

ALERT

NASD Closely Monitors Firms' Compliance With New Rule 15c2-6

The Securities and Exchange Commission's (SEC) rule imposing new suitability and recordkeeping requirements on broker-dealers that recommend certain low-priced, non-NASDAQ and nonexchange-listed securities to some customers took effect January 1, 1990.

NASD Executive Vice President John E. Pinto, Jr., says that "the new SEC rule is an important part of the joint NASD/SEC regulatory effort to protect investors, many of whom have little or no knowledge about the risks of low-priced securities, from high-pressure, cold-call telephone solicitations of such securities."

The NASD intends to examine members that are subject to the rule frequently and thoroughly to determine whether they are in compliance.

Given the NASD's and SEC's extensive educational efforts in this area, if these examinations disclose members that have taken little or no action to meet all of the requirements of the rules, formal disciplinary action is likely, according to Pinto.

As previously reported in NASD Notice-to-Members 89-65, SEC Rule 15c2-6 imposes new requirements on broker-dealers that recommend "designated securities" to persons who are neither "established" customers nor "accredited" investors.

The rule defines a "designated security" as a non-NASDAQ over-the-counter equity security that sells for less than \$5 per share issued by a company with less than \$2 million in net tangible assets.

The rule requires a broker-

dealer, before recommending a "designated security" to a customer that is not an "established" or "accredited" customer, to first obtain orally or in writing sufficient information from the customer about his or her financial situation, investment experience, and investment objectives.

An "established" customer is one who has had a trade or a deposit in his or her account with the firm that occurred at least one year earlier, or has previously made three purchases of designated securities on separate days involving different issuers.

Similarly, an "accredited" investor is one whose knowledge and experience in securities matters, or whose financial resources, satisfy standards prescribed by SEC Regulation D. These include financial institutions, officers of an issuer, or investors with a net worth of \$1 million.

The SEC considers the following to be highly relevant information that a broker-dealer should obtain from a customer:

- *Financial situation* — age, marital status, number of dependents, employment status, estimated annual income, sources of income, estimated net worth (exclusive of family residence), and estimated liquid net worth.

- *Investment experience* — number of years of experience, and the size, frequency, and type of transactions in stocks, bonds, options, commodities, and other investments.

- *Investment objectives* — such as safety of principal, income, growth, or speculation.

Using this information, the broker-dealer must determine the customer's suitability for investing in designated securities. This suitability determination includes a finding that the customer has sufficient knowledge and experience in financial matters to evaluate the risks of transactions in designated securities.

The customer's refusal to provide the broker-dealer with the requisite information about financial status, investment experience, and investment objectives does not relieve the broker-dealer from fully complying with any aspect of the rule.

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Rule 15c2-6 Compliance

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If found to be suitable, the broker-dealer must provide the customer with a written statement setting forth the basis of the broker-dealer's suitability determination. The statement must be signed and dated by the customer and returned to the broker-dealer. The suitability statement must also detail in a highlighted format that:

- a written agreement to the transaction is required;
- a written suitability determination is required; and
- the customer should not sign the statement if it does not accurately reflect his or her financial situation, investment experience, and investment objectives.

Along with the suitability statement, the customer must sign and deliver to the broker-dealer a written agreement providing the identity and quantity of a designated security before the broker-dealer can execute a transaction in that security.

However, the rule allows broker-dealers to obtain from customers their first written agreement for securities purchased at the same time that customers return their signed suitability statements but prior to the execution of the trade.

The price of the security need not be included in the written agreement and can be agreed on via the telephone once the broker-dealer receives the customer's written agreement. However, any modification of the quantity or security would require a new written agreement. Oral agreements to modify the written agreement are prohibited.

To comply with the rule, broker-dealers have to keep records sufficient to show that either the customers or securities are exempt, or that the remaining provisions are being observed.

Written procedures designed to achieve compliance with the rule as well as a system to adequately supervise these sales practices are also required under Article III, Section 27 of the NASD Rules of Fair Practice.

In addition, the SEC staff has issued the following rule interpretations:

- Securities listed on foreign stock exchanges, including those in Canada, are not exempt from the rule.

- Securities listed on the Spokane Stock Exchange are not exempt from the rule.

- To qualify as an "established" customer of the firm, the customer's account with the firm must meet the activity requirements of the rule, such as a transaction or deposit within the last year, regardless of prior or current activity by the customer at another firm, even if the same registered representative is handling the account.

