Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submissions, 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 the filing will also be available for inspection and copying at the Board's principal offices. All submissions should refer to File No. SR–MSRB–96–8 and should be submitted by September 17, 1996.

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.

[FR Doc. 96–21816 Filed 8–26–96; 8:45 am]

BILLING CODE 8010–01–M

[Release No. 34–37588; File No. SR–NASD–95–39]

Self-Regulatory Organizations; National Association of Securities Dealers, Inc; Order Granting Approval to Proposed Rule Change and Notice of Filing and Order Granting Accelerated Approval to Amendment Nos. 4 and 5 to Proposed Rule Change Relating to Application of the Rules of Fair Practice to Transactions in Exempted Securities (Except Municipals) and an Interpretation of Its Suitability Rule

August 20, 1996.

I. Introduction

On September 18, 1995, the National Association of Securities Dealers, Inc. (''NASD'' or ''Association'') submitted to the Securities and Exchange Commission (''SEC'' or ''Commission''), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'')[1] and Rule 19b–4 thereunder;[2] a proposed rule change to apply the Association's Rules of Fair Practice to transactions in exempted securities, other than municipals, and to adopt an interpretation of the Association's suitability rule as it applies to institutional customers.[3] The NASD filed Amendment No. 1 to the proposed rule change on October 17, 1995, Amendment No. 2 on January 22, 1996, and Amendment No. 3 on February 15, 1996.

The proposed rule change and Amendment No. 1 were published for comment in Securities Exchange Act Release No. 36383 (Oct. 17, 1995), 60 FR 54530 (Oct. 24, 1995). Amendment No. 2 was replaced by Amendment No. 3 before publication.[4] Amendment No. 3 was published for comment in Securities Exchange Act Release No. 36973 (Mar. 14, 1996), 61 FR 11655 (Mar. 21, 1996). On July 22, 1996 and August 14, 1996, the NASD filed Amendment Nos. 4 and 5, respectively, to the proposed rule change.[5] This order permanently approves the proposed rule change, as amended, and Amendment Nos. 4 and 5 on an accelerated basis.

II. Background

The Government Securities Act Amendments of 1993 (''GSAA'') eliminated the statutory limitations on the NASD's authority to apply sales practice rules to transactions in exempted securities, including government securities, other than municipals.[6] To implement the expanded sales practice authority granted to the NASD pursuant to the GSAA, the Association has proposed to delete the NASD Government Securities Rules and apply the NASD Rules of Fair Practice, where applicable, to exempted securities, including government securities, other than municipals.[7]

Concurrently, the NASD has proposed an interpretation of its suitability rule as it applies to members' dealings with institutional customers (''Suitability Interpretation'' or ''Interpretation''). The Interpretation would apply to all securities, except municipals, the purchase or sale of which is recommended by a broker-dealer. A draft of the proposed suitability interpretation contained in this proposed rule change was first published for comment in NASD Notice to Members 94–62 (August 1994) (''NTM 94–62'').[8] In response to this solicitation of comments, the NASD received 15 comment letters.[9] The

---

[1] 15 U.S.C. Section 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] The proposed rule change (i) Amends Article I, Section 4 and 5 of the Rules of Fair Practice to apply the Rules of Fair Practice to those members registered with the SEC solely under the provisions of Section 15C of the Act and to transactions in all securities, except municipals; (ii) merges the NASD's Government Securities Rules, where applicable, into the Rules of Fair Practice, (iii) makes clarifying amendments to certain sections and Interpretations under Articles III and IV of the Rules of Fair Practice relating to the government securities business; (iv) amends certain Rules of Fair Practice and Board Interpretations to exempt transactions in government securities; (v) amends Article III, Section 2 of the Rules of Fair Practice by amendment to Subsection 2(b) and adoption of an Interpretation of the Board of Governors—Suitability Obligations to Institutional Customers; (vi) makes technical changes to NASD By-Laws, Schedules to the By-Laws, the Rules of Fair Practice and the Code of Procedure to replace references to provisions of the Government Securities Rules with references to the appropriate Rules of Fair Practice, and to delete the terms ''exempted security'' or ''exempted securities,'' or, replace these terms with the term ''municipal securities,'' as applicable; and (vii) modifies references to SEC Rules 15c3–1 and 15c3–3 to reflect SEC amendments to those rules.

[4] Amendment No. 2 responded to some of the comments received on the original proposed rule change. Amendment No. 3 expanded upon the discussion contained in Amendment No. 2 by including responses to nine comment letters received on the original proposed rule change. Amendment No. 3 to SR–NASD–95–39 completely replaced and superseded Amendment No. 2. *See* letters from Joan C. Conley, Secretary, NASD, to Mark P. Barracca, Branch Chief, SEC, dated February 15, 1996, and March 4, 1996. The Commission received seven additional comment letters after the publication of Amendment No. 3.

[5] *See* Letter from Joan C. Conley, Secretary, NASD, to Katherine A. England, Assistant Director, Division of Market Regulation, SEC, dated July 22, 1996. Pursuant to an NASD rule proposal that became effective in May 1996, the *NASD Manual* has been reorganized to make it easier to use. *See* Securities Exchange Act Release No. 36698 (Jan. 11, 1996) (Rules that were formerly organized under the ''Rules of Fair Practice'' generally are grouped under the NASD's Conduct Rules at Rules 2000–3000). Amendment No. 4 provides the new numbering of those provisions of the *NASD Manual* that are being affected by this rule proposal. A conversion chart is attached to this order as Exhibit 1. Moreover, Amendment No. 4 proposes to apply Section 50, Article III of the Rules of Fair Practice to transactions in exempted securities (except municipals). The NASD states that Section 50, Article III, which requires NASD members to report to the NASD the occurrence of certain specified events and quarterly summary statistics concerning customer complaints, would be applicable to exempted securities (except municipals). *See* Letter from John A. Ramsay, Deputy General Counsel, to Katherine A. England, Assistant Director, Division of Market Regulation, SEC, dated August 14, 1996 (''Amendment No. 5''). In Amendment No. 5, the NASD notes that actions for conduct violating ''Fair Prices and Commissions'' of Article III, Section 4, and the Mark-Up Policy may be brought under Article III, Section 1, requiring members to adhere to just and equitable principles of trade.

[6] Government Securities Act Amendments of 1993, Pub. L. No. 103–202, § 1(a), 107 Stat. 2344 (1993).

[7] The terms ''exempted securities,'' ''government securities'' and ''municipal securities'' are defined in Sections 3(a)(12), 3(a)(42) and 3(a)(29) of the Act respectfully.

[8] A copy of the NTM 94–62 is included in File No. SR–NASD–95–39 as Exhibit 2 thereto.

[9] The NASD received letters regarding NTM 94–62 from the following: (1) Brian C. Underwood, Director of Compliance, A.G. Edwards & Sons, Inc., dated September 29, 1994; (2) Alan S. Kramer, Senior Managing Director, Bear Stearns & Co. Inc., dated October 17, 1994; (3) Marjorie E. Gross, Senior Vice President & Associate General Counsel, Chemical Bank, dated September 29, 1994; (4) Marjorie E. Gross, Senior Vice President & Associate General Counsel, Chemical Bank, dated October 14, 1994; (5) F. Smith, President, Freeman Securities Company, Inc., dated September 30, 1994; (6) Wendy R. Beer, Compliance Counsel, Furman Selz,

proposed suitability interpretation published in NTM 94–62 was revised, and a second draft was published for comment in Notice to Members 95–21 (April 1995) (''NTM 95–21'').[10] Sixteen comments were received in response thereto.[11] Thereafter, the NASD filed a proposed interpretation with the Commission.

III. Description

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

As shown in Table 1 below, the proposed rule change merges certain provisions of the current Government Securities Rules into the Rules of Fair Practice. The proposed rule change also applies certain of the NASD Rules of Fair Practice to exempted securities (except municipals) for the first time. Table 2 below indicates the Rules of Fair Practice that will be applicable to exempted securities (except municipals).

Amendments Merging Government Securities Rules into Rules of Fair Practice

The NASD proposes to merge certain provisions contained solely under the Government Securities Rules into corresponding sections of the Rules of Fair Practice to provide NASD members with one set of sales practice rules that will reflect the NASD's expanded authority under the GSAA. Specifically, the NASD proposes to add provisions of the Government Securities Rules into Article III, Section 21(c)(3), 38, and 39; Article IV, Sections 1 to 4; and Article V, Section 1 of the Rules of Fair Practice. The NASD also proposes to move provisions contained in Section 6 of the Government Securities Rules into new Section 38A of Article III of the Rules of Fair Practice. To effect these amendments, the NASD has reorganized and renumbered many of the provisions contained in the above-referenced sections of the Rules of Fair Practice.

Table 1 identifies the provisions of the Government Securities Rules and the corresponding provisions of the Rules of Fair Practice into which the Government Securities Rules will be merged. In addition, Table 1 indicates the corresponding section of the Rules of Fair Practice for each Government Securities Rule where no rule language change is necessary because of expanded authority under Article I, Section 5 of the Rules of Fair Practice.[12]

TABLE 1.—GOVERNMENT SECURITIES RULES MERGED INTO RULES OF FAIR PRACTICE

Sec. 1. Adoption of Rules	Article I, Sec. 1—No change.
Sec. 2. Applicability:	
Subsection (a)	Article I, Sec. 4 and 5(a).
Subsection (b)	Article I, Sec. 5 (b) and (c)—No change.
Sec. 3. Definitions in By-Laws and Rules of Fair Practice	Article II, Sec. 1 and 2—No change.
Sec. 4. Books and Records	Article III, Sec. 21.
Sec. 5. Supervision	Article III, Sec. 27—No change.
Sec. 6. Regulation of Activities of Members Experiencing Financial and/or Operational Difficulties.	Article III, Sec. 38 and 38A.
Explanation of Board of Governors—Restrictions on a Member's Activity.	Explanation of Board of Governors Restrictions on a Member's Activity—Article III, Sec. 38 and 38A.
Sec. 7. Approval of Change in Exempt Status under SEC Rule 15c3–3	Article III, Sec. 39.
Sec. 8. Communications with the Public	Article III, Sec. 35—No change.
Sec. 9. Availability to Customers of Certificate, By-Laws, Rules, and Code of Procedure.	Article IV, Sec. 1—No change.
Sec. 10. Complaints:	
Subsection (a) Complaints by Public Against Members	Article IV, Sec. 2.

dated October 31, 1994; (7) Betsy Dotson, Assistant Director, Federal Liaison Center, Government Finance Officers Association, dated September 30, 1994; (8) Kathryn S. Reimann, Senior Vice President and Director of Fixed Income Compliance, Lehman Brothers Inc., dated October 17, 1994; (9) Larry Forrester, Senior Vice President, Lyn-Hayes Financial, Inc., dated August 23, 1994; (10) Marguerite C. Willenbucher, Vice President and Senior Counsel, Debt and Equity Markets Group, Merrill Lynch, Pierce, Fenner & Smith Inc., dated October 17, 1994; (11) Ken DeRegt, Managing Director, Morgan Stanley & Co. Incorporated, dated October 14, 1994; (12) Prudential Insurance Company of America, dated October 31, 1994; (13) Marianna Maffucci, Senior Vice President and General Counsel, Public Securities Association, dated October 17, 1994; (14) William A. McIntosh, Managing Director and Co-Head of U.S. Fixed Income, Salomon Brothers Inc., dated September 30, 1994; and (15) Robert F. Price, Chairman, Federal Regulation Committee, and Mark T. Commander, Chairman, Self-Regulation and Supervisory Practice Committee, Securities Industry Association, dated October 17, 1994. A copy of each comment letter listed above is included in File No. SR–NASD–95–39 as Exhibit 3 thereto. These letters are discussed in Securities Exchange Act Release No. 36383 (Oct. 17, 1995), 60 FR 54530 (Oct. 24, 1995) (notice of proposed rule change for File No. SR–NASD–95–39).

