

**INFORMATIONAL**

**District Elections**

**Nominees For District Committees And District Nominating Committees**

**SUGGESTED ROUTING**

*The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.*

- Legal & Compliance
- Operations
- Registration
- Senior Management

**KEY TOPICS**

- District Elections

**Executive Summary**

The purpose of this *Special Notice to Members* is to announce the nominees for the District Committees and the District Nominating Committees. The individuals identified in this *Special Notice to Members* (see Attachment A) have been nominated for three-year terms on the District Committees and for one-year terms on the District Nominating Committees starting in January 2001. These nominees will be considered duly elected on October 2, 2000, unless an election is contested in accordance with the procedures summarized below.

We appreciate the interest shown by many of you in participating in the District Committees and thank everyone for their continuing support of the self-regulatory process. We look forward to your participation in the matters of the Districts during the coming year, as well as hope that those who were not selected this year will revisit this process next year.

**Contested Election Procedures**

If an officer, director, or employee of a National Association of Securities Dealers, Inc. (NASD®) member is interested in being considered as an additional candidate, he/she must indicate his/her interest to the District Director by **September 15, 2000**. If an additional candidate does not come forward by that date, the election of committee members is final.

If, however, an additional candidate(s) does come forward by that date, the candidate has until **October 2, 2000** to submit a petition to the District Nominating Committee with signatures from at least 10 percent of Executive Representatives of members eligible to vote in the District.

If no additional candidates submit petitions by October 2, 2000, then the candidates nominated by the District Nominating Committee shall be considered elected, and the District Committee shall certify the election to the Board of Directors of NASD Regulation.

Additional information pertaining to the District Election Procedures can be found in Article VIII of the By-Laws of NASD Regulation.

**Questions/Further Information**

Questions concerning this *Special Notice* may be directed to the District Director noted in Attachment A or to Joan Conley, Senior Vice President and Corporate Secretary, NASD, at (202) 728-8381 or via e-mail at: [joan.conley@nasd.com](mailto:joan.conley@nasd.com).

# **Special NASD Notice to Members 00-60**

## **Attachment A**

### **District Committee And District Nominating Committee Nominees**

#### **District 1**

Elisabeth P. Owens, District Director  
525 Market Street, Suite 300  
San Francisco, CA 94105  
(415) 882-1200

*Northern California (the counties of Monterey, San Benito, Fresno, and Inyo, and the remainder of the state north or west of such counties), northern Nevada (the counties of Esmeralda and Nye, and the remainder of the state north or west of such counties), and Hawaii*

#### **2000 District Nominating Committee Chairperson**

John E. Schmidt  
Credit Suisse First Boston Corporation  
San Francisco, CA

#### **District Committee Nominees**

Carol Van Bruggen  
Securities Service Network, Inc.  
Sacramento, CA

Susan K. Campbell  
Protected Investors of America  
San Francisco, CA

William C. Pack  
Salomon Smith Barney Inc.  
San Francisco, CA

#### **District Nominating Committee Nominees**

Steven R. Aaron  
Hambrecht & Quist LLC  
San Francisco, CA

Stephen R. Adams  
First Security Van Kasper  
San Francisco, CA

Nicholas C. Cochran  
American Investors Company  
Dublin, CA

John C. Helmer  
Caldwell Securities, Inc.  
Danville, CA

William A. Svoboda  
Morgan Stanley Dean Witter Reynolds  
San Jose, CA

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## **Special NASD Notice to Members 00-60**

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### **District 2**

Lani M. Sen Woltmann, District Director  
300 South Grand Avenue, Suite 1600  
Los Angeles, CA 90071  
(213) 627-2122

*Southern California (that part of the state south or east of the counties of Monterey, San Benito, Fresno, and Inyo), southern Nevada (that part of the state south or east of the counties of Esmeralda and Nye), and the former U.S. Trust Territories*

### **2000 District Nominating Committee Chairperson**

Robert L. Winston  
American Funds Distributors, Inc.  
Los Angeles, CA

#### **District Committee Nominees**

James E. Biddle  
The Securities Center Incorporated  
Chula Vista, CA

Chris M. Kanoff  
Jefferies & Company, Inc.  
Los Angeles, CA

Steven K. McGinnis  
National Planning Corporation  
Santa Monica, CA

Neal E. Nakagiri  
Associated Securities Corporation  
Los Angeles, CA

#### **District Nominating Committee Nominees**

Murray L. Finebaum  
Trading Edge, Inc.  
Santa Monica, CA

Jerry M. Gluck  
Jefferies & Company, Inc.  
Los Angeles, CA

James B. Guillou  
Sutro & Co., Incorporated  
La Jolla, CA

Joan B. Seidel  
Morton Seidel & Company, Inc.  
Beverly Hills, CA

Kaye M. Woltman  
Girard Securities, Inc.  
San Diego, CA

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## **Special NASD Notice to Members 00-60**

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### **District 3**

Frank J. Birgfeld, District Director  
Republic Plaza Building  
370 17th Street, Suite 2900  
Denver, CO 80202-5629  
(303) 446-3100

*Arizona, Colorado, New Mexico, Utah, and Wyoming*

James G. Dawson, District Director  
Two Union Square  
601 Union Street, Suite 1616  
Seattle, WA 98101-2327  
(206) 624-0790

*Alaska, Idaho, Montana, Oregon, and Washington*

### **2000 District Nominating Committee Chairperson**

Anthony Petrelli  
Neidiger, Tucker, Bruner, Inc.  
Denver, CO

### **District Committee Nominees**

Richard B. Bequett  
CUE  
Phoenix, AZ

George Diachok  
Multi-Financial Securities Corp.  
Denver, CO

John M. Rose  
Seattle-Northwest Securities Corp.  
Seattle, WA

Kathryn A. Supko  
Robert W. Baird & Co., Inc.  
Boise, ID

### **District Nominating Committee Nominees**

J. Wendell Garrett  
J.W. Garrett & Company  
Phoenix, AZ

Thomas R. Hislop  
Peacock, Hislop, Staley & Given, Inc.  
Phoenix, AZ

John Morton  
Morton Clarke Fu & Metcalf, Inc.  
Seattle, WA

Thomas Petrie  
Petrie Parkman & Co., Inc.  
Denver, CO

Douglas Strand  
Strand, Atkinson, Williams & York, Inc.  
Portland, OR

## **Special NASD Notice to Members 00-60**

### **District 4**

Thomas Clough, District Director  
120 W. 12th Street, Suite 900  
Kansas City, MO 64105  
(816) 421-5700

*Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota*

### **2000 District Nominating Committee Chairperson**

Todd W. Miller  
Miller, Johnson & Kuehn, Incorporated  
Minneapolis, MN

### **District Committee Nominees**

Gene M. Diedrich  
A.G. Edwards & Sons, Inc.  
Overland Park, KS

Jonathan M. Harris  
Dain Rauscher, Inc.  
Minneapolis, MN

Timothy J. Lyle  
Trusted Securities Advisors Corp.  
Minnetonka, MN

Pamela Kay Reinitz Ziermann  
Dougherty & Company  
Minneapolis, MN

### **District Nominating Committee Nominees**

Antonio J. Cecin  
U.S. Bancorp Piper Jaffray Inc.  
Minneapolis, MN

John D. Cleland  
Security Distributors, Inc.  
Topeka, KS

Cheryl Cook-Schneider  
Edward Jones  
St. Louis, MO

Wayne H. Peterson  
Cap Pro Brokerage Services, Inc.  
Minneapolis, MN

Brent Weisenborn  
Security Investment Company of Kansas City  
Kansas City, MO

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## **Special NASD Notice to Members 00-60**

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### **District 5**

Warren A. Butler, Jr., District Director  
1100 Poydras Street  
Energy Centre, Suite 850  
New Orleans, LA 70163-0802  
(504) 522-6527

*Alabama, Arkansas, Kentucky, Louisiana, Mississippi, Oklahoma, and Tennessee*

### **2000 District Nominating Committee Chairperson**

Jerry Roberts  
Sterne, Agee & Leach, Inc.  
Little Rock, AR

### **District Committee Nominees**

Norman Frager  
Capital West Securities, Inc.  
Oklahoma City, OK

David A. Knight  
Stephens Inc.  
Little Rock, AR

Lawrence J. Sisung  
Sisung Securities Corporation  
New Orleans, LA

David W. Wiley, III  
Wiley Bros., Aintree Capital, LLC  
Nashville, TN

### **District Nominating Committee Nominees**

Benjamin D. Capshaw, III  
Morgan Stanley Dean Witter  
New Orleans, LA

V. Hugo Marx, III  
Hugo Marx & Co., Inc.  
Birmingham, AL

Colin A. P. McNease  
PaineWebber Incorporated  
Jackson, MS

Jerry Roberts  
Sterne, Agee & Leach, Inc.  
Little Rock, AR

Dene R. Shipp  
SunTrust Equitable Securities, Inc.  
Nashville, TN

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## **Special NASD Notice to Members 00-60**

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### **District 6**

Bernerd Young, District Director  
12801 N. Central Expressway, Suite 1050  
Dallas, TX 75243  
(972) 701-8554

*Texas*

### **2000 District Nominating Committee Chairperson**

William B. Madden  
Madden Securities Corporation  
Dallas, TX

### **District Committee Nominees**

Christopher R. Allison  
M.E. Allison & Co. Inc.  
San Antonio, TX

David W. Turner  
First Union Securities Inc.  
Fort Worth, TX

R. Dwayne Whitehead  
Coastal Securities, L.P.  
Houston, TX

### **District Nominating Committee Nominees**

Jane E. Bates  
The Variable Annuity Marketing Company  
Houston, TX

William D. Connally  
Greenman Parker Connally Greenman, Inc.  
Fort Worth, TX

Malcolm L. Cooper  
Dain Rauscher, Inc.  
Austin, TX

Daniel C. Dooley  
Maplewood Investment Advisors, Inc.  
Dallas, TX

William H. Lowell  
Lowell & Company, Inc.  
Lubbock, TX

## **Special NASD Notice to Members 00-60**

### **District 7**

Alan M. Wolper, District Director  
One Securities Centre, Suite 500  
3490 Piedmont Road, NE  
Atlanta, GA 30305  
(404) 239-6100

*Florida, Georgia, North Carolina, South Carolina, Virginia, Puerto Rico, the Canal Zone, and the Virgin Islands*

### **2000 District Nominating Committee Chairperson**

Franklin C. Golden  
James M. Myer & Co., Inc.  
Charlotte, NC

### **District Committee Nominees**

Kenneth W. McGrath  
Popular Securities, Inc.  
Hato Rey, PR

Sharon K. Milligan  
Morgan Stanley Dean Witter  
Tampa, FL

C. John O'Bryant, III  
Legg Mason Wood Walker, Inc.  
Raleigh, NC

Charles R. Roberts  
Branch, Cabell & Co., Inc.  
Richmond, VA

### **District Nominating Committee Nominees**

Robert M. Balentine  
Balentine & Co.  
Atlanta, GA

Robert J. Brietz  
Marion Bass Securities Corp.  
Charlotte, NC

M. Anthony Greene  
Raymond James Financial Services, Inc.  
Atlanta, GA

R. Charles Shufeldt  
SunTrust Banks, Inc.  
Atlanta, GA

Raymond W. Snow  
Merrill Lynch  
Palm Beach, FL



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## **Special NASD Notice to Members 00-60**

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### **District 8**

Carlotta A. Romano, District Director  
10 South LaSalle, 20th Floor  
Chicago, IL 60603-1002  
(312) 899-4400

*Illinois, Indiana, Michigan, and Wisconsin*

William H. Jackson, Jr., District Director  
Renaissance on Playhouse Square  
1350 Euclid Avenue, Suite 650  
Cleveland, OH 44115  
(216) 694-4545

*Ohio and part of upstate New York (the counties of Monroe, Livingston, and Steuben, and the remainder of the state west of such counties)*

### **2000 District Nominating Committee Chairperson**

Paul E. Murin  
David A. Noyes & Company  
Chicago, IL

#### **District Committee Nominees**

George E. Bates  
Bates Securities, Inc.  
Rockford, IL

Gregory W. Goelzer  
Goelzer Investment Management, Inc.  
Indianapolis, IN

John A. Hawke  
Howe Barnes Investments, Inc.  
Chicago, IL

Jay B. MacKenzie  
Prudential Securities Incorporated  
Kalamazoo, MI

#### **District Nominating Committee Nominees**

Leonard L. Anderson  
Stifel Nicolaus & Company, Incorporated  
Grand Haven, MI

David L. Baker  
Baker & Company, Inc.  
Cleveland, OH

Thomas Harenburg  
Carl M. Hennig, Inc.  
Oshkosh, WI

David Slavik  
Pershing Division of Donaldson, Lufkin & Jenrette  
Securities Corporation  
Oak Brook, IL

G. Donald Steel  
Planned Investment Co., Inc.  
Indianapolis, IN

## **Special NASD Notice to Members 00-60**

### **District 9**

John P. Nocella, District Director  
11 Penn Center  
1835 Market Street, Suite 1900  
Philadelphia, PA 19103  
(215) 665-1180

