*

Written comments regarding the NASD's proposal in NTM 94-40 are summarized above.

**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 NASD 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, NW., Washington, DC 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 available for inspection and copying at the principal office of the NASD. All submissions should refer to SR-NASD-95-28 and should be submitted by July 19, 1995.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority, 17 CFR 200.30-3(a)(12).

**Margaret H. McFarland,**

*Deputy Secretary.*

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[Release No. 34-35879; File No. SR-MSRB-95-11]

**Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Municipal Securities Rulemaking Board Relating to Interpretation of Rule G-37 on Political Contributions and Prohibitions on Municipal Securities Business**

June 21, 1995.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. 78s(b)(1), and Rule 19b-4 thereunder, notice is hereby given that on June 16, 1995, the Municipal Securities Rulemaking Board ("Board" or "MSRB") filed with the Securities and Exchange Commission ("Commission" or "SEC") a proposed rule change as described in Items I, II, and III below, which Items have been prepared by the Board. The purpose of the proposed rule change is to provide interpretative guidance concerning rule G-37 on political contributions and prohibitions on municipal securities business. The Board has designated this proposal as constituting a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the Board under Section 19(b)(3)(A) of the Act, which renders the proposal effective upon receipt of this filing by the Commission. 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 Board is filing the proposed rule change to provide interpretative guidance concerning rule G-37 on political contributions and prohibitions on municipal securities business.<sup>1</sup>

<sup>1</sup> The Board plans to publish the interpretations in MSRB Reports Vol. 15, no. 2, at 3 (July 1995). The interpretations also are available for inspection and copying at the Commission's public reference room and at the Board.

**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 Board 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 Board 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*

On April 7, 1994, the Commission approved Board rule G-37, concerning political contributions and prohibitions on municipal securities business.<sup>2</sup> Since that time, the Board has received numerous inquiries concerning the application of the rule. In order to assist the municipal securities industry and, in particular, brokers, dealers and municipal securities dealers in understanding and complying with the provisions of the rule, the Board published four prior notices of interpretation which set forth, in question-and-answer format, general guidance on rule G-37.<sup>3</sup> In prior filings with the Commission, the Board stated that it will continue to monitor the application of rule G-37, and, from time to time, will publish additional notices of interpretations, as necessary.<sup>4</sup> In light of questions recently received from market participants concerning the applicability of the rule to contributions to issuer officials seeking election to the U.S. Presidency, as well as the operation of the exemption provision set forth in section (i) of rule G-37, the Board has determined that it is necessary to provide further guidance to the municipal industry. Accordingly, the

<sup>2</sup> Securities Exchange Act Release No. 33868 (April 7, 1994), 59 FR 17621 (April 13, 1994). The rule applies to contributions made on and after April 25, 1994.

<sup>3</sup> See Securities Exchange Act Release No. 34161 (June 6, 1994), 59 FR 30379 (June 14, 1994); Securities Exchange Act Release No. 34603 (Aug. 25, 1994), 59 FR 45049 (Aug. 31, 1994); Securities Exchange Act Release No. 35128 (Dec. 20, 1994), 59 FR 66989 (Dec. 28, 1994) and Securities Exchange Act Release No. 35544 (Mar. 28, 1995), 60 FR 16896 (Apr. 3, 1995). See also MSRB Reports Vol. 14, No. 3 at 11-16 (June 1994); Vol. 14, No. 4 at 31-32 (August 1994); Vol. 14, No. 5 at 8 (December 1994) and Vol. 15, No. 1 (April 1995) at 21; MSRB Manual, General Rules, Rule G-37 (CCH) ¶ 3681.

<sup>4</sup> File Nos. SR-MSRB-94-6, SR-MSRB-94-15, SR-MSRB-94-16 and SR-MSRB-95-02.

Board is publishing this fifth set of questions and answers.

The Board believes that the proposed rule change is consistent with Section 15B(b)(2)(C) of the Act, which provides that the Board's rules shall be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market in municipal securities, and, in general, to protect investors and the public interest.

*B. Self-Regulatory Organization's Statement of Burden on Competition*

Because the proposed rule change would apply equally to all brokers, dealers and municipal securities dealers, the Board does not believe that the proposed rule change will impose any burden on competition not necessary or appropriate in furtherance of the purposes of the Act.

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

Written comments were neither solicited nor received.

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

The foregoing rule change has become effective upon filing pursuant to Section 19(b)(3)(A)(i) of the Act and subparagraph (e) of Rule 19b-4 thereunder because the rule change constitutes a stated policy, practice, or interpretation with respect to the meaning, administration, or enforcement of an existing rule of the Board.

At any time within 60 days of the filing of a rule change pursuant to Section 19(b)(3)(A) of the Act, the Commission may summarily abrogate the rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act.

**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, NW.,