[10] A copy of NTM 95–21 is included in File No. SR–NASD–95–39 as Exhibit 4 thereto.

[11] The NASD received letters regarding NTM 95–21 from the following: (1) Allen Weintraub, Chairman and Chief Executive Officer, The Advest Group, Inc., dated May 5, 1995; (2) Brian C. Underwood, Director of Compliance, A.G. Edwards & Sons, Inc., dated May 15, 1995; (3) Michael S. Caccese, Esq., Senior Vice President, General Counsel, and Secretary, Association for Investment Management and Research; (4) Marjorie E. Gross, Senior Vice President & Associate General Counsel, Chemical Bank, dated May 17, 1995; (5) Michael J. Wilk, Managing Director, Comerica Securities, dated May 12, 1995; (6) Douglas E. Harris, Senior Deputy Comptroller for Capital Markets, Comptroller of the Currency, dated May 17, 1995; (7) Lawrence Jacob, Senior Vice President, Assistant Secretary and Director of Compliance, Daiwa Securities America Inc., dated May 16, 1995; (8) James A. Brickley, President and CEO, Federal Farm Credit Banks Funding Corp., dated May 17, 1995; (9) Mitchell Delk, Vice President Government and Industry Relations, Freddie Mac, dated June 1, 1995; (10) Betsy Dotson, Assistant Director, Federal Liaison Center, Government Finance Officers Association, dated May 17, 1995; (11) Matthew Lee, Executive Director, Inner City Press/Community on the Move, dated May 15, 1995; (12) Matthew Elderfield, Assistant Director, London Investment Banking Association, dated June 13, 1995; (13) Linda D. Edwards, Vice President Compliance, Llama Company, dated May 9, 1995; (14) Scott H. Rockoff, Managing Director, Director of Compliance, and Assistant General Counsel, Nomura Securities International, Inc., dated May 17, 1995; (15) Robert D. McKnew, Chairman, Public Securities Association, dated May 18, 1995; and (16) Robert F. Price, Chairman Federal Regulation Committee, Richard O. Scribner, Chairman, Self-Regulation and Supervisory Practices Committee, and Zachary Snow, Chairman OTC Derivative Products Committee, Securities Industry Association, dated June 7, 1995. A copy of each comment letter listed above is included in File No. SR–NASD–95–39 as Exhibit 5 thereto. These letters are discussed in Securities Exchange Act Release No. 36383, *supra* note 9 (notice of proposed rule change for File No. SR–NASD–95–39).

[12] The NASD proposes to amend Article I, Section 5(a) of the Rules of Fair Practice by deleting the phrase ''other than those members registered with the Securities and Exchange Commission solely under the provisions of Section 15C of the Act and persons associated with such members'' to expand the application of the Rules of Fair Practice to members involved in the government securities business pursuant to Section 1 15C of the Act.

TABLE 1.—GOVERNMENT SECURITIES RULES MERGED INTO RULES OF FAIR PRACTICE—Continued

Subsection (b) Complaints by District Business Conduct Committees.	Article IV, Sec. 3.
Subsection (c) Complaints by the Board of Governors	Article IV, Sec. 4.
Sec. 11. Reports and Inspection of Books for Purpose of Investigating Complaints.	Article IV, Sec. 5—No change.
Resolution of Board of Governors—Suspension of Members for Failure to Furnish Information Duly Requested.	Resolution of Board of Governors—Suspension of Members for Failure to Furnish Information Duly Requested—No change
Sec. 12. Sanctions for Violation of the Rules	Article V, Sec. 1.
Sec. 13. Payment of Fines or Costs	Article V, Sec. 2—No change.
Sec. 14. Cost of Proceedings	Article V, Sec. 3—No change.

Application of NASD Rules of Fair Practice to Government Securities

As indicated in Table 2 below, certain provisions of the Rules of Fair Practice will not be immediately applicable to transactions in government securities. The NASD intends to review the application of these rules to the government securities market.

Front Running. Currently, the NASD Front Running Interpretation [13] applies only to equity securities. The NASD believes, however, that the member conduct prohibited by the Front Running Interpretation may occur under certain circumstances in the government securities market, and will review the application of the Front Running Interpretation to the government securities market.[14] In the interim, the NASD believes that actions for similar front running conduct occurring in the government securities market may be brought under Article III, Section 1 of the Rules of Fair Practice.[15]

Trading ahead of customer limit orders [16] and trading ahead of research reports,[17] also are currently drafted to apply only to equity securities. The NASD believes the conduct addressed by these Interpretations also may occur under certain circumstances in the government securities market and intends to review the application of these Interpretations to the government securities market. The NASD also believes that actions for similar conduct occurring in the government securities market may be brought under Article III, Section 1 of the Rules of Fair Practice.

Article III, Section 35A of the Rules of Fair Practice/Schedule C to the By-Laws

The proposed rule change would apply Schedule C of the By-Laws (''Schedule C''), regarding NASD registration requirements of persons associated with a member, to the personnel of sole-government securities broker-dealers, including persons selling options on government securities. The proposed rule change also would have the effect of applying Article III, Section 35A of the Rules of Fair Practice (''Section 35A'') to the options communications of such members with the public. The NASD currently is considering whether it is appropriate to require a government securities broker-dealer to register an associated person as its ''Compliance Registered Options Principal'' under Part II, Section 2(f) of Schedule C. The NASD intends to file separately a proposed rule change concerning this issue.[18] Section 35A(b) of the Rules of Fair Practice requires the registration of such a Principal to approve certain options advertisements, sales materials and other literature for government securities options transactions. The NASD has determined that Article III, Section 35A(b) will not be applicable to options advertisements, sales materials and other literature for government securities options transactions during the interim period when the NASD is reviewing the registration issue.

Customer Account Statements. The proposed rule change would phase-in the implementation of Article III, Sections 21, 27, 32, and 45 of the Rules of Fair Practice to dealers in government securities within three months of the effective date of the rule change. The NASD believes that the phase-in is necessary to provide members with sufficient time to change their internal procedures to comply with these rules.

TABLE 2.—APPLICABILITY OF THE RULES OF FAIR PRACTICE TO EXEMPTED SECURITIES, INCLUDING GOVERNMENT SECURITIES (EXCEPT MUNICIPALS)

ARTICLE III	
Section 1:	
Business Conduct of Members	Applicable.
Interpretations of the Board of Governors:	
Execution of Retail Transactions in the Over-the Counter Market	Applicable.
Prompt Receipt and Delivery	Not Applicable.
Forwarding of Proxy and Other materials	Not Applicable.
Free-Riding and Withholding	Amending to be Not Applicable.
Interpretation on Limit Order Protection	Not Applicable.
Front Running Policy	Not Applicable.
Trading Ahead of Research Reports	Not Applicable.[1]
Section 2:	
Recommendations to Customers	Applicable.
Policy of the Board of Governors—Fair Dealing With Customers Policy	Applicable.

[13] Interpretation of the Board of Governors at paragraph 2151.08.

[14] Securities Exchange Act Release No. 36973 (Mar. 14, 1996), 61 FR 11655 (Mar. 21, 1996).

[15] *Id.*

[16] Interpretation of the Board of Governors at paragraph 2151.07.

[17] Interpretation of the Board of Governors at paragraph 2151.09.

[18] Securities Exchange Act Release No. 36973, *supra* note 14.

TABLE 2.—APPLICABILITY OF THE RULES OF FAIR PRACTICE TO EXEMPTED SECURITIES, INCLUDING GOVERNMENT SECURITIES (EXCEPT MUNICIPALS)—Continued

Section 3:	
Charges to Customer	Applicable.
Section 4:	
Fair Prices and Commissions	Applicable.[2]
Interpretation of the Board of Governors—NASD Mark-Up Policy	Applicable.[3]
Section 5:	
Publication of Transactions and Quotations	Applicable.
Interpretation of the Board of Governors—Manipulative and Deceptive Quotations	Applicable.
Section 6:	
Offers at Stated Prices	Applicable.
Policy of the Board of Governors—Policy With Respect to Firmness of Quotations	Applicable.
Section 7:	
Disclosure of Prices in Selling Agreements	Applicable only to traditional underwriter arrangements.
Section 8:	
Securities Taken in Trade	Not Applicable.
Interpretation of the Board of Governors—Safe Harbor and Presumption of Compliance	Not Applicable.
Section 9:	
Use of Information Obtained in Fiduciary Capacity	Applicable.
Section 10:	
Influencing or Rewarding Employees of Others	Applicable.
Section 11:	
Payment Designed to Influence Market Prices, Other than Paid Advertising	Applicable.
Section 12:	
Disclosure on Confirmations	Not Applicable; superseded by SEC rules.
Section 13:	
Disclosure of Control	Not Applicable.
Section 14:	
Disclosure of Participation or Interest in Primary or Secondary Distribution	Applicable.
Section 15:	
Discretionary Accounts	Applicable.
Section 16:	
Offers ''At the Market''	Not Applicable.[4]
Section 17:	
Solicitation of Purchases on an Exchange to Facilitate a Distribution of Securities	Applicable.
Section 18:	
Use of Fraudulent Devices	Applicable.
Section 19:	
Customers Securities or Funds	Applicable.
Section 20:	
Installment or Partial Payment Sales	Applicable.
Section 21:	
Books and Records	Applicable, except for proposed amendments to Subsection (b)(i).
Section 22:	
Disclosure of Financial Condition	Applicable.
Section 23:	
Net Prices to Persons Not in Investment Banking or Securities Business	Not Applicable.
Section 24:	
Selling Concessions	Not Applicable.
Interpretation of the Board of Governors—Services in Distribution	Not Applicable.
Section 25:	
Dealing with Non-Members	Not Applicable.
Interpretation of the Board of Governors—Transactions Between Members and Non-members	Not Applicable.
Section 26:	
Investment Companies	Not Applicable.
Section 27:	
Supervision	Applicable.
Section 28:	
Transaction for or by Associated Persons	Applicable.
Section 29:	
Variable Contracts of an Insurance Co.	Not Applicable.
Section 30:	
Margin Accounts	Applicable.
Section 31:	
Securities Failed to Receive and Failed to Deliver	Not Applicable.
Section 32:	
Fidelity Bonds	Applicable.
Section 33:	
Options	Not Applicable.