NASD members that have questions about SEC Rule 15c2-6 may call Gary Carleton or Daniel Sibears in the NASD Compliance Division at (202) 728-8959.

NASD Sanctions Firm and Officers For Misconduct

The NASD has announced a disciplinary action taken by its District 12 Committee against Investors Center, Inc., Anthony J. Stoisch, President; Anthony Ferruzzi, Executive Vice President; and Anthony J. DeStefano, Chief Financial Officer, based on NASD proceedings, which involved a letter of Acceptance, Waiver and Consent (AWC) submitted by these individuals and the firm.

Pursuant to the AWC, Stoisch was barred from association with any NASD member in any capacity and fined \$450,000; Ferruzzi was barred from association with any NASD member in any capacity and fined \$150,000; and DeStefano was barred from association with any NASD member as a Financial and Operations Principal, suspended from association with any NASD member in any capacity for two years, and fined \$50,000.

Without admitting or denying the allegations, Investors Center,

Stoisch, and Ferruzzi consented to findings of violations of NASD rules prohibiting the use of any manipulative, deceptive, or other fraudulent behavior in the purchase or sale of any security.

Also, without admitting or denying the allegations, Investors Center, Stoisch, and DeStefano consented to findings of violations of the SEC customer protection rule and net capital rule.

Investors Center was a broker-dealer based in Long Island, New York that specialized in low-priced, speculative securities, primarily "penny stocks." The firm ceased doing business on February 23, 1989.

The NASD's action related to fraudulent markups charged to customers in principal sales of Partner's National Corp. (PNC), a non-NASDAQ penny stock.

The NASD charged that the firm, Stoisch, and Ferruzzi engaged in a course of conduct that defrauded purchasers of PNC. The NASD found that Investors Center, acting through these individuals, dominated and controlled the trading in PNC and charged fraudulently excessive markups in sales to customers.

As part of such domination and control of trading in PNC, the firm sold all 25 million units of PNC to its customers, executed 100 percent of all purchase and sale transactions, and effected 100 percent of total purchase and sale volume from December 18, 1987, through December 31, 1987.

In at least 1,035 transactions during this time, customers who purchased their PNC stock from the firm were charged fraudulent markups ranging up to 130 percent over the prevailing market price, contrary to NASD rules, which require that markups must be fair and reasonable.

The NASD's investigation also found numerous and repeated instances of violations of SEC minimum net capital requirements (Rule 15c3-1) and the SEC customer protection rule (Rule 15c3-3) by Investors Center, Stoisch and DeStefano.

Investors Center conducted a se-

curities business while failing to maintain minimum net capital as required, with deficiencies ranging from more than \$373,000 to nearly \$4.9 million. In 1988 and 1989, the firm failed to make required deposits to its Special Reserve Account for the Exclusive Benefit of Customers in amounts ranging from \$1 million to more than \$5 million.

The investigation was conducted by the NASD's District 12 office in New York, in cooperation with the SEC's New York regional office.

In a separate but related matter, the SEC announced settlement of its public administrative proceedings against Investors Center, Stoisch, and DeStefano for violations of the federal securities laws wherein Stoisch and DeStefano were barred from the securities industry.

The NASD routinely cooperates with enforcement efforts of the SEC, other self-regulatory organizations, and governmental law enforcement agencies, and also conducts its own regulatory investigations.

This action is part of a major commitment by the NASD to address fraud and other serious sales practice abuses.

Computerized FOCUS Filings Will Begin This Summer

In 1990, the NASD will begin a program for electronic filing of FOCUS reports. When fully implemented, the NASD will require members to file monthly and quarterly FOCUS reports electronically through the Automated Regulatory Reporting System (ARRS).

To fulfill their filing obligations under the program, members will need a personal computer, a modem, and NASD-developed software. The NASD will provide the necessary software, which will collect, edit, and electronically transmit the completed FOCUS report to the NASD.

With this service, members will be able to satisfy their regulatory

reporting requirements in a more timely, accurate, and cost-effective manner. In addition, the NASD will receive key regulatory information on an accelerated basis.

The NASD will distribute software and users' manuals as well as provide training prior to the program's startup.

In the coming months, the NASD will provide members with more information on this developing program.

Board Bans Automatic Quote Updates on NASDAQ

The NASD Board of Governors has adopted a limited one-year ban, ending on or before January 1, 1991, on the automated update of quotations by market makers in NASDAQ.

If approved by the SEC, the policy would prohibit members from using "autoquote" systems to automatically update their quotes or track inside quotations.