*Delaware, Pennsylvania, West Virginia, District of Columbia, Maryland, and the part of southern New Jersey in the immediate Philadelphia vicinity*

Gary K. Liebowitz, District Director  
581 Main Street, 7th Floor  
Woodbridge, NJ 07095  
(732) 596-2000

*New Jersey (except southern New Jersey in the immediate Philadelphia vicinity)*

### **2000 District Nominating Committee Chairperson**

Mark W. Cresap  
Cresap, Inc.  
Radnor, PA

### **District Committee Nominees**

Jerry V. Duhovic  
Datek Online Brokerage Services LLC  
Iselin, NJ

Kimberly Tillotson Fleming  
Hefren-Tillotson, Inc.  
Pittsburgh, PA

Howard B. Scherer  
Janney Montgomery Scott LLC  
Philadelphia, PA

Mark Thomas Whaley  
Gibraltar Securities Co., a division of Tucker Anthony  
Incorporated  
Florham Park, NJ

### **District Nominating Committee Nominees**

Philip S. Cottone  
Rutherford, Brown & Catherwood, LLC  
Philadelphia, PA

Victor M. Frye  
Calvert Distributors, Inc.  
Bethesda, MD

Allen S. Jacobson  
Gibraltar Securities Co., a division of Tucker Anthony  
Incorporated  
Florham Park, NJ

James J. Malespina  
Herzog, Heine, Geduld, Inc.  
Jersey City, NJ

Jerome J. Murphy  
Janney Montgomery Scott, LLC  
Philadelphia, PA

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## **Special NASD Notice to Members 00-60**

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### **District 10**

David A. Leibowitz, District Director  
NASD Financial Center  
33 Whitehall Street  
New York, NY 10004  
(212) 858-4000

*The five boroughs of New York City, and Long Island*

### **2000 District Nominating Committee Chairperson**

Joan S. Green  
BT Brokerage Corporation  
New York, NY

### **District Committee Nominees**

Constantine Gus Economos  
Sandler O'Neill & Partners LP  
New York, NY

Ruth S. Goodstein  
Paine Webber Inc.  
New York, NY

Patrick Remmert  
Credit Suisse First Boston Corporation  
New York, NY

Charles V. Senatore  
Merrill Lynch Pierce Fenner & Smith Inc.  
New York, NY

Jeffrey Zuckerman  
Salomon Smith Barney Inc.  
New York, NY

### **District Nominating Committee Nominees**

Arthur S. Ainsberg  
Brahman Securities, Inc.  
New York, NY

Laurence H. Bertan  
Sanford C. Bernstein & Co. Inc.  
New York, NY

Frank F. DiGregorio  
Credit Suisse First Boston Corporation  
New York, NY

Harold G. Ognelodh  
Salomon Smith Barney Inc.  
New York, NY

Vicki Z. Holleman  
Loeb Partners Corporation  
New York, NY

# Special NASD Notice to Members 00-60

## District 11

Fred McDonald, District Director  
260 Franklin Street, 16th Floor  
Boston, MA 02110  
(617) 261-0800

*Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont, and New York (except for the counties of Monroe, Livingston, and Steuben; and the five boroughs of New York City, and Long Island)*

### 2000 District Nominating Committee Chairperson

Edward L. Sherr  
Carl P. Sherr & Company  
Worcester, MA

#### District Committee Nominees

Stephen Anikewich, Jr.  
Warburg Dillon Read LLC  
Stamford, CT

John I. Fitzgerald  
American General Funds Distributors, Inc.  
Boston, MA

Robert V. Rodia  
People's Securities, Inc.  
Bridgeport, CT

Gregory D. Teese  
Equity Services Inc.  
Montpelier, VT

#### District Nominating Committee Nominees

Harry H. Branning  
Advest, Inc.  
Hartford, CT

Stephanie Brown  
Linsco/Private Ledger Corp.  
Boston, MA

Sheldon Fechter  
Fechtor, Detwiler & Co., Inc.  
Boston, MA

Arthur F. Grant  
Cadaret, Grant & Co., Inc.  
Syracuse, NY

Frank V. Knox, Jr.  
Fidelity Distributors Corporation  
Boston, MA

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## INFORMATIONAL

### Margin

#### NASD Regulation Files Rule Proposal With SEC Requiring Delivery Of Margin Disclosure Statement To Customers

## SUGGESTED ROUTING

*The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.*

- Executive Representatives
- Legal & Compliance
- Operations
- Senior Management

## KEY TOPICS

- Customer Disclosures
- Margin

### Executive Summary

On September 5, 2000, NASD Regulation, Inc. (NASD Regulation<sup>SM</sup>) filed with the Securities and Exchange Commission (SEC) a rule proposal that would require members to deliver to non-institutional customers a specified disclosure statement that discusses the operation of margin accounts and the risks associated with trading on margin. Members would be permitted to develop an alternative margin disclosure statement, provided that the alternative disclosure statement is substantially similar to the mandated statement and incorporates all of the relevant concepts. The rule proposal would require that the disclosure statement be provided to customers prior to or at the opening of a margin account and to all margin customers on an annual basis. As proposed, members would be required to provide the disclosure statement to existing margin customers at the time of the next annual statement to the customer, but not to exceed 180 days from the effective date of the rule change. (See SR-NASD-00-55). A copy of this rule filing can be found at the NASDR Web Site (See [www.nasdr.com/filings/rf00\\_55.htm](http://www.nasdr.com/filings/rf00_55.htm)).

The SEC will publish the proposed rule change in the *Federal Register*, indicating a time period during which members and other interested parties may comment. When SEC publication has taken place, NASD Regulation will notify members of the comment period in the NASD Regulation executive representative weekly e-mail broadcast. Those interested in commenting on the proposed rule change should submit comments directly to the SEC prior to the close of the comment period indicated in the *Federal Register* release. Before becoming effective, the proposed rule change must be approved by the SEC. Members,

however, should consider providing the margin disclosure statement described in this *Notice* to customers on a voluntary basis prior to SEC action on the proposed requirements.

Attachment A provides a sample disclosure statement.

### Questions/Further Information

Questions concerning this proposal may be directed to Stephanie M. Dumont, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8176.

### Background

The recent growth in the level of customer margin account balances, coupled with the increase in customer inquiries and complaints to NASD Regulation and SEC staffs relating to the handling of margin accounts, has raised concerns as to whether investors understand the operation and risks associated with margin trading. NASD Regulation staff believes that investors' misconceptions about margin requirements, particularly with respect to maintenance margin, may cause investors to underestimate the risks of margin trading and to misunderstand the operation of and reasons for margin calls. Investors who cannot satisfy margin calls have had substantial portions of their accounts liquidated to satisfy these margin calls. Such liquidations can create realized losses for these customers that may far exceed the risk of loss they would have faced if they had not engaged in margin trading.