TABLE 2.—APPLICABILITY OF THE RULES OF FAIR PRACTICE TO EXEMPTED SECURITIES, INCLUDING GOVERNMENT SECURITIES (EXCEPT MUNICIPALS)—Continued

Section 34:	
Direct Participation Programs Appendix F	Not Applicable.
Section 35:	
Communications With the Public	Applicable.
Section 35A:	
Options Communications With the Public	Not Applicable/Under Review.
Section 36:	
Transactions with Related Persons	Not Applicable.
Interpretation of the Board of Governors—Transactions With Related Persons	Not Applicable.
Section 37:	
[Reserved] [5]	
Section 38:	
Regulation of Activities of Members Experiencing Financial and/or Operational Difficulties	Applicable.
Section 39:	
Approval of Change in Exempt Status under SEC Rule 15c3–3	Applicable.
Section 40:	
Private Securities Transactions	Applicable.
Section 41:	
Short-Interest Reporting	Not Applicable.
Section 42:	
Prohibition on Transactions During Trading Halts	Not Applicable.
Section 43:	
Outside Business Activities	Applicable.
Section 44:	
The Corporate Financing Rule	Not Applicable.
Section 45:	
Customer Account Statements	Applicable.
Section 46:	
Adjustment of Open Orders	Not Applicable.
Section 47:	
Clearing Agreements	Applicable.
Section 48:	
Short Sale Rule	Not Applicable.
Section 49:	
Primary Nasdaq Market Maker Standards	Not Applicable.
Section 50:	
Reporting Requirements	Applicable.[6]
ARTICLE IV	
Section 1:	
Availability to Customers of Certificate, By-laws, Rules and Code of Procedures	Applicable.
Section 2:	
Complaints by Public Against Members for Violations of Rules	Applicable.
Section 3:	
Complaints by District Business Conduct Committee	Applicable.
Section 4:	
Complaints by Board of Governors	Applicable.
Section 5:	
Reports and Inspection of Books for Purpose of Investigating Complaints	Applicable.
ARTICLE V	
Section 1:	
Sanctions for Violations of Rules	Applicable.
Interpretation of the Board of Governors—The Effect of a Suspension or Revocation of the Registration, if any, of a Person Associated with a Member or the Barring of a Person from further Association with any Member.	
Section 2:	
Payment for Fines, Other Monetary Sanctions, or Costs	Applicable.
Section 3:	
Costs of Proceedings	Applicable.

[1] As noted previously, the NASD will review the application of this Interpretation to the government securities market.

[2] Amendment No. 5 states that the NASD may bring action for conduct violating Article III, Section 4 (''Fair Prices and Commissions'') under its just and equitable principles of trade rule. *See* Amendment No. 5, *supra* note 5.

[3] Article III, Section 4 of the Rules of Fair Practice and the NASD Mark-Up Policy currently apply to transactions in equity and corporate debt securities. The NASD is developing an Interpretation of the Mark-Up Policy with respect to exempted securities and other debt securities. Therefore, the current application of Article III, Section 4 of the Rules of Fair Practice and the NASD Mark-Up Policy will not apply to transactions in exempted securities until adoption of an Interpretation of the NASD Mark-Up Policy with respect to all debt securities. However, current Article III, Section 4 of the Rules of Fair Practice and the Mark-Up Policy remain in full force and effect for all equity and corporate debt transactions. *See* letter from Elliott R. Curzon, Assistant General Counsel, NASD, to Mark P. Barracca, Branch Chief, Division of Market Regulation, SEC, dated October 17, 1995 (Amendment No. 1 to the proposed rule change). In Amendment No. 5, the NASD clarifies that it may bring action for conduct violating the Mark-Up Policy under its just and equitable principles of trade rule. *See* Amendment No. 5, *supra* note 5.

[4] The NASD has indicated that it will review the application of this Interpretation to the government securities market.

[5] In Amendment No. 4, the NASD indicated that the reference to Section 37 in Amendment No. 3 was in error because the Commission approved the NASD's deletion of this section on March 8, 1994. *See* Amendment No. 4, *supra* note 5.

[6] In Amendment No. 4, the NASD proposed that the Reporting Requirements be applicable to exempted securities (except municipals). The NASD noted that Section 50, Article III was approved by the Commission on September 8, 1995. *See* Amendment No. 4, *supra* note 5.

B. Suitability Interpretation—Description of the Proposal

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

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

In its proposal filed with the Commission, the NASD states that the Suitability Interpretation is intended to provide guidance to members in fulfilling their customer-specific suitability obligations, *i.e.*, the manner in which a member determines that a recommendation is suitable for a particular customer.[19] The manner in which a member fulfills this suitability obligation will vary depending on the customer and the specific transaction. The NASD further states that the proposed Suitability Interpretation and the factors contained therein are not intended either to create a safe harbor for members or a burdensome evidentiary checklist.

The proposed Suitability Interpretation states that the two most important considerations in determining the scope of a member's suitability obligations in making recommendations to an institutional customer are the customer's capability to evaluate investment risk independently, and the extent to which the customer is exercising independent judgment in evaluating a member's recommendation. Thus, under the proposed Interpretation, a member must determine, based on information available to it, the customer's capability to evaluate investment risk. In some cases, the member may conclude that the customer is not capable of making independent investment decisions in general. In other cases, the institutional customer may have general capability, but may not be able to understand a particular type of instrument or its risk. The NASD states that if a customer is either generally not capable of evaluating investment risk or lacks sufficient capability to evaluate the particular product, the scope of the member's obligation under the suitability rule would not be diminished by the fact that the member was dealing with an institutional customer.[20]

Members also must make a determination regarding whether the customer is exercising independent judgment in its investment decision, that is, whether the customer's investment decision will be based on its own independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations. The proposed Suitability Interpretation states that a member's determination that a customer is making independent investment decisions will depend on the nature of the relationship that exists between the member and customer.

A member's determination of a customer's capability to evaluate investment risk independently will depend on an examination of the customer's capability to make its own investment decisions, including the resources available to the customer to make informed decisions. The NASD specified several factors relevant to making such a determination. These considerations include: (1) the use of one or more consultants, investment advisers or bank trust departments; (2) the general level of experience of the institutional customer in financial markets and specific experience with the type of instruments under consideration; (3) the customer's ability to understand the economic features of the security involved; (4) the customer's ability to independently evaluate how market developments would affect the security; and (5) the complexity of the security or securities involved.

With respect to the determination that a customer is making independent investment decisions, the NASD proposed several relevant factors. These considerations include: (1) any written or oral understanding that exists between the member and the customer regarding the nature of the relationship between the member and the customer and the services to be rendered by the member; (2) the presence or absence of a pattern of acceptance of the member's recommendations; (3) the use by the customer of ideas, suggestions, market views and information obtained from other members or market professionals, particularly those relating to the same type of securities; and (4) the extent to which the member has received from the customer current comprehensive portfolio information in connection with discussing recommended transactions or has not been provided important information regarding its portfolio or investment objectives.

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

The NASD states that it is important to clarify when a member may consider its suitability obligations fulfilled pursuant to the guidelines provided by the proposed Suitability Interpretation. Therefore, the proposed Suitability Interpretation provides that where the broker-dealer has reasonable grounds for concluding that the institutional customer is making independent

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

[20] The NASD also states that a customer who initially needed help understanding a potential investment may ultimately develop an understanding and make an independent investment decision.

investment decisions and is capable of independently evaluating investment risk, then a member's obligation to determine that a recommendation is suitable for a particular customer is fulfilled.[21]

Finally, for purposes of the proposed Suitability Interpretation, the NASD states that the term ''institutional customer'' should not be arbitrarily defined by referencing a threshold institutional asset size or portfolio size or various statutory designations. Rather, the NASD states that for purposes of the Suitability Interpretation, an institutional customer shall be any entity other than a natural person. The NASD states that it believes the Interpretation is more appropriately applicable to an entity having at least $10 million invested in securities in the aggregate in its portfolio or under management.

IV. Summary of Comments

The Commission received 16 comment letters from a total of 13 commenters.[22] Most of the comment letters addressed the proposed Suitability Interpretation of the rule proposal. The NASD responded to most of the comment letters in Amendment No. 3.

A. Application of the Rules of Fair Practice to Government Securities

1. *Prompt Receipt and Delivery Interpretation*

One commenter requested that the ''long sale'' provisions of the Prompt Receipt and Delivery Interpretation,[23] which would require a member to make affirmative determinations regarding whether a customer is ''long'' the security at the time the dealer is purchasing a government security from a customer, prior to accepting a long sale from any customer, not apply to transactions in government securities.[24] This commenter argued that an affirmative determination requirement is contrary to the practice in the government securities market that permits a customer to sell a security to a dealer and then cover that sale with a subsequent purchase or repurchase transaction in the ''specials market.'' The commenter noted that this practice has been recognized by the Board of Governors of the Federal Reserve System. In response to this comment, the NASD amended its proposal to exempt government securities from the long sales requirements.[25]

2. *Best Execution Interpretation*

One commenter had reservations about the application of the ''best execution'' concept to government securities that are executed on a principal basis at a ''net price.''[26] Two commenters noted that members would have difficulty complying with the procedural requirements of the best execution concept because the government securities market lacks systems similar to the Consolidated Quotation System (''CQS'') and the Intermarket Trading System (''ITS'').[27] The NASD responded that it believes the general concept of the Best Execution Interpretation (*e.g.*, that a member should seek in executing customer transactions to obtain the best price for the customer)[28] should apply to the government securities market, just as it applies to all other markets subject to the NASD's jurisdiction.[29] The NASD stated that it would further consider whether an amendment to the Best Execution Interpretation is necessary to clarify its position as it applies to government securities, but it considered such an amendment unnecessary at this time.