During the temporary ban, members may not use automated quotation tracking or updating systems to transmit quotation information to the NASDAQ System for processing unless such systems either require a market maker's manual entry of the information or if the information is automatically updated to reflect a transaction by the market maker in securities of that issuer.

Currently, the securities industry uses a variety of autoquote systems. The proposed policy aims to curb the use of systems that track changes to the inside quotation on NASDAQ and automatically keep a market maker's quote away from the best market price.

The NASD is concerned that these systems are reactive, and may add to quotation volatility.

"The velocity with which these quote updates can be generated in response to fast-moving, active markets could have a deleterious ef-

fect on NASDAQ operations," says Glen R. Shipway, NASD Senior Vice President, Market Operations.

"It has the potential to overload the system, leading to delayed price changes and system stoppages," he added.

The NASD plans to study the issue during the temporary ban. The study will analyze autoquote systems in place now or under development and their potential impact on market volatility and NASDAQ capacity.

The NASD would use the study results to establish broader policy guidelines for market makers using the NASDAQ System.

NASD Proposes Full Disclosure on Members' Exam Charges

Responding to complaints from registration applicants, the NASD is proposing more disclosure and possible refunds by firms that require candidates to pay up front to register for qualification examinations.

Many member firms require applicants to pay, in advance, a portion or the entire cost of the qualification, training, and registration process. The NASD is concerned that, although this practice may serve a motivational purpose, there is a potential for abuse by member firms.

Whether an applicant or the member pays training and registration costs is a decision for the member to make. However, the NASD has proposed that a member firm, which requires applicants for registration to pay some or all of such fees, provide the applicant with an itemized accounting of the costs incurred. The amendment also would require the member firm to refund any unused portion of the fees collected if the applicant withdraws from the registration process for any reason.

For example, a member firm collects monies from an applicant to cover an examination training course,

NASD registration and examination fees, a testing fee for the Series 63 Uniform Securities Agent State Law Examination, and licensing fees for three states.

Under the proposal, the member must give the applicant an itemized accounting of these expected costs at the time the applicant pays.

If the applicant completes the training courses after the firm applies for the NASD examination and registration but withdraws from registration before the member commits the state registration fees, the applicant must receive an itemized refund of anticipated but unspent state fees.

Member comments on the proposal are due by February 20. The NASD will consider all comments before finalizing and submitting the proposal to the SEC for approval.

Rule Changes Reflect New Notification Procedures

The NASD recently changed its rules to accommodate new procedures for notifying members about NASD disciplinary actions.

Largely because the *NASD Manual* is now updated only quarterly and not monthly as before, the NASD is providing information about the previous month's final disciplinary actions on a monthly basis by way of *Notices to Members*, which are distributed to all NASD members.

Before this new procedure, the NASD used the monthly update to the *NASD Manual* to notify members of disciplinary actions as well as suspensions and expulsions of firms for failure to pay monetary sanctions or to file financial information.

Monthly Manual Updates

Under an NASD Rule of Fair Practice, the NASD furnished every office of every NASD member with a list of all NASD members. Monthly

updates in the *NASD Manual* kept every office of every member advised of all new members and all suspensions and cancellations of membership.

Members, in turn, could use this list, as amended, to comply with Article III, Section 25 of the Rules of Fair Practice, titled "Dealing with Nonmembers."

Under the new procedure, the NASD provides only the main offices of the members with the list. Each member has to distribute the list within its branch network as necessary.

Other rule changes clarify that members may need to rely on a current membership list in order to comply with other rules aside from the one on dealing with nonmembers.

In a related matter, the NASD required "every office" of a member to maintain an *NASD Manual*.

Clarifying the Requirement

To clarify this requirement, particularly in light of the new definition of "branch office," effective earlier in 1989, the NASD amended the rule so members must now maintain the manual or an up-to-date copy of the NASD-supplied quarterly reprint of the manual in each *branch* office.

The NASD also amended a Board of Governors resolution under Article V, Section 1 of the Rules of Fair Practice.

When it originally adopted the resolution, the Board contemplated including notice to the membership and press of significant disciplinary actions in the Changes to the List of Members section of the then-monthly *NASD Manual*.

The amendment to the resolution eliminates the requirement that such notification be included in the supplement to the list of members in the *NASD Manual*.

Instead, it permits dissemination of these notifications by way of *Notices to Members*.

Publication of these matters in *Notices to Members* substitutes for inclusion in *NASD Manual* updates and provides members with more timely notification of disciplinary actions.