In this regard, a recent report issued by the General Accounting Office (GAO) noted that the SEC has determined from the customer complaints it has received that

## NASD Notice to Members 00-61

many investors who traded online did not understand margin requirements.<sup>1</sup> The lack of disclosures relating to when firms would sell securities in a margin account to cover margin loans was among the leading margin-related complaints that the SEC received.

The GAO Report also collected and summarized information from 12 online broker/dealers.<sup>2</sup> All of the online firms contacted did provide their customers the limited information currently required on margin trading.<sup>3</sup> Some firms also provided additional information relating to margin, such as requirements for account opening, procedures for selling securities to cover account losses, or special requirements for volatile stocks. However, nearly half of the firms contacted automatically<sup>4</sup> opened margin accounts for new customers without providing the customer with information relating to the risks associated with margin trading. At three firms that automatically opened margin accounts, customers would find out about their account type only if they read and understood their account agreements, which SEC staff indicated were written in legal language and may be difficult for investors to understand. Three of the 12 online broker/dealers contacted did take “extra measures” to ensure that their customers understood that stocks could be sold to cover outstanding loans in a margin account. These firms included information on their Web sites that explained that accounts could be liquidated in fast-moving markets before the customary period.

The GAO Report concluded that better investor protection information, including information relating to margin requirements, was needed on Web sites of some

online broker/dealers. In this regard, the GAO Report recommended that the SEC ensure that broker/dealers with online trading systems include accurate and complete information on their Web sites regarding, among other things, margin requirements.

### Specific Areas Of Concern

Based on customer complaints and inquiries it has received, NASD Regulation staff identified several areas associated with margin trading that may have generated confusion and misunderstanding between customers and members. These include:

#### **Margin Calls – Notification**

Some investors hold the mistaken belief that their broker/dealer must contact them for a margin call to be valid, and that their broker/dealer cannot liquidate securities in their account to meet the call unless a specified number of days have passed and/or the broker/dealer has contacted the customer. There are no such restrictions in Regulation T or National Association of Securities Dealers, Inc. (NASD<sup>®</sup>) Rule 2520. Moreover, securities that have been purchased on margin by a customer are collateral for the margin loan and are, therefore, subject to the security claim of the broker/dealer until they are fully paid. Thus, if a broker/dealer believes that the collateral for the margin loan is at risk, the broker/dealer is entitled to take any steps necessary to protect its financial interests, including immediate liquidation without notice to the customer. Some broker/dealers will attempt to notify their customers of margin calls, but they are not required to do so. However, even if a broker/dealer has contacted a customer and provided a specific date by which

the customer can meet a margin call, the broker/dealer can still take necessary steps to protect its financial interests, including immediate liquidation, without further notice to the customer.

#### **Extensions Of Time On Margin Calls**

Some investors believe they are automatically entitled to an extension of time to meet margin calls. While an extension of time to meet *initial* margin requirements may be available to the customer under certain conditions, it is only granted if the clearing firm chooses to request an extension from its Designated Examining Authority; the customer does not have a right to an automatic extension.

In addition, some investors believe that when a *maintenance* margin call has been issued that they are entitled to one or more extensions of time to meet the call; however, there is no mechanism for extending maintenance margin calls. If the customer fails to meet a maintenance margin call, the broker/dealer can, under certain circumstances, take a charge to its net capital in lieu of collecting the call, but the broker/dealer is not required to do so, and the customer has no right to demand it.

#### **Right To Dictate Which Security Is Liquidated**

Some investors believe that they have the right to control which securities are liquidated to meet a maintenance margin call if there is more than one security in the account. There is no provision in the margin rules that gives the customer the right to control liquidation decisions. As discussed above, because the securities are collateral for the margin loan, the broker/dealer has the right to control the disposition of the collateral in order to protect its

## NASD Notice to Members 00-61

interests. In this regard, the broker/dealer may choose which securities in the margin account to liquidate, and this selection need not relate to factors associated with the individual customer. For example, the broker/dealer may choose a particular security in a customer's account to liquidate based on a high concentration of the security held by customers firm-wide.

### **Members Raising Their Maintenance Margin Requirements**

Some members have increased their "house" maintenance margin requirements as a result of concerns about the volatility and extreme price run-ups on certain stocks and the risks to their customers and the member's own potential exposure to losses from margin defaults. These changes in policy often take effect immediately and will result in the issuance of a maintenance margin call. A customer's failure to satisfy the call will usually cause the member to liquidate a portion of the customer's account.

Some investors believe that a member must provide 30 days written notice before implementing this type of change. While SEC Rule 10b-16 requires members to disclose to customers the credit terms (interest rates and methods of calculating interest) for margin transactions and requires advance written notice of such changes, it does not require advance notice of the amount of margin required.

### **NASD Regulation Web Page Relating To Margin**

To increase investor and member awareness of issues relating to margin, NASD Regulation created a Web page ([www.nasdr.com/5700.htm](http://www.nasdr.com/5700.htm)) dedicated to margin-related

information for members and investors. An easily accessible direct link to this Web page has been provided on the NASD Regulation homepage. Among other things, the Web page provides investor guidance on margin, including some basic facts about the mechanics of margin accounts, specific examples illustrating the operation of a margin transaction and statistics on outstanding margin debt. In addition, NASD Regulation provides an "account statement stuffer," which describes basic information about purchasing on margin and managing a margin account. NASD Regulation has received requests for over 600,000 copies of this statement stuffer. In addition, approximately 20 firms have requested electronic copies of this statement stuffer for in-house printing purposes.

### **Proposed Requirements**

Although NASD Regulation recognizes that some members are providing disclosures to customers relating to margin, the content of these disclosures is not consistent from firm to firm and may not always be in a form that is understandable to investors. As such, NASD Regulation has filed with the SEC a proposed rule change that would require members to deliver to non-institutional customers a specified disclosure statement that discusses the operation of margin accounts and the risks associated with trading on margin.<sup>5</sup> Members would be required to deliver the disclosure statement, in writing or electronically, to customers on an individual basis,<sup>6</sup> prior to or at the opening of a margin account. The proposed rule change also would require members to deliver the disclosure statement annually to all non-institutional customers with

margin accounts. Members would be required to provide the disclosure statement to existing margin customers at the time of the next annual statement to the customer, but not to exceed 180 days from the effective date of the rule change. A sample margin disclosure statement is provided as Attachment A, which:

- describes the operation of a margin account;
- emphasizes that customers should carefully review their margin agreements; and
- clarifies some of the risks associated with margin trading, including that the customer can lose more funds than initially deposited, the firm can force the sale of the securities in the customer's account without notice to the customer, the firm can dictate which security is selected for liquidation, and the customer is not entitled to an extension of time on a margin call.