3. *Front Running Policy*

One commenter sought clarification on whether and how the front running interpretation would apply to government securities brokers and dealers.[30] The commenter noted that the interpretation was designed for the equity securities. In response, the NASD noted that its front running interpretation was designed for the equity securities markets and, accordingly, amended its proposal so that the front running interpretation would not apply to the government securities market.[31] The NASD, however, stated that because the member conduct probihited by the front running interpretation may occur in the government securities market under certain circumstances, it will review the application of the front running interpretation to this market. In the interim, the NASD reminded members that actions for front running conduct occurring in the government securities market may be brought under Article III, Section 1 of the Rules of Fair Practice.[32]

---

[21] *See supra* note 19.

[22] The Commission received letters from the following: (1) Brian C. Underwood, Vice President-Director of Compliance, A.G. Edwards & Sons, Inc., to Jonathan G. Katz, Secretary, SEC, dated November 14, 1995 (''Edwards Letter''); (2) David J. Master, Chairman and CEO, Coastal Securities Ltd., to Jonathan G. Katz, Secretary, SEC, dated November 28, 1995 (''Coastal Letter''); (3) Betsy Dotson, Assistant Director, Federal Liaison Center, Government Finance Officers Association, to Jonathan G. Katz, Secretary, SEC, dated November 14, 1995 (''GFOA Letter No. 1''); (4) Thomas M. Selman, Associate Counsel, Investment Company Institute, to Jonathan G. Katz, Secretary, SEC, dated November 14, 1995 (''ICI Letter''); (5) Jane D. Carlin, Principal and Counsel, Morgan Stanely & Co. Incorporated, to Jonathan G. Katz, Secretary, SEC, dated December 5, 1995 (''Morgan Stanley Letter''); (6) Paul Saltzman, Senior Vice President and General Counsel, Public Securities Association, to Jonathan G. Katz, Secretary, SEC, dated November 30, 1995 (''PSA Letter No. 1''); (7) Scott H. Rockoff, Managing Director, Director of Compliance, and Assistant General Counsel, Nomura Securities International, Inc., to Jonathan G. Katz, Secretary, SEC, dated December 14, 1995 (''Nomura Letter''); (8) Robert F. Price, Chairman, Federal Regulation Committee, and Zachary Snow, Chairman, OTC Derivatives Products Committee, Securities Industry Association, to Jonathan G. Katz, Secretary, SEC, dated December 17, 1995 (''SIA Letter No. 1''); (9) David Rosenau, President, The Winstar Government Securities Company L.P., to Jonathan G. Katz, Secretary, SEC, dated December 27, 1995 (''Winstar Letter''); (10) Steven Alan Bennett, Senior Vice President and General Counsel, Banc One Corporation, to Jonathan G. Katz, Secretary, SEC, dated April 16, 1996 (''Banc One Letter''); (11) Betsy Dotson, Assistant Director/Legislative Counsel, Federal Liaison Center, Government Finance Officers Association, to Jonathan G. Katz, Secretary, SEC, dated April 22, 1996 (''GFOA Letter No. 2''); (12) Paul Saltzman, Senior Vice President and General Counsel, Public Securities Association, to Jonathan G. Katz, Secretary, SEC, dated April 22, 1996 (''PSA Letter No. 2''); (13) Marshall Bennett, President, National Association of State Auditors, Comptrollers and Treasurers, to Secretary, SEC, dated April 22, 1996 (''NASACT Letter''); (14) C. Evan Stewart, Chairman, Federal Regulation Committee, Zachary Snow, Chairman, OTC Derivatives Products Committee, and Richard O. Scribner, Chairman, Self-Regulation and Supervisory Practices Committee, Securities Industry Association, to Jonathan G. Katz, Secretary, SEC, dated April 23, 1996 (''SIA Letter No. 2''); (15) Sarah A. Miller, General Counsel, American Bankers Association and the American Bankers Association Securities Association to Jonathan G. Katz, Secretary, SEC, dated April 24, 1996 (''ABA Letter''); and (16) William R. Rothe, Chairman, and John L. Watson III, President, Security Traders Association, to Jonathan G. Katz, Secretary, SEC, dated April 29, 1996 (''STA Letter'').

[23] *See* Article III, Section 1 of the Rules of Fair Practice.

[24] *See* PSA Letter No. 1, *supra* note 22.

[25] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 9.

[26] *See* PSA Letter No. 1, *supra* note 22.

[27] *See* PSA Letter No. 1 and Winstar Letter, *supra* note 22.

[28] *See* Article III, Section 1 of the Rules of Fair Practice.

[29] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 11.

[30] *See* PSA Letter No. 1, *supra* note 22.

[31] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 12.

[32] Similarly, the NASD noted that the Interpretation of the Board of the Governors regarding the trading ahead of customer limit orders and the Interpretation of the Board of Governors—trading Ahead of Research Reports, are drafted to apply to equity securities. The NASD stated that it intends to review the application of these Interpretations to the government securities market because it believes that the conduct addressed by these Interpretations may occur under certain circumstances in the government securities market.

4. *Article III, Section 23 of the Rules of Fair Practice*

One commenter sought clarification on the effect of the provision ''Net Prices to Persons Not in Investment Banking or Securities Business'' on government securities transactions.[33] In response, the NASD determined that the requirements contained in Article III, Section 23 are superseded and more clearly provided for under: (i) Rule 10b–10 of the Act relating to Confirmation of Transactions; and (ii) Article III, Section 25 of the Rules of Fair Practice relating to Dealing with Non-Members.[34] The NASD amended the proposal to reflect this change.

5. *Article III, Section 35A of the Rules of Fair Practice/Schedule C to the By-Laws*

One commenter requested clarification as to whether the proposed rule change would require a government securities broker or dealer to register an associated person as its ''Compliance Registered Options Principal'' under Part II, Section 2(f) of Schedule C to comply with Section 35A(b) of the Rules of Fair Practice, which requires the registration of such a Principal to approve certain options advertisements, sales materials, and other literature for government securities options transactions.[35] In response, the NASD stated that it is currently reviewing the issue of whether a ''Compliance Registered Options Principal'' should be required for members that trade options on government securities. The NASD further noted that it intends to file a proposed rule change regarding this registration issue and, therefore, the NASD amended to Applicability Table to indicate that Article III, Section 35A(b) is ''Not Applicable/Under Review.''[36]

6. *Customer Account Statements*

One commenter suggested that the implementation of Article III, Section 45 (''Customer Account Statements'') be delayed for three months after the effective date of the rule change to give affected members sufficient time to set up appropriate procedures to comply with the requirements of Section 45.[37] The NASD agreed and amended the proposal.[38]

B. Suitability Obligations to Institutional Customers

1. General Comments

Most of the commenters agreed with the general principles expressed in the Suitability Interpretation, although some commenters disagreed on the proper allocation of responsibility between members and institutional customers for investment making decisions.[39] Two commenters did not support the proposal.[40] One commenter believed that the proposal would create both greater confusion and uncertainty and additional duties for NASD members with respect to institutional accounts.[41] The other commenter believed that the proposal would impose unnecessary regulatory burdens on members.[42]

One commenter believed that the proposal would create confusion because it does not define the terms ''recommendation'' and ''institutional investor.''[43] The NASD responded that neither term lent itself to definition. First, it noted that Article III, Section 2 of the Rules of Fair Practice has been applicable to members' recommendations since the inception of the NASD and a significant amount of case law has developed from NASD disciplinary actions with respect to this provision.[44] The NASD further believes that defining the term ''recommendation'' is unnecessary and would raise many complex issues in the absence of the specific facts of a particular case. Second, the NASD believes that an objective definition of ''institutional investor'' would arbitrarily discriminate between institutional investors based on factors such as asset size, portfolio size or institutional type. The NASD stated that the proposed Suitability Interpretation would provide guidance to members on relevant considerations that should be examined by a member in fulfilling its suitability obligations to all institutional customers and would not unfairly discriminate between institutional customers based on such factors.[45]

2. Considerations in Determining the Scope of a Member's Suitability Obligations in Making Recommendations to an Institutional Customer

Several commenters had concerns about the specific guidelines included in the proposal that the NASD stated could be used by a member in determining the scope of the member's suitability obligations.

(i) Member Determination Regarding the Institutional Customer's Capability to Evaluate Investment Risk Independently

One commenter asserted that the relevance of the customer's use of consultants, investment advisers or a bank trust department would depend on the extent of the use of the outside advice and what, if any, contractual arrangement exists between the customer and the outside adviser.[46] This commenter questioned whether outside managers of investment pools and trustees would fall within this guideline. In response, the NASD agreed that the relevance of a customer's use of professional advisers would depend on the extent of the use of such outside advice.[47] Moreover, the NASD believes that the proposed Suitability Interpretation would apply to any delegated agents of the customer, including outside managers for investment pools, trustees, and other agents.[48]

One commenter stated that the usefulness of the customer's general level of experience in the financial markets and with the type of instruments under consideration would depend not only on the expertise of the customer's staff but also on the nature of the changing markets.[49] This commenter also argued that the relevance of a customer's ability to understand economic features of a security would depend on the nature of information provided to the investor by the NASD member about the features of a specific instrument. The commenter further contended that a customer's track record in making investment decisions or an affirmative statement by the customer that it has the ability to

[33] *See* PSA Letter No. 1, *supra* note 22.

[34] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 14.

[35] *See* PSA Letter, No. 1, *supra* note 22.

[36] Article III, Section 35A(b) will not be applicable to options advertisements, sales materials and other literature for government securities options transactions during this interim review period. *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 15.

[37] *See* PSA Letter No. 1, *supra* note 22.

[38] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 16.

[39] *See* Coastal Letter, GFOA Letter No. 1, PSA Letter Nos. 1 and 2, SIA Letter Nos. 1 and 2, Banc One Letter, NASACT Letter, STA Letter, and Morgan Stanley Letter, *supra* note 22.

[40] *See* Nomura Letter and ABA Letter, *supra* note 22.

[41] *See Nomura Letter, sura* note 22.

[42] *See* ABA Letter, *supra* note 22.

[43] *See* Nomura Letter, *supra* note 22.

[44] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 39–40.

[45] *See id.* at 39.

[46] *See* GFOA Letter No. 1, *supra* note 22.

[47] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 26.

[48] In fact, the Suitability Interpretation specifically states that where a customer has delegated decision-making authority to an agent, such as an investment adviser or a bank trust department, the Interpretation shall be applied to the agent.