NASD Reviews Comments on Deferred Sales Charges

The NASD is reviewing member comments on a proposal to require disclosure of any deferred sales charges on customer confirmations for mutual fund purchases.

Under the proposed change (*Notice to Members 89-77*) to Section 12 of the NASD Rules of Fair Practice, all confirmations for investment company shares that impose a deferred sales charge on redemption would have to include the following:

On selling your shares, you may pay a sales charge. For this charge and other fees, see the prospectus.

Earlier Announcement

In *Notice to Members 89-35*, published earlier last year, the NASD advised members that a registered representative would violate NASD rules if he or she states or implies to a prospective investor that an investment company with a contingent deferred sales charge is a "no load fund."

The notice was a response to complaints from investors who claimed they were unaware of the existence of a sales charge on redemption and that they had been advised that the companies were "no load" or "no initial load" funds.

In that notice, the NASD said contingent deferred sales loads are sales loads charged on redemption on an annually declining percentage basis that usually reaches zero percent by the sixth or seventh year of share ownership.

The NASD concluded that to claim a mutual fund with a contingent deferred sales load is a "no load" fund is an unacceptable misrepresentation.

Furthermore, to state that there is "no initial load" without explanation of the nature of the contingent deferred sales load is an omission of material information.

According to the NASD, members and their registered representatives must ensure that prospective investors understand the nature of the various charges made by mutual funds to defray sales and sales-promotion expenses, regardless of whether they are deducted from an initial investor's purchase payment, charged on redemption, or levied against the net assets of the fund.

Often, investors do not study the prospectus thoroughly before making a purchase of investment company shares and instead rely only on the oral statements of a registered representative.

Thus, through inadvertence or design, the investors may not be aware of the possibility of a sales charge on redemption.

Disclosing the possibility of a deferred sales charge on redemption would help, in the NASD's view, to alert prospective investors to the existence of such charges before they have paid for the shares.

NASD Proposal Would Expand Application of Schedule E

The NASD has proposed for member comment an amendment to Schedule E to the NASD By-Laws that addresses the potential conflict of interest that arises when an underwriter owns certain securities of the issuer.

The concern is that members' ownership of large amounts of an issuer's debt, preferred stock, or non-voting common stock may create an appearance of or an actual conflict of interest that the application of Schedule E could resolve.

Currently, Schedule E applies when the underwriter and issuer are affiliated by either voting control through ownership of equity securities or by common control of management through interlocking officers or directors.

Under such circumstances, Schedule E requires an independent

underwriter to price the offering, conduct due diligence, and participate in the preparation of the registration statement and prospectus.

The independent underwriter also assumes the underwriter's liability for the offering.

New Provisions

Because Schedule E does not now address conflicts of interest resulting from the ownership of debt, preferred stock, or nonvoting common stock, the NASD is proposing an expansion of the schedule to cover such instances.

If adopted by the NASD Board and approved by the Securities and Exchange Commission, the revised schedule would apply to any public distribution of the securities of an issuer when a member proposing to participate in the distribution of those securities owns:

- 10 percent or more of the issuer's outstanding debt;
- 10 percent or more of the issuer's preferred stock; or
- 10 percent or more of the issuer's common stock.

For purposes of this rule, all debt of the issuer, both short- and long-term, will be aggregated and compared with the dollar amount of debt held by the member firm or its affiliates.

For common or preferred stock, the schedule would apply if a member owns 10 percent or more of the issuer's outstanding common or preferred stock regardless of class, voting rights, or convertibility.

Advertising Department Helps Members With Compliance

The NASD's Advertising Department reviews and comments in writing on each piece of advertising and sales literature submitted by members to ensure member compliance with applicable NASD, Municipal Securities Rulemaking Board, and SEC rules.

As noted elsewhere in this publication, members must file certain types of sales material and may voluntarily file others under the NASD's rules.

The NASD encourages members to voluntarily file such sales material when designing new types of communications, marketing new types of products, or if they are uncertain whether a piece meets current advertising standards.

If members have any questions on their filing obligations or other matters related to advertising and sales literature, they should contact the NASD Advertising Department at (202) 728-8330 or fax it to (202) 728-6976.

The department staff will answer general questions but may not issue specific comments unless hard copy has been submitted for review.

NASD Rules Require Members To File Certain Literature

The NASD requires members to file certain types of advertising and sales literature with its Advertising Department in Washington, D.C.