Members would be permitted to develop an alternative margin disclosure statement, provided that the alternative disclosure statement is substantially similar to the mandated statement and incorporates all of the relevant concepts. Under the proposed rule, disclosure at or prior to the opening of the account must be made in a separate document, even if a member chooses to deliver the disclosures as part of or within the margin agreement or other opening account documentation. However, with respect to the annual disclosure requirement, members would be permitted to provide the disclosures within other documentation, such as the customer account statement.

## NASD Notice to Members 00-61

### Publication Of Proposed Rule

The SEC will publish the proposed rules in the *Federal Register*, indicating a time period during which members and other interested parties may comment. When SEC publication has taken place, NASD Regulation will notify members of the comment period in the NASD Regulation executive representative weekly e-mail broadcast. Those interested in commenting on the proposed rule change should submit comments directly to the SEC prior to the close of the comment period indicated in the *Federal Register* release. Among other issues, members and other interested parties may wish to comment on the following, which were raised by NASD Regulation standing and District committees: (1) the permissible methods of delivery of the disclosure statement for both the initial and the annual disclosure requirements; (2) whether providing only the "bulleted" information in the margin disclosure statement would be appropriate for fulfilling the annual disclosure requirement; and (3) whether 180 days from the effective date is an appropriate amount of time for the first delivery of the disclosure statement to all existing margin customers.

Before becoming effective, the proposed rule change must be approved by the SEC. Members, however, should consider providing

the margin disclosure statement described in this *Notice* to customers on a voluntary basis prior to SEC action on the proposed requirements.

### Endnotes

<sup>1</sup>See *On-Line Trading, Better Investor Protection Information Needed*, Report to Congressional Requesters, GAO, General Government Division, 00-43 (May 2000) (GAO Report). According to the GAO Report, between January 1998 and June 1999, 140 margin-related complaints concerning online trading firms were submitted to the SEC.

<sup>2</sup>These firms represented less than 10 percent of the total estimated number of firms that offer online trading. However, they accounted for about 90 percent of the online **trading volume** during early 1999.

<sup>3</sup>Rule 10b-16 of the Securities Exchange Act of 1934 (SEC Rule 10b-16) requires that broker/dealers that extend credit to customers to finance securities transactions furnish, in writing, specified information regarding the terms of the loan. These disclosures must be made on both an initial and periodic basis. For instance, at the time a customer opens a margin account, a broker/dealer must provide the customer with a written statement disclosing, among other things, the annual rate of interest, the method of computing interest, and what other credit charges may be imposed.

<sup>4</sup>Those firms that provided clear indications of the type of account to be opened offered

their customers the option on the Web site to choose either a cash or margin account, or both. However, those firms that automatically opened margin accounts only offered new customers a choice with respect to account ownership, such as joint or individual account.

<sup>5</sup>The term "non-institutional customer" would mean a customer who does not qualify as an "institutional account" under NASD Rule 3110(c)(4). Rule 3110(c)(4) defines "institutional account" to mean the account of: (1) a bank, savings and loan association, insurance company, or registered investment company; (2) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or agency or office performing similar functions); or (3) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million.

<sup>6</sup>Members would be required to deliver the disclosure statement to each customer individually. For example, a member firm posting the disclosure statement on its Web site would not fulfill the proposed delivery requirements, although such supplemental disclosure would be beneficial to investors.

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**Attachment A — Sample Margin Disclosure Statement**

Your brokerage firm is furnishing this document to you to provide some basic facts about purchasing securities on margin, and to alert you to the risks involved with trading securities in a margin account. Before trading stocks in a margin account, you should carefully review the margin agreement provided by your firm. Consult your firm regarding any questions or concerns you may have with your margin accounts.

When you purchase securities, you may pay for the securities in full or you may borrow part of the purchase price from your brokerage firm. If you choose to borrow funds from your firm, you will open a margin account with the firm. The securities purchased are the firm's collateral for the loan to you. If the securities in your account decline in value, so does the value of the collateral supporting your loan, and, as a result, the firm can take action, such as issue a margin call and/or sell securities in your account, in order to maintain the required equity in the account.

It is important that you fully understand the risks involved in trading securities on margin. These risks include the following:

**You can lose more funds than you deposit in the margin account.** A decline in the value of securities that are purchased on margin may require you to provide additional funds to the firm that has made the loan to avoid the forced sale of those securities or other securities in your account.

**The firm can force the sale of securities in your account.** If the equity in your account falls below the maintenance margin requirements under the law, or the firm's higher "house" requirements, the firm can sell the securities in your account to cover the margin deficiency. You also will be responsible for any shortfall in the account after such a sale.

**The firm can sell your securities without contacting you.** Some investors mistakenly believe that a firm must contact them for a margin call to be valid, and that the firm cannot liquidate securities in their accounts to meet the call unless the firm has contacted them first. This is not the case. Most firms will attempt to notify their customers of margin calls, but they are not required to do so. However, even if a firm has contacted a customer and provided a specific date by which the customer can meet a margin call, the firm can still take necessary steps to protect its financial interests, including immediately selling the securities without notice to the customer.

**You are not entitled to choose which security in your margin account is liquidated or sold to meet a margin call.** Because the securities are collateral for the margin loan, the firm has the right to decide which security to sell in order to protect its interests.

**The firm can increase its "house" maintenance margin requirements at any time and is not required to provide you with advance written notice.** These changes in firm policy often take effect immediately and may result in the issuance of a maintenance margin call. Your failure to satisfy the call may cause the member to liquidate or sell securities in your account.

**You are not entitled to an extension of time on a margin call.** While an extension of time to meet margin requirements may be available to customers under certain conditions, a customer does not have a right to the extension.

### INFORMATIONAL

## Day-Trading Rules

SEC Approves Day-Trading Rules; **Effective Date: October 16, 2000**

### SUGGESTED ROUTING

*The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.*

- Executive Representatives
- Legal & Compliance
- Operations
- Registered Representatives
- Senior Management
- Trading & Market Making

### KEY TOPICS

- Day Trading
- Risk Disclosure

### Executive Summary

On July 10, 2000, the Securities and Exchange Commission (SEC) approved rule changes proposed by the National Association of Securities Dealers, Inc. (NASD<sup>®</sup>) that require a firm that is promoting a day-trading strategy to furnish a risk disclosure statement to a non-institutional customer prior to opening an account for the customer. The firm will further be required to either: (1) approve the customer's account for a day-trading strategy; or (2) obtain from the customer a written agreement that the customer does not intend to use the account for day-trading purposes. As part of the account approval process, the firm will be required to make a threshold determination that day trading is appropriate for the customer.