[49] *See* GFOA Letter No. 1, *supra* note 22.

evaluate independently the effect of the market on a security, are not reliable indicators of a customer's ability to independently evaluate the effects of the market on the security. The NASD agreed that the relevance of the factors listed in the proposed Suitability Interpretation would vary depending on numerous circumstances.[50] The NASD also noted its belief that a customer's track record and an affirmative statement by the customer regarding its capability are helpful, but not dispositive, factors pertaining to the customer's capability to evaluate investment risk dependently.

One commenter suggested three additional factors that should be considered by a member in determining whether an institutional customer has the capability to evaluate investment risk independently: (1) whether the customer is engaged in either the financial industry or the business of managing its or others' investments, (2) whether the customer has in-house investment professionals charged with responsibility for recommending or making investment decisions on behalf of the customer, and (3) whether the customer independently adopted investment guidelines and whether the customer provides explicit investment guidelines to the member broker-dealer.[51] In response, the NASD acknowledged that additional factors may be valuable to members in considering whether an institutional customer is capable of evaluating investment risk independently or may be pertinent to a specific situation.[52]

(ii) Member Determination Regarding Whether the Institutional Customer is Exercising Independent Judgment

One commenter pointed out that one of the factors in determining the scope of a member's suitability obligation—the extent to which the customer *intends* to exercise independent judgment—is inconsistent with a member's obligation to determine that a customer *is making* independent investment decisions.[53] In response to this comment, the NASD amended the proposal to replace the phrase ''intends to exercise'' with the phrase ''is exercising'' to eliminate any confusion.[54]

One commenter sought clarification that the lack of a written agreement would not work against investors in disputed cases and that the inclusion of written or oral understandings as a relevant consideration in the proposal does not indicate a preference for such agreements.[55] The NASD responded that whereas developing such agreements with a customer may be helpful to a member in determining its suitability obligations to the customer, the existence or absence of such an agreement is not intended to create a presumption as to whether the member has or has not fulfilled its suitability obligation.[56]

One commenter argued that the factor referencing the ''presence or absence of a pattern of acceptance of a member's recommendation'' was too broad and should refer only to captive accounts, where a single broker-dealer is effectively controlling substantially all investment decisions of an account.[57] The NASD disagreed and stated that the presence or absence of a pattern of customer acceptance of a member's recommendation should be considered whenever appropriate and reasonable and should not be limited to ''captive accounts.''[58]

One commenter believed that the factor referencing the use by the customer of ideas, suggestions and information obtained from other NASD members or market professionals may discourage investors from becoming more informed and responsible.[59] The NASD disagreed, stating that institutional customers often rely on financial information other than that provided by the member and may be required by a fiduciary obligation to do so.[60]

One commenter believed that a member's consideration of ''the extent to which the member has received from the customer current comprehensive portfolio information in connection with discussing recommended transactions'' may not be prudent for the institutional investor with concerns that a member's detailed knowledge of the institution's holdings may affect the institution's ability to trade certain portions of the portfolio or may adversely affect the market for the institution's holdings.[61] This commenter recommended first, replacing this factor with a requirement to provide ''material relevant to a particular transaction'' and, second a requirement that the broker-dealer make a reasonable request to obtain relevant portfolio or investment objectives information. The NASD agreed that any material relevant to a particular transaction provided by a customer would assist members in fulfilling their suitability obligations under the proposed Interpretation. The NASD believes, however, that the ''material information'' referred to by the commenter would include current comprehensive portfolio information in connection with the transaction. The NASD also believes that the more specific guideline is appropriate even though a customer may not be willing to provide such information.[62]

(iii) Portfolio Threshold

One commenter believed that the $10 million portfolio designation is contrary to the language in the congressional report on the GSAA and contradicts the intent of the suitability rule.[63] This commenter argued that the portfolio designation would be difficult to apply and requested clarification on how the standard would be implemented in the context of a government unit. The commenter also urged that if the NASD retains the portfolio designation, an amount higher than $10 million be used because the Interpretation inappropriately could be applied to small governmental entities with portfolios that are nominal in the context of government operations. The commenter further requested more explanation on how institutional investors with a portfolio less than the designated amount will be treated. The NASD responded that there is greater likelihood that the member could apply the proposed Suitability Interpretation to an institutional customer with at least $10 million invested in securities in the aggregate in its portfolio and/or under management, but it had not intended to create a presumption either above or below that aggregate dollar amount that the Interpretation will apply to a

[50] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 27.

[51] *See* Morgan Stanley Letter, *supra* note 22. Another commenter believed that institutions with the first two characteristics are capable of making their own independent investment decisions. *See* SIA Letter Nos. 1 and 2, *supra* note 22. This commenter suggested that the proposal be amended to state that a rebuttable presumption exists that institutions are capable of making their own independent investment decisions. *See* SIA Letter Nos. 1 and 2, *supra* note 22. For more discussion on rebuttable presumptions, *see infra* Section (B)(3) of the Summary of Comments.

[52] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 24–25.

[53] *See* Morgan Stanley Letter, *supra* note 22.

[54] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 22.

[55] *See* GFOA Letter No. 1, *supra* note 22.

[56] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 28.

[57] *See* Morgan Stanley Letter, *supra* note 22.

[58] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 27–28.

[59] *See* GFOA Letter No. 1, *supra* note 22.

[60] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 29.

[61] *See* GFOA Letter No. 1, *supra* note 22.

[62] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 30. The NASD notes that all the factors are guidelines and the inclusion or absence of any factor is not dispositive of the suitability interpretation.

[63] *See* GFOA Letter No. 1, *supra* note 22.

particular institutional customer.[64] Moreover, the NASD stated that in calculating the $10 million test, it intends to look to SEC Rule 144A for guidance.

One commenter recommended that the $10 million threshold not be considered for registered investment companies accounts.[65] This commenter argued that all registered investment companies are equally subject to the Investment Company Act of 1940 and must operate within the same competitive environment in which they are expected to obtain professional experienced investment management for their shareholders. The commenter argued that an interpretation that liberalizes the suitability requirements of its members with respect to larger investment companies could inadvertently lead to discrimination against smaller investment companies. Another commenter also believed that the proposal would have an adverse effect on smaller institutional clients by reducing competition for these accounts.[66]

The NASD responded that the reference to $10 million does not imply a definitive threshold that distinguishes capable from non-capable institutional customers.[67] Therefore, the NASD believed that the $10 million threshold should not result in inadvertent discrimination against investment companies or other institutional customers with less than $10 million invested in securities.

One commenter criticized the definition of non-institutional customer as being too broad and stated that the information-gathering requirement in Article III, Section 2(b) should only apply to customers that are not considered institutional customers under the proposed Suitability Interpretation.[68] This commenter argued that a member may reasonably conclude that an institutional customer with less than $50 million in assets is capable of understanding the risks of the recommended transaction and intends to exercise reasonable judgment in evaluating the member's recommendation, but the member would still have to gather information required by Article III, Section 2(b) from that customer. The commenter suggested that the definition of non-institutional customer be amended by eliminating the reference to Section 21(c)(4) and incorporating a definition of institutional customer in Section 2(b) that is consistent with the proposed Suitability Interpretation.

In response, the NASD stated that the proposed rule change to Article III, Section 2(b) of the Rules of Fair Practice is meant to distinguish this requirement from the suitability obligations under Article III, Section 2(a) of the Rules of Fair Practice and the proposed Suitability Interpretation.[69] The NASD stated that fulfilling the suitability obligation under the proposed Suitability Interpretation would not reduce the member's other obligation under Article III, Section 2(b) to customers that do not qualify as institutional accounts under Article III, Section 21(c)(4) of the Rules of Fair Practice, even though some of these customers may be considered institutional customers according to the proposed Suitability Interpretation.

3. Safe Harbor/Rebuttable Presumption

Several commenters were concerned that the proposal would in effect make the member a guarantor of a recommended investment's performance and inappropriately shift responsibility for poor investment decisions to the broker-dealer.[70] Some commenters recommended that the proposal include a safe harbor for broker-dealers that comply with the proposed interpretation.[71] Other commenters believed that if the institutional investor employs an investment professional, the investment professional should bear the responsibility for the investment decisions it makes.[72]

In response, the NASD stated that it would not be appropriate to create a safe harbor for member's suitability obligations or to change or reduce members' obligations under the suitability rule in Article III, Section 2 of the Rules of Fair Practice.[73] The NASD stated that there are no safe harbors in the Suitability Interpretation.[74]

Rather than a safe harbor, one commenter suggested that the proposal provide a rebuttable presumption that a member's recommendations to institutional customers are suitable.[75] This commenter believed that the existence of an advisory relationship should be the primary consideration and that, absent extraordinary circumstances, an advisory relationship should be deemed to exist only if the parties evidence such an agreement in writing.[76]

In response, the NASD stated that a member's suitability obligation under Article III, Section 2(a) of the Rules of Fair Practice remains with the member until fulfilled and therefore, the creation of a rebuttable presumption through the fulfillment of certain procedures would not be appropriate.[77] Moreover, the NASD stated that such a rebuttable presumption would only be acceptable if a definable class of institutional investors could be identified that would not need the protection of the NASD's

[64] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 32.

[65] *See* ICI Letter, *supra* note 22.

[66] *See* Edwards Letter, *supra* note 22.

[67] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 34.

[68] *See* PSA Letter No. 1, *supra* note 22. Pursuant to Article III, Section 2(b), prior to the execution of a transaction recommended to a non-institutional customer (other than transactions with customers where investments are limited to money market mutual funds), a NASD member must make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer. For purposes of this information gathering requirement, an institutional customer means: (1) a bank, savings and loan association, insurance company, or registered investment company; (2) an investment adviser registered under Section 203 of the Investment Advisers Act of 1940; or (3) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least $50 million.

[69] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 35.

[70] *See* Nomura Letter, Edwards Letter, Morgan Stanley Letter, and ABA Letter *supra* note 22. One commenter was concerned that market participants were inappropriately using the suitability concept to make the dealer the guarantor of an investment's performance. *See* PSA Letter No. 1, *supra* note 22.

[71] *See* ABA Letter and Coastal Letter, *supra* note 22. Alternatively, one of the commenters believed that compliance with the interpretative guidance should create a rebuttable presumption that a member's suitability obligations with respect to institutional customers have been satisfied. *See* ABA Letter, *supra* note 22.

[72] *See* Edwards Letter, Morgan Stanley Letter, PSA Letter No. 1, and STA Letter, *supra* note 22. One commenter, however, disagreed because there may be variation in the type and degree of services offered by a third-party professional to its clients. *See GFOA Letter No. 2, supra* note 22.

[73] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 30–31.