Under Article III, Section 35(c) of the NASD Rules of Fair Practice, each NASD member, new or existing, which has never filed sales material with the NASD, must file all its advertising with the Advertising Department at least 10 days prior to use for a period of one year from the date of its first filing.

Any firm that did not meet the one-year pre-filing requirement for general sales material by January 1, 1989, will have to fulfill a separate one-year pre-filing requirement for government securities advertising.

In addition, pursuant to Section 35(c) members must file the following types of sales material with the NASD:

- *Investment Company Material* — All members must file advertisements and sales literature

concerning registered investment company securities (such as mutual funds, variable contracts, and unit investment trusts, among others) within 10 days of first use unless the material was filed previously and is being used without change.

■ **Direct Participation Program Material**— All members must file advertisements and sales literature concerning public offerings of these securities within 10 days of first use. However, the NASD strongly recommends advance filing of such literature. Members need not file materials previously submitted if used without change.

■ **Options Material**— Members have to file options advertisements and options-related communications used with persons who have not received the appropriate disclosure document(s) at least 10 days prior to use.

■ However, members need not file such material if a registered securities exchange or other regulatory body, using standards substantially the same as the NASD's, has already approved it.

■ **Government Securities Advertisements**— Members have to file advertisements concerning government securities within 10 days of first use.

Exclusions From Requirements

The NASD's rules contain the following exclusions from these filing requirements for general and government securities:

■ Advertisements for general and government securities that relate solely to changes in a member's name, personnel, location, ownership, offices, business structure, officers or partners, telephone or teletype numbers, or concerning a merger with, or acquisition by, another member.

■ Material that only identifies the member's NASDAQ symbol and/or a security in which the member is a NASDAQ-registered market maker.

■ Material for general and government securities that only identifies the member and/or offers specific securities at a stated price.

■ Material for general and government securities sent to branch offices or other internal material not distributed to the public.

■ Offering documents used in a securities underwriting registered or filed with the SEC or any state or that is exempt from such registration. (Note: Investment company prospectuses published under Rule 482 of the Securities Act of 1933 are not excluded.)

■ Tombstone advertisements for securities other than options, direct participation programs, or securities issued by registered investment companies.

■ Material that refers to investment company securities, direct participation programs, options, or government securities solely as part of a listing of products or services offered by the member.

How to File

Each submission should include:

■ One copy of each piece to be reviewed.

■ The appropriate filing fee (\$25 per piece).

■ A typed cover letter with any special instructions.

Material should be sent to: NASD Advertising Department, 1735 K Street, NW, Washington, DC 20006, or faxed to the department at (202) 728-6976.

Important Note: Material sent without fees attached or that is faxed can be accepted only if the firm maintains a sufficient balance in its Advertising Department filing-fee account. To establish such an account, call Shirley Dorsey at (202) 728-8330.

"Prime Rate Funds" Marketing Techniques Concern NASD

Citing adverse publicity and concerns about marketing techniques, the NASD's Investment Companies Committee is

encouraging members to take a responsible approach when marketing so-called "prime rate funds." These funds, which are invested in senior collateralized corporate loans, are a new kind of closed-end fund that is continuously offered.

Five Areas of Concern

Some of the NASD's specific concerns are that members have:

■ Presented these funds as having stable net asset values, as do money market funds, when, in fact, the net asset value may fluctuate.

■ Presented the funds as being liquid investments, similar to open-end funds, when liquidity actually depends on approval by the fund's board of a tender offer of shares. Such a tender offer may be no more frequent than quarterly.

■ Implied that the fund is a substitute investment for a certificate of deposit without explaining the material differences between the two vehicles.

■ Failed to adequately disclose the potential risks of fluctuating net asset values, illiquidity, and "prime rate" obligations.

■ Insufficiently disclosed applicable fees, especially when the absence of other fees or loads is emphasized.

■ Not adequately educated registered representatives about these funds, thereby increasing the risk of misleading the potential investor.

Tackling the Problem

To address these concerns, the NASD says that members need to clearly define the product so there is no confusion as to exactly what type of fund is being offered with what type of portfolio.

When comparing the fund with certificates of deposit, members should include an explanation of the differences between the two and neither directly nor indirectly imply that an investment in the fund is the same as an investment in a certificate of deposit.

In addition, members should not imply either directly or indirectly that the net asset value of the funds

will not fluctuate. The NASD will not object to members using the term "liquidity" when discussing "prime rate funds."