The new rules are included with this *Notice* (see Attachment A). These rules become effective on October 16, 2000. The day-trading rules will not apply to an existing customer unless the customer opens a new account at a firm that is promoting a day-trading strategy.

### Questions/Further Information

Questions regarding this *Notice* may be directed to Eric Moss, Assistant General Counsel, Office of General Counsel, NASD Regulation, Inc. (NASD Regulation<sup>SM</sup>), at (202) 728-8982.

### Day-Trading Rules

In general, day traders seek to profit from very small movements in the price of a security. Such a strategy often requires aggressive trading of a brokerage account. As a result, day trading generally requires a significant amount of capital, a sophisticated understanding of securities markets

and trading techniques, and high risk tolerance. Even experienced day traders with in-depth knowledge of the securities markets may suffer severe and unexpected financial losses.

To address investor protection concerns arising from day-trading activities, the NASD is amending its rules to include new Rule 2360 and 2361. As noted above, these rules will require a firm that is promoting a day-trading strategy to furnish a risk disclosure statement to a non-institutional customer prior to opening an account for the customer.<sup>1</sup> The firm will further be required to either:

- (1) approve the customer's account for a day-trading strategy; or
- (2) obtain from the customer a written agreement that the customer does not intend to use the account for day-trading purposes.

A firm will not be permitted to rely on the written agreement from the customer if the firm knows that the customer intends to use the account for day trading. In addition, if a customer signs the written agreement stating that he/she does not intend to use the account for day-trading purposes, but the firm later discovers that the customer is using the account for day-trading activities, then the firm will be required to approve the customer's account for day trading in accordance with the rule as soon as practicable, but in no event later than 10 days from the date of discovery.

### Account Approval Requirement

As part of the account approval process, the firm will be required to make a threshold determination that day trading is appropriate for

the customer. In making this determination, the firm will be required to exercise reasonable diligence to ascertain the essential facts relative to the customer, including his or her: investment objectives; investment and trading experience and knowledge; financial situation; tax status; employment status; marital status and number of dependents; and age. The firm also will be required to prepare a record setting forth the basis on which the firm has approved the customer's account. Any record or written statement prepared or obtained by the firm pursuant to the rule change will have to be preserved in accordance with NASD Rule 3110(a).

The day-trading rules define "day-trading strategy" to mean "an overall trading strategy characterized by the regular transmission by a customer of intra-day orders to effect both purchase and sale transactions in the same security or securities." The NASD believes that this definition includes those instances where an individual regularly transmits one or more purchase and sale (*i.e.*, "round-trip") transactions in a single day. In addition, although as a practical matter, day trading typically requires electronic delivery of orders, the definition of "day-trading strategy" includes orders transmitted by non-electronic means, such as by telephone.

### **Risk Disclosure Requirement**

The day-trading rules require a firm that is promoting a day-trading strategy to deliver a disclosure statement to the customer discussing the unique risks posed by day trading. The day-trading rules require firms to deliver the disclosure statement to each customer individually, by mail or electronic means, prior to the

opening of the account. This approach protects against a firm posting the disclosure statement in a remote place on its Web site and claiming that it was delivered to all customers in such a manner. The day-trading rules do not require customers to sign the disclosure statement. The NASD believes that it is sufficient for firms to have written procedures in place for delivery of the document and to be able to identify those procedures to any examiners.

The disclosure statement includes several factors that a customer should consider before engaging in day trading, including that the customer should be prepared to lose all of the funds that he or she uses for day trading and that day trading on margin may result in losses beyond the initial investment. The disclosure statement is set forth in Rule 2361(a) in Attachment A. The firm will be permitted to develop an alternative risk disclosure statement, provided that the alternative statement is substantially similar to the mandated statement and is filed with, and approved by, NASD Regulation's Advertising Department.

For more information about the filing process and related fees, please contact the Advertising Regulation Department at 9509 Key West Avenue, Rockville, MD 20850, telephone (240) 386-4500.

### **Members That Promote Day Trading**

A member will be subject to the day-trading rules if it affirmatively promotes day-trading activities or strategies through advertising, training seminars, or direct outreach programs. For instance, a firm generally will be subject to the new rules if its advertisements

address the benefits of day trading, rapid-fire trading, or momentum trading, or encourages persons to trade or profit like a professional trader. A firm also will be subject to the new rules if it promotes its day-trading services through a third party. Moreover, the fact that many of a firm's customers are engaging in a day-trading strategy will be relevant in determining whether a firm has promoted itself in this way.<sup>2</sup>

The day-trading rules only will be triggered by firms' general promotional efforts or by firm-sponsored promotional efforts. The day-trading rules clarify that a member will not be deemed to be promoting a day-trading strategy for purposes of the rule solely by engaging in the following actions:

- (1) promoting efficient execution services or lower execution costs based on multiple trades;
- (2) providing general investment research or advertising the high quality or prompt availability of such general research; or
- (3) having a Web site that provides general financial information or news or that allows the multiple entry of intra-day purchases and sales of the same securities.

However, firms may not promote day trading through individuals in an effort to circumvent the rules. In addition, if a principal or officer of the firm is aware that brokers in the firm are soliciting customers for day trading, then the firm will be deemed to be promoting day trading.

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## NASD Notice to Members 00-62

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### Endnotes

<sup>1</sup>For purpose of the day-trading rules, the term “non-institutional customer” means a customer that does not qualify as an “institutional account” under NASD Rule 3110(c)(4). Rule 3110(c)(4) defines “institutional account” to mean the account of (1) a bank, savings and loan association, insurance company, or registered

investment company; (2) an investment adviser registered either with the SEC under Section 203 of the Investment Advisers Act of 1940 or with a state securities commission (or agency or office performing like functions); or (3) any other entity (whether a natural person, corporation, partnership, trust, or otherwise) with total assets of at least \$50 million.

<sup>2</sup>The new rules do not define the term “promoting a day-trading strategy.” However, firms may submit their advertisements to NASD Regulation’s Advertising Department for review and guidance on whether the content of the advertisement constitutes such activity for purposes of the new rules.

## Attachment A

### Text Of New Rules

*(Note: All language is new.)*

#### **Rule 2360. Approval Procedures for Day-Trading Accounts**

(a) No member that is promoting a day-trading strategy, directly or indirectly, shall open an account for or on behalf of a non-institutional customer, unless, prior to opening the account, the member has furnished to the customer the risk disclosure statement set forth in Rule 2361 and has:

(1) approved the customer's account for a day-trading strategy in accordance with the procedures set forth in paragraph (b) and prepared a record setting forth the basis on which the member has approved the customer's account; or

(2) received from the customer a written agreement that the customer does not intend to use the account for the purpose of engaging in a day-trading strategy, except that the member may not rely on such agreement if the member knows that the customer intends to use the account for the purpose of engaging in a day-trading strategy.