[74] *See id.* at 45.

[75] *See* Nomura Letter, *supra* note 22. One commenter stated that there should be a cutoff for institutions with more than a stated amount of assets under management. *See* STA Letter, *supra* note 22. One commenter argued, however, that there should be no rebuttable presumption that recommendations made to institutional investors are suitable. *See* GFOA Letter No. 2, *supra* note 22. Another commenter agreed that the broker-dealers should be held responsible for their recommendations to institutional investors. *See* NASACT Letter, *supra* note 22.

[76] *See* Nomura Letter, *supra* note 22. Moreover, one commenter argued that three particular situations warrant reconsideration as determinative factors or rebuttable presumptions that the member has fulfilled its suitability obligation: the presence of an investment advisor; transactions executed consistent with investment guidelines or permitted investment statutes; and the execution of a written agreement. *See* PSA Letter Nos. 1 and 2, *supra* note 22.

[77] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 40.

suitability rule under all conceivable circumstances. The NASD was unable to define such a class.[78]

4. Additional Obligations on Members

Several commenters argued that the NASD's proposed Suitability Interpretation would impose new or additional duties on its members. One commenter was concerned that the proposal would create an obligation to document affirmative determinations of the factors referenced under the two principal considerations because it believed that the proposal implies that NASD examiners will expect to see an affirmative determination on all or some of the described criteria for compliance purposes.[79] Another commenter believed that these analyses will greatly increase a member's responsibility to gather detailed information about its institutional customers and to keep extensive records of any information gathered.[80]

One commenter requested that the NASD incorporate explicit language stating that it did not intend to create: (1) a checklist for NASD compliance examinations; (2) an affirmative obligation on NASD members to make trade-by-trade or continual suitability determinations based on the designated considerations; or (3) new NASD member suitability determination documentation or record maintenance requirements.[81]

On the other hand, other commenters supported imposing additional obligations on members. One commenter suggested that the proposal require the broker-dealer to provide certain specific types of information to customers with regard to specific transactions such as an instrument's behavior under a variety of conditions, types of risk incurred with certain instruments, and valuation information.[82] This commenter also supported the inclusion of an affirmative duty to inquire about a customer's risks and constraints, including any investment policies.[83]

The NASD responded that it was not imposing through the proposed Suitability Interpretation additional duties on members that are not already imposed by current Article III, Section 2 of the Rules of Fair Practice, general anti-fraud principles in Section 10(b) of the Act and other provisions of the federal securities laws, or in Article III, Section 18 of the NASD's Rules of Fair Practice.[84] The NASD stated that Article III, Section 2(a) of the Rules of Fair Practice does not contain books and records requirements and, similarly, the proposed Suitability Interpretation does not contain books and records requirements.[85] The NASD warned, however, that members are responsible for demonstrating the fulfillment of their suitability obligation under Article III, Section 2(a) in NASD examinations and that members would have the same responsibility under the proposed Suitability Interpretation. The NASD also stated that it had intended to eliminate the appearance that the listed factors create an evidentiary checklist for NASD compliance review. The NASD stated that the responsibilities of the member are limited under Article III, Section 2(a) of the Rules of Fair Practice in that the member is not the guarantor of the investment nor reponsible for the absence of information not provided by the institutional customer.

V. Discussion

The government securities market, widely considered to be the largest and most liquid securities market in the world, has enabled the U.S. government to meet its large financing needs in an effective manner. In 1991, however, certain events threatened the public confidence in the fairness and integrity of this market and prompted the Treasury Department, the Board of Governors of the Federal Reserve System and the Commission to undertake an informal review of the government securities market.[86] As a result of this review, and Congressional inquiries into the government securities market in general, in 1993 Congress decided to modify the limited regulatory structure in the Government Securities Act of 1986 by enacting the GSAA.

In the GSAA, Congress provided the NASD and bank regulators with the authority to issue rules aimed at preventing fraudulent or manipulative acts and practices and to promote just and equitable principles of trade in the government securities market.[87] Pursuant to this legislation, the NASD has proposed rule changes to impose for the first time various provisions of the Rules of Fair Practice to transactions in exempted securities, including government securities, other than municipals. The GSAA also stimulated the NASD to provide further guidance to members on their suitability obligations in Section 2, Article III when making recommendations to institutional customers.[88]

For the reasons discussed below, the Commission has determined that the NASD's proposals are consistent with the requirements of the Act and the rules and regulations thereunder applicable to the NASD and, in particular, the requirements of Section 15A[89] and the rules and regulations thereunder.[90] The Commission believes that the proposed rule change is consistent with the Section 15A(b)(6) requirements that the rules of the association be designed to prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest.[91]

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

To implement the authority conferred by the GSAA to address abusive and manipulative practices in the government securities market, the NASD has proposed to merge certain provisions of its current Government Securities Rules into the Rules of Fair Practice, and to apply certain provisions of the Rules of Fair Practice to exempted securities (except municipals) for the first time. The Commission believes that the application of the various sections of the NASD's Rules of Fair Practice, which the NASD deems to be appropriate and necessary for regulating

[78] *See id.* at 42.

[79] *See* Nomura Letter, *supra* note 22.

[80] *See* ABA Letter, *supra* note 22.

[81] *See* SIA Letter Nos. 1 and 2, *supra* note 22.

[82] *See* GFOA Letter No. 1, *supra* note 22.

[83] *See* GFOA Letter No. 2, *supra* note 22.

[84] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 25.

[85] *See id.* at 38.

[86] The Treasury Department, the Board of Governors of the Federal Reserve System, and the Commission produced a report on this review of the government securities market. *See* Joint Report on the Government Securities Market (Jan. 1992).

[87] H.R. Rep. 103–255, 103d Cong., 1st Sess. (1993) (Congress believed that ''it is appropriate to extend normal sales practice standards and other registered securities association rules to transactions in the government securities market by removing the statutory restrictions on the authority of such associations in the government securities market'').

[88] The Office of the Comptroller of the Currency (''OCC''), the Federal Deposit Insurance Corporation (''FDIC''), and the Board of Governors of the Federal Reserve System (''Board'') also have solicited comment on rules, largely similar to those proposed by the NASD, to apply to government securities brokers and dealers under the jurisdiction of these agencies. *See* Government Securities Sales Practices, 61 FR 18470 (Apr. 25, 1996) (joint notice of proposed rulemaking).

[89] 15 U.S.C. 78*o*–3.

[90] The GSAA also requires the Commission to consult with the Treasury Department prior to the adoption of the NASD proposal. The Commission has consulted with the Treasury Department.

[91] 15 U.S.C. 78*o*–3(b)(6).

transactions in exempted securities, including government securities, other than municipals, is consistent with the purposes of the Act and the intention of Congress in enacting the GSAA.[92]

Under the proposal, the NASD has determined to exempt government securities transactions from certain provisions of the Rules of Fair Practice. The NASD found some provisions not to be applicable to the government securities market while others will be considered for further review. A few of the provisions under further review are especially worthy of note.

First, the NASD acknowledged that its current front running interpretation applies only to equity securities. The NASD has committed, however, to review the application of its front running interpretation to the government securities market because the NASD believes that front running may occur in this market under certain circumstances.[93] Moreover, in the interim, the NASD has represented that actions for front running conduct occurring in the government securities market may be brought under its rule requiring members to adhere to just and equitable principles of trade.[94]

Second, with the proposed rule change, the NASD will not apply its prohibitions against trading ahead of customer limit orders and trading ahead of research reports to the government securities market. As with the front running interpretation, the NASD intends to review the application of these interpretations to the government securities market because the NASD believes that conduct addressed by the interpretations may occur in this market under certain circumstances.[95] In the meantime, the NASD will bring action for such conduct under its just and equitable principles of trade rule.

The Commission believes that the NASD's determination to apply certain of its general rules, only formerly applicable to equity or corporate debt securities, to government securities is consistent with the Act, and that the NASD has made a reasonable determination regarding which of its general rules should be applicable to government securities. With respect to those provisions of the Rules of Fair Practice that the NASD plans to consider further for application to the government securities markets, the Commission anticipates that the NASD will undertake a prompt and thorough evaluation and submit proposed rule changes with the Commission as appropriate.

B. Suitability Interpretation

The concept of suitability, rooted in notions of just and equitable principles of trade and the protection of investors, plays an important role in the scheme of the federal securities laws. Prohibitions against making unsuitable recommendations arise under the rules of all self-regulatory organizations.[96] They lay the foundation for good and sound business practices by broker-dealers and help avoid potential abusive sales practices regarding customers. The NASD's articulation of the suitability principles as set forth in Article III, Section 2 of the Rules of Fair Practice has applied to members' recommendations since the inception of the NASD. Article III, Section 2(a) requires that in recommending to a customer the purchase, sale or exchange of any security, a member must have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and financial situation and needs. With the enactment of the GSAA, and NASD has decided to provide further guidance to members on their suitability obligations and has proposed guidelines for its members regarding how members may fulfill their ''customer-specific'' suitability obligations when making recommendations to institutional customers.[97]

The current version of the Suitability Interpretation is the product of the NASD's extensive consultation with broker-dealers, investors and other participants in the securities industry over a period of several years. It reflects much discussion and great diversity of input by various parties. The first draft of the proposed Suitability Interpretation was published for comment in Notice to Members 94–62 (August 1994). Fourteen commenters submitted 15 comment letters on the draft proposals. In response to the comments received, the NASD amended the proposal and published a second draft for comment in Notice to Members 95–21 (April 1995). Sixteen comments were received on the second draft. The NASD, against, amended the proposal Suitability Interpretation in response to the comments received, before filing a proposed interpretation with the Commission. The NASD provided further clarification and amendments to the proposal in March 1996, when Amendment No. 3 to the proposal was filed. Thus, the final proposal currently before the Commission reflects the NASD's effort to consider all comments on the numerous versions of the proposal and balance the issues raised in those comments.

The NASD's Suitability Interpretation is predicated on a determination that the two most important considerations in determining the scope of a member's suitability obligation in making recommendations to an institutional customer are (1) the customer's capability to evaluate investment risk independently, and (2) the extent to which the customer is exercising independent judgment. The Suitability Interpretation further describes factors that may be relevant in a members evaluation of these two important considerations. The NASD has emphasized that these factors are guidelines that will be utilized to determine whether a member has fulfilled suitability obligations with respect to a specific institutional customer transaction and that the absence or inclusion of any of these factors is not dispositive of the suitability determination.