However, any such references must include an explanation that the only liquidity is the potential for a tender offer by the fund which, if approved by the fund's board of directors, may be no more frequent than quarterly.

Finally, members should make the risks attendant to these investments clear to investors.

The degree of disclosure should increase with the degree of emphasis placed on the stability or quality of the fund.

NASD Issues Interpretations on Branch Office Communications

In response to member requests, the NASD's Qualifications Committee recently issued several interpretations under Article III, Section 27(g)(2) of the NASD Rules of Fair Practice, which defines branch office.

Specifically, the interpretations clarify the rule's definition of a branch office and the exemption from branch office registration available for nonbranch business locations that meet certain conditions under the rule.

A location may be exempt from registration as a branch office if it is identified to the public only in telephone book listings, business cards, or stationery that also include the address and telephone number of the branch office or office of supervisory jurisdiction (OSJ) responsible for supervising the nonbranch business location.

Under a recent interpretation, members' sales literature may include the local address of a nonbranch business location.

However, the literature also must identify the location and telephone number of the appropriate supervisory branch office or OSJ of the member.

In addition, members' advertisements may include a local telephone number and/or local post-office box provided that the advertisements also identify the location and telephone number of the appropriate branch office or OSJ. These advertisements may not include the address of the nonbranch location.

Uses for Reply Purposes

Another new interpretation allows a member to use the firm's main office address and telephone number for reply purposes on sales literature, advertisements, business cards, and business stationery.

However, a member wishing to list such a central site instead of a supervisory branch or OSJ must demonstrate that it has in place a significant and geographically dispersed supervisory system appropriate to its business. In addition, any complaints coming through the central site have to be sent to the office or offices with jurisdiction over the nonbranch business location.

Finally, the committee agreed that a member need not designate a location as a branch office if sales material is merely placed on a display rack in a branch of a bank or savings and loan.

To qualify for such an exemption, the member may not conduct any securities business at the bank or savings and loan office and must post a sign directing interested parties to the member firm's telephone number.

On the other hand, the presence of a registered representative even on a part-time basis would require that the member register the location as a branch office.

The following is a reprint of the definition of branch office as contained in Article III, Section 27(g)(2) of the NASD Rules of Fair Practice: *"Branch Office" means any location identified by any means to the public or customers as a location at which the member conducts an investment banking or securities business, excluding any location identified solely in a telephone directory line listing or on a business card or letterhead, which listing, card, or*

letterhead also sets forth the address and telephone number of the branch office or OSJ of the firm from which the person(s) conducting business at the nonbranch location are directly supervised.

NASD Provides Guidance for Firms Marketing Variable Life

In 1983, the NASD's Variable Contracts Committee developed standards governing the content of communications with the public in the offer of the relatively new variable life insurance contracts.

Given the growing popularity of these products (some 65 companies now issue them), the committee decided to review its original positions and to respond to member requests for some relaxation in certain of these standards.

Insurance and Investment

Since 1983, the NASD's position has been that the primary benefit in a variable life insurance policy is the death benefit. However, the NASD recognized that, although such a contract cannot be properly described as an investment, it nevertheless contains important investment aspects reflected in the cash surrender value.

At the time, only annual premium variable life insurance contracts were available, and the NASD adopted a standard that requires a balanced presentation of both the investment and insurance aspects in communications with the public.

Since then, single premium variable life insurance contracts in which the investment aspect is predominant have become available. The NASD still considers the death benefit the primary benefit of a variable life insurance contract.

However, if the investment element is predominant, the NASD believes members may give more weight to it in communications with the public.

Thus, the NASD believes there should be no absolute requirement that members maintain a "balance" in descriptions of the investment and insurance elements although they should describe both elements of the contract in all such communications.

The Securities and Exchange Commission (SEC) permits variable life insurance prospectuses to include hypothetical illustrations of death benefits and cash values using assumed gross investment rates of zero percent, 4 percent, 6 percent, 8 percent, and 12 percent.

However, the SEC does not permit the use of such illustrations in the prospectuses of variable annuities or mutual funds. In the case of variable life insurance, which is an extremely complex product, the SEC believes such illustrations are needed to explain adequately to prospective customers how such contracts work.

The NASD considers it unnecessary for sales literature accompanying a prospectus to include illustrations using all of the investment rates that are in the prospectus. Instead, the NASD reaffirmed its position that members should be allowed to include illustrations using any combination of investment rates up to and including 12 percent, provided that one of the illustrations used is at a zero percent investment rate.