(b) In order to approve a customer's account for a day-trading strategy, a member shall have reasonable grounds for believing that the day-trading strategy is appropriate for the customer. In making this determination, the member shall exercise reasonable diligence to ascertain the essential facts relative to the customer, including:

- (1) Investment objectives;
- (2) Investment and trading experience and knowledge (e.g., number of years, size, frequency and type of transactions);
- (3) Financial situation, including: estimated annual income from all sources, estimated net worth (exclusive of family residence), and estimated liquid net worth (cash, securities, other);
- (4) Tax status;
- (5) Employment status (name of employer, self-employed or retired);
- (6) Marital status and number of dependents; and
- (7) Age.

(c) If a member that is promoting a day-trading strategy opens an account for a non-institutional customer in reliance on a written agreement from the customer pursuant to paragraph (a)(2) and, following the opening of the account, knows that the customer is using the account for a day-trading strategy, then the member shall be required to approve the customer's account for a day-trading strategy

in accordance with paragraph (a)(1) as soon as practicable, but in no event later than 10 days following the date that such member knows that the customer is using the account for such a strategy.

(d) Any record or written statement prepared or obtained by a member pursuant to this rule shall be preserved in accordance with Rule 3110(a).

(e) For purposes of this rule, the term "day-trading strategy" means an overall trading strategy characterized by the regular transmission by a customer of intra-day orders to effect both purchase and sale transactions in the same security or securities.

(f) For purposes of this rule, the term "non-institutional customer" means a customer that does not qualify as an "institutional account" under Rule 3110(c)(4).

(g) A firm will not be deemed to be "promoting a day-trading strategy" for purposes of this rule solely by its engaging in the following activities:

- (1) Promoting efficient execution services or lower execution costs based on multiple trades;
- (2) Providing general investment research or advertising the high quality or prompt availability of such general research; and
- (3) Having a Web site that provides general financial information or news or that allows the multiple entry of intra-day purchases and sales of the same securities.

### Rule 2361. Day-Trading Risk Disclosure Statement

(a) Except as provided in paragraph (b), no member that is promoting a day-trading strategy, directly or indirectly, shall open an account for or on behalf of a non-institutional customer unless, prior to opening the account, the member has furnished to each customer, individually, in writing or electronically, the following disclosure statement:

You should consider the following points before engaging in a day-trading strategy. For purposes of this notice, a "day-trading strategy" means an overall trading strategy characterized by the regular transmission by a customer of intra-day orders to effect both purchase and sale transactions in the same security or securities.

**Day trading can be extremely risky.** Day trading generally is not appropriate for someone of limited resources and limited investment or trading experience and low risk tolerance. You should be prepared to lose all of the funds that you use for day trading. In particular, you should not fund day-trading activities with retirement savings, student loans, second mortgages, emergency funds, funds set aside for purposes such as education or home ownership, or funds required to meet your living expenses. Further, certain evidence indicates that an investment of less than \$50,000 will significantly impair the ability of a day trader to make a profit. Of course, an investment of \$50,000 or more will in no way guarantee success.

**Be cautious of claims of large profits from day trading.** You should be wary of advertisements or other statements that emphasize the potential for large profits in day trading. Day trading can also lead

to large and immediate financial losses.

**Day trading requires knowledge of securities markets.** Day trading requires in-depth knowledge of the securities markets and trading techniques and strategies. In attempting to profit through day trading, you must compete with professional, licensed traders employed by securities firms. You should have appropriate experience before engaging in day trading.

**Day trading requires knowledge of a firm's operations.** You should be familiar with a securities firm's business practices, including the operation of the firm's order execution systems and procedures. Under certain market conditions, you may find it difficult or impossible to liquidate a position quickly at a reasonable price. This can occur, for example, when the market for a stock suddenly drops, or if trading is halted due to recent news events or unusual trading activity. The more volatile a stock is, the greater the likelihood that problems may be encountered in executing a transaction. In addition to normal market risks, you may experience losses due to system failures.

**Day trading will generate substantial commissions, even if the per trade cost is low.** Day trading involves aggressive trading, and generally you will pay commissions on each trade. The total daily commissions that you pay on your trades will add to your losses or significantly reduce your earnings. For instance, assuming that a trade costs \$16 and an average of 29 transactions are conducted per day, an investor would need to generate an annual profit of \$111,360 just to cover commission expenses.

**Day trading on margin or short selling may result in losses beyond your initial investment.**

When you day trade with funds borrowed from a firm or someone else, you can lose more than the funds you originally placed at risk. A decline in the value of the securities that are purchased may require you to provide additional funds to the firm to avoid the forced sale of those securities or other securities in your account. Short selling as part of your day-trading strategy also may lead to extraordinary losses, because you may have to purchase a stock at a very high price in order to cover a short position.

**Potential Registration Requirements.** Persons providing investment advice for others or managing securities accounts for others may need to register as either an "Investment Advisor" under the Investment Advisors Act of 1940 or as a "Broker" or "Dealer" under the Securities Exchange Act of 1934. Such activities may also trigger state registration requirements.

(b) In lieu of providing the disclosure statement specified in paragraph (a), a member that is promoting a day-trading strategy may provide to the customer, individually, in writing or electronically, prior to opening the account, an alternative disclosure statement, provided that:

- (1) The alternative disclosure statement shall be substantially similar to the disclosure statement specified in paragraph (a); and
- (2) The alternative disclosure statement shall be filed with the Association's Advertising Department (Department) for review at least 10 days prior to

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## NASD Notice to Members 00-62

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use (or such shorter period as the Department may allow in particular circumstances) for approval and, if changes are recommended by the Association, shall be withheld from use until any changes specified by the Association have been made or, if expressly disapproved, until the alternative disclosure statement has been refiled for, and has received, Association approval. The member must provide with each

filing the anticipated date of first use.

(c) For purposes of this rule, the term "day-trading strategy" shall have the meaning provided in Rule 2360(e).

(d) For purposes of this Rule, the term "non-institutional customer" means a customer that does not qualify as an "institutional account" under Rule 3110(c)(4).