The Commission believes that the NASD's approach to determining the scope of a member's suitability obligation in making recommendations to an institutional customer appropriately responds to the varied nature of institutional customers and the varied significance of a member's recommendation for different institutional customers. The NASD acknowledges, as does the Commission, that the relationship between a broker-dealer and an institutional customer generally may be different in important respects from the relationship a broker-dealer has with a non-institutional investor. In the latter circumstance, a broker-dealer frequently has knowledge about the investment and its risks and costs that are not possessed by or easily available to the investor. Some

[92] *See* H.R. Rep. 103–255, 103d Cong., 1st Sess. (1993).

[93] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 12.

[94] *See id.*

[95] *See id.* at 13.

[96] *See, e.g.,* New York Stock Exchange Rule 405, NYSE Guide (CCH) ¶ 2405; American Stock Exchange Rule 411, Amex Guide (CCH) ¶ 9431. *See also Duker & Duker,* 6 S.E.C. 386, 388 (1939). As part of the obligation of fair dealing, all broker-dealers are required to have a reasonable basis for believing that their securities recommendations are suitable for the customer in light of the customer's financial needs, objectives, and circumstances.

[97] The NASD Suitability Interpretation will be applicable to all securities, except for municipals. Municipal Securities Rulemaking Board (''MSRB'') rule G–19 governs the suitability obligations for municipal securities. Like Article III, Section 2 of the Rules of Fair Practice, MSRB rule G–19 makes no distinction between institutional and non-institutional customers in requiring that a broker, dealer, or municipal securities dealer must have reasonable grounds for believing that a recommendation is suitable.

sophisticated institutional customers, however, may in fact possess both the capability to understand how a particular securities investment could perform, as well as the desire to make their own investment decisions, without reliance on the knowledge or resources of the broker-dealer. Other investors that meet a definition of ''institutional customer'' may not possess the requisite capability to understand the particular investment risk, or may not be exercising independent judgment in making a particular investment decision, and so may be largely dependent on the broker-dealer's analysis and recommendation in evaluating whether to purchase a recommended security.

The NASD proposal recognizes the varied nature of investor profiles, even among investors that meet some definition of ''institutional investor.'' It accommodates a wide range of relationships because it does not establish rigid thresholds or requirements, but rather provides its members with some reasonable factors by which an NASD member can determine the nature of its relationship with a customer. The Interpretation correctly recognizes that there can be instances in which an institutional customer possesses a general capability to understand certain kinds of investments, but does not have the requisite capability to understand the particular investment under consideration. In such a circumstance, the NASD appropriately notes that a broker-dealer's suitability obligation would not be diminished based solely on the financial wherewithal of the customer.

The Commission also believes that the factors enumerated in the Interpretation, which could be relevant to the two considerations, provide members with appropriate points to consider in satisfying their suitability obligations. Some commenters were concerned about the relevance of, and the proper weight to be given to, the considerations listed. Some commenters also expressed concern regarding the specific application of these considerations.[98] The NASD acknowledges that these considerations are not necessarily the only relevant factors, but merely guidelines for use in determining whether a member has fulfilled its suitability obligations with respect to a specific institutional customer transaction. They neither create nor reduce a member's suitability obligation and their relevance would vary depending on numerous circumstances.[99] The Commission concurs with the NASD in this regard. Moreover, these enumerated factors are not meant to create a checklist, which the Commission would consider inappropriate in these circumstances because it could lead to a mechanical application of the Interpretation without adequate consideration by the broker-dealer of whether the customer understands the transaction or product.

Some commenters, believing that the suitability responsibility is already unevenly placed on broker-dealers, supported inclusion in the Suitability Interpretation of a safe harbor or a rebuttable presumption. In keeping with its purpose to provide guidance and not to create or reduce a member's suitability obligations, the NASD did not create a safe harbor or provide for a rebuttable presumption in the Suitability Interpretation.[100] In response to the arguments of some industry members that if an investor employs an investment professional, that professional should wholly bear the responsibility for the investment decision it makes, the NASD clarified that while the institution would still be covered by the suitability rule, the factors analysis of the proposed Suitability Interpretation would apply to any delegated agents of customers, including any professional advisers that an investor may employ.

The Commission believes that the NASD's decision not to create a safe harbor or rebuttable presumption is consistent with the purposes of the Act. A safe harbor or a rebuttable presumption that applied to institutions that were likely to rely on a broker-dealer's guidance regarding a security could lead to serious abuses that are inconsistent with the purposes of the Act. For example, a safe harbor could allow a broker-dealer to recommend a risky security to an institutional investor without consideration of the appropriateness of the investment for the investor, and despite knowing that the customer did not understand the product. Moreover, a safe harbor or a rebuttable presumption that all institutions with similar amounts to invest possess similar or equal financial acumen, which has not proven to be the case. As one commenter noted, ''institutional customers'' could be educational institutions, churches, charities, or governments, which range from small special districts to large state governments, and the characteristics and portfolios of these customers vary widely.[101] A safe harbor or a rebuttable presumption would depend on the ability of the NASD to define objectively a class of institutional investors that uniformly would not need the protections of the NASD's suitability rule.

The NASD, however, has not sought to define such a class. Rather, the NASD has taken a flexible approach in defining the term ''institutional investor'' by not including financial criteria in the term; for purposes of the Interpretation, an institutional customer may be any entity other than a natural person. The Suitability Interpretation potentially would apply to all institutional investors, though more appropriately to institutional investors with portfolios of at least $10 million in securities. The NASD believes that excluding institutional investors from the protections of the suitability rule based on objective financial criteria would arbitrarily discriminate among institutional investors based on factors such as asset size, portfolio size or institutional type that are not necessarily determinative of financial sophistication. The Commission believes that the NASD's choice not to rely on objective criteria that may mask what is really an unsophisticated investor is reasonable in the context of a standard that incorporates factors that reflect the nature of the investor, and where the suitability of the recommendation itself depends on the nature of the investor. Categorizing investors by an isolated financial criteria may improperly attribute the capability to evaluate investment risk independently and the exercise of

[98] For example, some commenters expressed concern about the $10 million portfolio designation. A few commenters believed that such a threshold may lead to discrimination against smaller institutions or investments companies. One commenter believed that the GSAA prohibited such a portfolio designation. The NASD has represented that it had not intended to create a presumption that the Interpretation would apply to a particular institutional customer either above or below the aggregate dollar amount or to imply that the $10 million constituted a definitive threshold in determining whether a broker-dealer's suitability obligation was satisfied in dealing with a particular institution. *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 32, 34. The Commission agrees that the $10 million portfolio designation will not discriminate against certain institutional customers nor is it contrary to the language of the Congressional report on the GSAA. The $10 million portfolio designation does not create a presumption that institutions that exceed the $10 million portfolio amount satisfy the Interpretation's factors and thus are not covered by the protections of the suitability rule; rather, the Interpretation indicates that the analysis of the suitability obligation to be conducted using the factors set forth in the interpretation is more appropriate for these larger institutions than for institutions with a smaller portfolio.

[99] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 27.

[100] *See id.* at 40, 45.

[101] *See* GFOA Letter No. 2, *supra* note 22.

independent judgment to an customer without an appropriate analysis of the investor's true characteristics.[102]

Moreover, in view of the great diversity of institutional customers, the Interpretation affords broker-dealers the flexibility to negotiate understandings and terms with a particular customer. Such agreements, freely negotiated between consenting parties, can be useful in establishing, prior to a transaction, the obligations and responsibilities of both parties. The NASD's approach assists broker-dealers and customers to define their own expectations and roles with respect to their specific relationship.

Some industry members were concerned that the Interpretation would create greater confusion and uncertainty and additional duties on broker-dealers. Industry members were especially concerned that the proposed Interpretation would impose an obligation on members to document and retain extensive records of information gathered or expose them to NASD compliance examinations based on a ''checklist.'' Again, the NASD represented that it was not imposing through the proposed Interpretation additional duties on members that are not already imposed by the NASD's suitability rules, general anti-fraud provisions of the federal securities laws, or Article III, Section 18 of the NASD's Rules of Fair Practice. The NASD confirmed that the proposed Interpretation does not impose a books and records requirement nor does it create an evidentiary checklist for NASD compliance review. The NASD's reassurances that these considerations are provided merely for guidance purposes and not to impose any additional duties or to reduce any existing obligations should alleviate the commenters' concerns regarding the specific application of the Interpretation. Moreover, the NASD has repeatedly indicated that the Interpretation does not make the broker-dealer a guarantor, which the Commission believes is appropriate.

Moreover, the NASD has committed to continuing its examination of members for compliance with the suitability obligations under Article III, Section 2(a) and, upon the approval of the Interpretation, members' compliance with the Interpretation.[103] The Commission expects the NASD to extend its examinations to members' compliance with the Interpretation once it becomes effective.

Finally, the Commission finds good cause for approving Amendment Nos. 4 and 5 to the proposed rule change prior to the thirtieth day after the date of publication of notice of filing thereof. The Exchange's proposal was published in the Federal Register for the full statutory period.[104] Amendment No. 4 merely clarifies the new numbering of the *NASD Manual* and proposes to apply Section 50, Article III, to transactions in exempted securities (except municipals). The NASD's adoption of reporting requirements in Section 50, Article III, was the product of a review by the NASD and the New York Stock Exchange, which was undertaken because of concerns on the part of the Commission and others over the frequency and severity of sales practices abuses.[105] The Commission approved NASD adoption of Section 50, Article III stating that the reporting requirements will provide important regulatory information that will assist in the detection and investigation of sales practice violations. Therefore, the Commission believes that applying this provision to transactions in exempted securities, including government securities, other than municipals is consistent with Congress' mandate to the NASD to extend its sales practice standards and other rules to address abusive and manipulative practices in the government securities market. Moreover, Amendment No. 5 merely clarifies and reminds members that its rules requiring members to adhere to just and equitable principles of trade apply to conduct that may violate the Fair Prices and Commissions provision and the Mark-Up Policy. The Commission believes that this clarification is not substantive because the rule requiring that members adhere to just and equitable principles of trade would have applied to such conduct regardless of this clarification. Based on the above, the Commission finds that there is good cause, consistent with Section 6(b)(5) of the Act, to accelerate approval of Amendment Nos. 4 and 5.

VI. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning Amendment Nos. 4 and 5. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying at the Commission's Public Reference Section, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such filing will also be available for inspection and copying at the principal office of the Exchange. All submissions should refer to File No. SR–NASD–95–39 and should be submitted by September 17, 1996.