Permissible Comparisons

The NASD also reviewed its longstanding policy of permitting comparisons of variable life insurance contracts with other forms of financial instruments.

The issue arose in response to a member's request for permission to include comparisons with a savings account in hypothetical illustrations.

The NASD noted that, in today's environment, customers often need comparisons among different investments they might purchase to achieve financial goals.

Furthermore, nothing in securities rules and regulations prohibit comparisons that are complete, fair, and not misleading.

However, the NASD does not

believe that performance comparisons between variable life insurance and other financial instruments should utilize hypothetical investment rates of return such as those appearing in variable life insurance prospectuses.

Such comparisons, in the NASD's view, would go beyond the limited purpose of variable life insurance hypothetical illustrations.

Purpose of Comparisons

The purpose is to facilitate a customer's understanding of how variable life insurance contracts operate. The NASD decided that a member may compare variable life insurance performance with that of other financial instruments.

When making such comparisons, however, the member must base the performance illustrated on actual experience of the variable life insurance contract and the financial instrument and not on assumed hypothetical performance.

Such performance comparisons should be fair, balanced, and complete, and must comply with NASD rules governing communications with the public.

This would necessitate, among other things, describing the material differences and similarities between the vehicles.

This would make the standards governing variable life insurance contracts comparable to those that apply to variable annuities and other investment product products.

Advertising and sales literature for those products can only illustrate past performance and may not use any projections, hypothetical or otherwise.

The NASD also determined that nonperformance comparisons between variable life insurance contracts and other forms of investment would be acceptable, provided that the comparisons are complete, fair, and not misleading, and they comply with NASD rules governing such communications.

Before illustrating the gross or net investment performance of the funds underlying variable life in-

urance, a member would have to provide some further explanation of how such performance affected policy benefits (i.e., death benefits and cash values). This is necessary because no direct relationship exists between such performance and the actual percentage increase or decrease in policy benefits.

Such an explanation could be in the form of a factual example, a written explanation, or a reference to the appropriate section of the prospectus that describes the relationship between investment performance and policy benefits.

Some companies use previously existing mutual funds as the underlying investment vehicles for their variable life insurance policies.

When such a mutual fund is utilized, there may be changes in the investment philosophy or objectives of the investment manager, a new investment manager may be appointed, or the separate account investment restrictions under insurance laws may limit investment flexibility.

To the extent that any of these events occur, the NASD determined that it would be inappropriate for such companies to illustrate variable life insurance policy benefits using the past investment performance of such funds.

Important Notice



As announced in *Notice to Members 89-64* (October 1989), amendments to Appendix E to Article III, Section 33 of the NASD Rules of Fair Practice take effect March 1.

These amendments require members to develop and maintain written procedures for the approval, review, and supervision of customer accounts engaged in uncovered short option transactions.

The revised rules also require members to distribute to customers a risk disclosure document concerning uncovered option writing. Members must be in compliance with these rule changes no later than March 1.

NASD Says Short-Sale Rules Have Helped Curb Trading Abuses

The NASD's short-sale regulatory actions during the past three years constitute a careful and deliberate approach to regulating short sales in the NASDAQ market and to closing loopholes in the execution and settlement process, two NASD officers stressed in congressional testimony last month.

The officers, Executive Vice President John E. Pinto, Jr., and Chief Economist and Vice President Gene Finn, appeared before the House Commerce, Consumer and Monetary Affairs Subcommittee of the Committee on Government Operations.

The panel held two days of hearings on the adequacy of short-sale regulation and the effects of short selling on the equity markets.

The NASD noted the various regulatory actions that it has taken during the past three years regarding short sales.

They include the following:

- Requiring marking of sell-order tickets long or short so that compliance with the NASD's reporting and delivery rules can be properly overseen.

- Modifying the NASD's prompt receipt and delivery rule, applicable to customers, to require affirmative determination, prior to short sale, that securities can be borrowed and delivered.

- Mandating monthly reporting and publication of short-interest positions.

- Extending the prompt receipt and delivery requirement to transactions of broker-dealers that are not market makers or not completely hedged or arbitrated (currently at the SEC for approval).

- Establishing a requirement that buy-in transactions be for cash or guaranteed delivery.

- Successfully petitioning the SEC to adopt a Rule 10b-21 to

prohibit the covering of short sales out of a securities offering when the short sales were made between the filing and offering date.

- Monitoring by NASD's Market Surveillance Department of short-sale activities in securities with large reported short-interest positions.