VII. Conclusion

In conclusion, the Commission believes that the NASD's proposal to impose the Rules of Fair Practice to transactions in exempted securities other than municipals, and to provide further guidance to members on their suitability obligations in Section 2, Article III when making recommendations to institutional customers is consistent with the purposes of the Act and the GSAA. Especially with respect to the proposed suitability Interpretation, the NASD has undergone an extensive consultative process, whereby interested parties were able to participate in the development of the Interpretation. The Commission believes that the suitability Interpretation is a reasoned approach to the concept of suitability, which fosters an environment for dialogue between broker-dealers and customers regarding the nature of their relationship, and, therefore, should promote the protection of investors.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[106] that the proposed rule change (SR–NASD–95–39) is approved.

[102] In testimony before the Subcommittee on Telecommunications and Finance Committee on Commerce, SEC Chairman Arthur Levitt testified against a provision in the proposed legislation that would crate a presumption that a broker-dealer is not liable for investment decisions of institutional clients unless the parties have contracted to the contrary. Chairman Levitt testified that the presumption under the federal securities laws that broker-dealers generally are responsible for making suitability recommendations, whether their clients are institutional or individual investors, should be maintained. *See* Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning H.R. 2131, The ''Capital Markets Deregulation and Liberalization Act of 1995,'' before the Subcomm. on Telecommunications and Finance Committee on Commerce (Nov. 30, 1995).

[103] *See* Securities Exchange Act Release No. 36973, *supra* note 14, at 38.

[104] *See* Securities Exchange Act Release Nos. 36383 and 36973, *supra* notes 9 and 14.

[105] *See* Securities Exchange Act Release No. 36211 (Sept. 8, 1995) 60 FR 48182.

[106] 15 U.S.C. 78s(b)(2).

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[107]

Margaret H. McFarland,
Deputy Secretary.

EXHIBIT 1.—OLD-TO-NEW CONVERSION CHART

Former provision	New number
By-Laws	Unchanged
* * * * * * *	
Schedules to the by-laws:	
Schedule A	Unchanged
* * * * * * *	
Schedule C	1000
* * * * * * *	
II. Registration of Principals	1020
* * * * * * *	
(2) Categories of Principal Registration	1022
* * * * * * *	
VI. Persons Exempt from Registration	1060
* * * * * * *	
Rules of fair practice	Titled deleted
Article I:	
Adoption and application	0110
* * * * * * *	
4. Effect on Transactions in Exempted Securities	0114
5. Applicability	0115
* * * * * * *	
CONDUCT RULES	
Article III—Rules of Fair Practice	
1. Business Conduct of Members	2110
Interpretation on Execution of Retail Transactions in the Over-the-Counter Market	2320
Interpretation on Prompt Receipt and Delivery of Securities	3370
Interpretation on Forwarding of Proxy and Other Materials	2260
Interpretation on ''Free-Riding and Withholding''	IM–2110–1
Interpretation on Trading Ahead of Customer Limit Orders	IM–2110–2
Interpretation on Front Running Policy	IM–2110–3
Interpretation on Trading Ahead of Research Reports	IM–2110–4
2. Recommendations to Customers	2310
Policy on Fair Dealing with Customers	IM–2310–2
3. Charges for Services Performed	2430
4. Fair Prices and Commissions	2440
Interpretation on NASD Mark-Up Policy	IM–2240
5. Publication of Transactions and Quotations	3310
Interpretation on Manipulative and Deceptive Quotations	IM–3310
6. Offers at Stated Prices	3320
Policy with Respect to Firmness of Quotations	IM–3320
7. Disclosure of Price in Selling Agreements	2770
8. Securities Taken in Trade	2730
Interpretation on Safe Harbor and Presumption of Compliance	IM–2730
9. Use of Information Obtained in Fiduciary Capacity	3120
10. Influencing or Rewarding Employees of Others	3060
11. Payment Designed to Influence Market Prices, Other than Paid Advertising	3330
12. Disclosure on Confirmations	2230
Explanation on ''Third Market Confirmations''	IM–2230
13. Disclosure of Control	2240
14. Disclosure of Participation or Interest in Primary or Secondary Distribution	2250
15. Discretionary Accounts	2510
16. Offering ''At the Market''	2760
17. Solicitation of Purchases on an Exchange to Facilitate a Distribution of Securities	2780
18. Use of Fraudulent Devices	2120
19. Customers' Securities or Funds	2330
Explanation of Paragraph (d) of Section 19	IM–2330
20. Installment or Partial Payment Sales	2450

[107] 17 CFR 200.30–3(a)(12).

EXHIBIT 1.—OLD-TO-NEW CONVERSION CHART—Continued

Former provision	New number
21. Books and Records	3110
22. Disclosure of Financial Condition	2270
Resolution on Requirements of Members to Furnish Recent Financial Statement to Other Members	2910
23. Net Prices to Persons Not in Investment Banking or Securities Business	2410
24. Selling Concessions	2740
Interpretation on Services in Distribution	IM–2740
25. Dealing with Non-Members	2420
Interpretation on Transactions Between Members and Non-Members	IM–2420–1
26. Investment Companies	2830
27. Supervision	3010
28. Transactions for or by Associated Persons	3050
29. Variable Contracts of an Insurance Company	2820
30. Margin Accounts	2520
31. Securities ''Failed to Receive'' and ''Failed to Deliver''	3210
32. Fidelity Bonds	3020
33. Options	2860
Interpretation on Opening Accounts for Options Customers	IM–2860–2
34. Direct Participation Programs	2810
35. Communications with the Public	2210
Guidelines Regarding Communications with the Public about Collateralized Mortgage Obligations (CMOs)	IM–2210–1
Guidelines Regarding Communications with the Public about Variable Life Insurance and Variable Annuities	M–2210–2
Guidelies for the Use of Rankings in Investment Companies Advertisements and Sales Literature	M–2210–3
35A. Options Communications with the Public	2220
36. Transactions with Related Persons	2750
Interpretation on Transactions with Related Persons	IM–2750
37. [Reserved]	
38. Regulation of Activities of Members Experiencing Financial and/or Operational Difficulties	3130
Explanation on Restrictions on a Member's Activity	IM–3130
39. Approval of Change in Exempt Status under SEC Rule 15c3–3	3140
40. Private Securities Transactions	3040
41. Short-Interest Reporting	3360
42. Prohibition on Transactions During Trading Halts	3340
43. Outside Business Activities	3030
44. The Corporate Financing Rule	2710
45. Customer Account Statements	2340
46. Adjustment of Open Orders	3220
47. Clearing Agreements	3230
48. Short Sale Rule	3350
Interpretation on Short Sale Rule	IM–3350
49. Primary Nasdaq Market Maker Standards	4612
50. Reporting Requirements	3070
* * * * * * *	
COMPLAINTS INVESTIGATIONS AND SANCTIONS	
Article IV—Complaints	
1. Availability to Customer of Certificate, By-Laws, Rules and Code of Procedure	8110
2. Complaints by Public Against Members for Violations of Rules	8120
3. Complaints by District Business Conduct Committees	8130
4. Complaints by the Board of Governors	8140
5. Reports and Inspection of Books for Purpose of Investigating Complaints	8210
Resolution on Suspension of Members for Failure to Furnish Information Duly Requested	8220
Article V—Penalties	
1. Sanctions for Violation of the Rules	8310
Interpretation on the Effect of a Suspension or Revocation of the Registration, if Any, of a Person Associated with a Member or the Barring of a Person from Further Association with a Member.	IM–8310–1
Resolution on Notice to Membership and Press of Suspensions, Expulsions, Revocations, and Monetary Sanctions and Release of Certain Information Regarding Disciplinary History of Members and Their Associated Persons.	IM–8310–2
2. Payment of Fines, Other Monetary Sanctions, or Costs	8320
3. Costs of Proceedings	8330
* * * * * * *	
Code of procedure	9000
Article II:	
Disciplinary Actions by District Business Conduct Committees, The Market Surveillance Committee and Others	9200
* * * * * * *	
10. Acceptance, Waiver and Consent, Minor Rule Violations And Summary Complaint Procedures	9217

EXHIBIT 1.—OLD-TO-NEW CONVERSION CHART—Continued

Former provision	New number
* * * * * * *	
Appendix:	
Violations Appropriate For Disposition Under the Minor Rule Violations Plan	IM–9217

[FR Doc. 96–21757 Filed 8–26–96; 8:45 am]

BILLING CODE 8010–01–M

[Release No. 34–37585; File No. SR–NYSE–96–25]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by New York Stock Exchange, Inc., Relating to the Listing Criteria for Equity-Linked Debt Securities

August 20, 1996.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''),[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on August 16, 1996, the New York Stock Exchange, Inc. filed with the Securities and Exchange Commission the proposed rule change as described in Items I and II below, which Items have been prepared by the self-regulatory organization. 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 New York Stock Exchange, Inc. (''NYSE'' or ''Exchange'') is proposing amendments to its listing standards for Equity-Linked Debt Securities (''ELDS''). These listing standards are contained in Para. 703.21 of its Listed Company Manual.

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 self-regulatory organization 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 self-regulatory organization 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) *Purpose*—ELDS are non-convertible debt securities of an issuer where the value of the debt is based, at least in part, on the value of another issuer's common stock or nonconvertible preferred stock (the ''underlying security''). The Exchange's listing standards currently permit the listing of ELDS if, among other things, (i) the issuer has a minimum tangible net worth of $150 million and (ii) the original issue price of the ELDS, combined with all the issuer's other publicly-traded ELDS, does not exceed 25 percent of the issuer's net worth (the ''net worth standard'').

The proposed rule change makes two amendments to the ELDS listing standards. First, the Exchange proposes to add an alternative net worth standard. Under the new test, a issuer with tangible net worth of at least $250 million would be able to issue ELDS without being subject to the limit that the ELDS be no more than 25 percent of the issuer's net worth. Issuers with a tangible net worth of at least $150 million, but less than $250 million, will still be subject to the 25 percent limit. This will provide the largest issuers with increased flexibility in their financing and capitalization planning.

Second, with respect to the listing of ELDS linked to non-U.S. securities, the Exchange proposes to amend the definition of ''Relative U.S. Share Volume'' and to delete the definition of ''Relative ADR Volume.'' Specifically, the Exchange proposes collapsing these two definitions into a single definition of ''Relative U.S. Volume.'' The Exchange believes that this change is non-substantive and is proposed solely to clarify and simplify the rule.

(b) *Basis*—The basis under the Act for the proposed rule change is the requirement under Section 6(b)(5) that an exchange have rules that are 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 securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

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

The Exchange believes that the proposed rule change does not impose any burden on competition that is 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

The Exchange has not solicited, and does not intend to solicit, comments on this proposed rule change. The Exchange has not received any unsolicited written comments from members or other interested parties.

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

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

(a) By order approve such proposed rule change, or

(b) Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.