- On-site field examinations to review for compliance with all short-sale regulations.

Evidence of abusive naked short selling could not be proven.

In its testimony to the subcommittee, the NASD stressed that it has conducted investigations of alleged "naked" short-selling abuses (when the seller fails to borrow and deliver the securities) involving NASDAQ issuers.

Invariably, these investigations showed that, although short selling very well may have occurred, there were no significant short positions to the clearing corporation.

This demonstrates that the shares were being borrowed and delivered in order to close out open contracts.

Evidence of abusive naked short selling could not be proven.

Notwithstanding these findings, the NASD recognizes that short-selling abuses may occur.

As a result, the NASD Board has proposed a mandatory close-out requirement aimed primarily at curbing naked or abusive short selling in NASDAQ securities.

Abuses May Occur

This new rule would impose a mandatory close-out requirement on the short seller's broker in the rela-

tively small number of NASDAQ stocks that have significant short positions at the clearinghouse in relation to outstanding shares.

The rule, if approved by the SEC, will require that NASDAQ stocks with clearing short positions aggregating 10,000 shares or more and equivalent to at least one-half of one percent of a company's outstanding stock be identified by the NASD and placed on a "restricted list."

Any subsequent short sale would be subject to a mandatory close-out if a fail-to-deliver exists 10 days after the normal settlement date.

The NASD in cooperation with the clearing agencies would generate periodically a listing of such stocks and post it on the NASDAQ System.

Such stocks would be subject to the mandatory close-out requirement.

The NASD Board has also adopted new requirements for registered market makers that substantially increased their obligations and risk exposure.

These requirements include mandatory participation in the Small Order Execution System (SOES) and higher exposure limits on automated executions through SOES.

With these increased requirements, there is less incentive for a short seller to use market-maker registration as a way to avoid normal stock-delivery obligations.

These actions demonstrate that the NASD is working to eliminate the abuses that may occur with short selling, the two officers said.

The NASD also stressed that because short-sales activities by market makers are often risk-reducing rather than risk-increasing transactions, the preponderance of such transactions are considered to be conservative and asset protecting rather than speculative.

Dealer short sales aim primarily at providing liquidity in the market in response to buying interest, Finn told the hearing.

"For this reason," he said, "it is important to avoid broad restrictions that reduce trading efficiency in many thousands of stocks while attacking abuses in a very few."

Guide to Locating Advertising and Sales Literature Rules

When communicating with members, the Advertising Department staff generally refers to NASD, Municipal Securities Rulemaking Board, and SEC advertising rules and guidelines. The following is a list of these rules and guidelines, along with where the text may be found:

Rules	Location of Text
1. Article III, Section 27(g)(2), NASD Rules of Fair Practice	Page 2110, <i>NASD Manual</i> ; <i>Notice to Members 88-84</i> ; <i>Notice to Members 89-34</i>
2. Article III, Section 35, NASD Rules of Fair Practice	Page 2174, <i>NASD Manual</i>
3. SEC Rule 34b-1, under Investment Company Act of 1940, "Sales Literature Rule"	Page 5057, <i>NASD Manual</i> ; SEC Release #33-6753; CFR 270.346-1
4. SEC Rule 134, under Securities Act of 1933, "Tombstone Advertising Rule"	Page 5041, <i>NASD Manual</i> ; CFR 230.134
5. SEC Rule 135a, under Securities Act of 1933, "Generic Advertising Rule"	Page 5045, <i>NASD Manual</i> ; CFR 230.135a
6. SEC Rule 482, under Securities Act of 1933, "Omitting Prospectus Rule"	Page 5055, <i>NASD Manual</i> ; SEC Release #33-6753; CFR 230.482
7. Section 8, NASD Government Securities Rules	Page 2267, <i>NASD Manual</i> ; <i>Notice to Members 88-96</i>
8. Rule G-21, Municipal Securities Rulemaking Board (MSRB) Rules	Page 4955, MSRB Manual
9. Article 11, Section 4, By-Laws of the Securities Investor Protection Corporation (SIPC)	Available from Advertising Department staff
Guidelines	Location of Text
1. NASD Guidelines Regarding Communications With the Public About Investment Companies and Variable Contracts	Page 5101, <i>NASD Manual</i>
2. Guidelines for Government Securities Advertising	Available from Advertising Department staff
3. Guidelines for Discount Brokerage Service Communications	Available from Advertising Department staff
4. Guidelines for Proper Broker-Dealer Identification	<i>Notice to Members 89-22</i>