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### INFORMATIONAL

## Arbitration Awards

### NASD Regulation Provides Guidance On The Use Of Installment Payments To Satisfy Arbitration Awards

### SUGGESTED ROUTING

*The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.*

- Legal & Compliance
- Operations
- Senior Management

### KEY TOPICS

- Arbitration Awards
- Motions to Vacate
- Nonpayment Of Awards
- Suspension Proceedings

### Executive Summary

In August 2000, the National Association of Securities Dealers, Inc. (NASD<sup>®</sup>) published *Notice to Members 00-55* which announced that NASD Dispute Resolution, Inc. (NASD Dispute Resolution<sup>SM</sup>) will require firms to certify in writing that they have complied with arbitration awards within 30 days of receipt of the award notice.

This *Notice* is intended to provide guidance to members on the use of installment payments to satisfy arbitration awards, in light of the Securities and Exchange Commission (SEC) Rule 15c3-1 (the Net Capital Rule).

### Questions/Further Information

Questions regarding this *Notice* may be directed to Susan M. DeMando, Director, Member Regulation, NASD Regulation, Inc. (NASD Regulation<sup>SM</sup>), at (202) 728-8411; or Daniel M. Sibears, Senior Vice President, Member Regulation, NASD Regulation, at (202) 728-6911.

### Background

Rule 10330(h) of the Code of Arbitration Procedure (Code) requires that all monetary awards shall be paid within 30 days of receipt unless a motion to vacate has been filed with a court of competent jurisdiction. NASD By-Laws, Article VI, Sec. 3 provides for the suspension or cancellation of membership or registration for, among other reasons, the failure to comply with an award of arbitrators properly rendered pursuant to NASD rules, where a timely motion to vacate or modify such award has not been made pursuant to applicable law or where such a motion has been denied; or for failure to comply with a written and

executed settlement agreement obtained in connection with an arbitration or mediation submitted for disposition pursuant to NASD Rule 9510 Series.

Based on these rules, NASD Dispute Resolution will institute a suspension proceeding for failure to pay an arbitration award against the member firm or associated person, unless a basis for nonpayment is established.

In *Notice to Members 00-55*, five possible bases were listed including, "the parties have agreed to installment payments of the amount awarded or have otherwise agreed to settle the action."

### Interpretative Guidance

This *Notice* is intended to provide guidance to members that seek to satisfy an arbitration award through the use of installment payments, in light of the Net Capital Rule.

### Basis For The Use Of Installment Payments

According to the SEC's interpretation of the Net Capital Rule:

"A broker/dealer that is the subject of an adverse award in an arbitration proceeding should book said award as an actual liability at the time the award is made, even though the appeal process has not been exhausted and no judgment has been rendered, because grounds for revision on appeal are very limited."

An agreement among the parties to installment payments of the amount awarded does not change the requirement to book the award as an actual liability at the time the award is made. While an installment plan indicates the



## NASD Notice to Members 00-63

payment terms of the liability, it does not reduce the liability. A broker/dealer must reflect the entire amount of the arbitration award as a liability.

As a result, the use of installment payments to satisfy an arbitration award is only appropriate when the broker/dealer has sufficient net capital to conduct a securities business after recording the full liability.

### **Example 1**

Claimant Jones received an arbitration award for \$120,000 against Firm ABC. The claimant has agreed to installment payments of \$5,000 per month from the broker/dealer. This payment plan would be permissible for any broker/dealer in the financial position to include the entire \$120,000 as a liability of the firm and still maintain sufficient net capital to continue to conduct a securities business. That is, after recording the entire amount of the

arbitration award as a liability, the firm is still in compliance with the Net Capital Rule.

### **Example 2**

Claimant Smith received an arbitration award for \$60,000 against Firm DEF. The firm has excess net capital of \$40,000. Since the \$60,000 award is greater than the firm's excess net capital, the required recording of the arbitration award will place the firm under its minimum net capital requirement. Installment payments are mute as the firm does not have sufficient net capital to continue to conduct a securities business.

### **Sub-Loans**

An acceptable alternative to the cessation of business is if the claimant is willing to subordinate the amount of the arbitration award pursuant to an approved sub-loan meeting all the conditions of the Net Capital Rule, Appendix D.

However, the NASD will not approve debt sub-loans if, at the time of signing, the firm's debt-to-debt-equity ratio would exceed 70 percent. Therefore, the use of debt sub-loans may not be available to all firms and their claimants.

Members are reminded that for sub-loans to be added back in their net capital computation, they must be approved by their self-regulatory organization. By virtue of subordinating an arbitration award through a sub-loan, claimants become junior to other creditors in the event of the broker/dealer's insolvency. Therefore, claimants should clearly understand the risks associated with any such subordination *prior* to entering into the agreement.

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## INFORMATIONAL

### Mediation Fees

SEC Approves Rule Changes To Amend Mediation Fee Structure; Effective Date: November 1, 2000

## SUGGESTED ROUTING

*The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.*

- Legal & Compliance
- Senior Management

## KEY TOPICS

- Dispute Resolution
- Mediation

### Executive Summary

On August 11, 2000, the Securities and Exchange Commission (SEC) approved a change to the Code of Arbitration Procedure (Code) to permit NASD Dispute Resolution, Inc., (NASD Dispute Resolution<sup>SM</sup>) to implement a new fee structure for its mediation services.<sup>1</sup> When the rule change becomes effective, NASD Dispute Resolution will replace its current flat fee for cases filed directly as mediations with a sliding-scale fee schedule that will result in lower fees to mediate smaller claims.

The rule change also affects cases filed as arbitrations that move to mediation. NASD Dispute Resolution will now charge the parties in such cases a mediation filing fee, except that no fee will be charged if a case involves claims of \$25,000 or less. Previously, no mediation filing fee was assessed when parties in arbitration decided to mediate. However, as an inducement to parties to mediate cases in arbitration, parties will no longer pay the arbitration adjournment fee if they choose to mediate with NASD Dispute Resolution. The rule change also makes it clear that parties that choose to mediate can adjourn their arbitration, so they are not participating in two processes simultaneously. The rule change becomes effective for mediations filed on or after November 1, 2000.<sup>2</sup>

Attachment A outlines the Code changes.

### Questions/Further Information

Questions regarding this *Notice* may be directed to Kenneth L. Andrichik, Associate Vice President and Director of Mediation, NASD Dispute Resolution, at (212) 858-3915, e-mail: [ken.andrichik@nasd.com](mailto:ken.andrichik@nasd.com);

Elizabeth McCoy, Assistant Director of Mediation, NASD Dispute Resolution, at (212) 858-4341, e-mail: [elizabeth.mccoy@nasd.com](mailto:elizabeth.mccoy@nasd.com); or Louise Corso, Assistant General Counsel, Office of General Counsel, NASD Regulation, Inc. (NASD Regulation<sup>SM</sup>), at (202) 728-6939, e-mail: [louise.corso@nasd.com](mailto:louise.corso@nasd.com).

### Background

NASD Regulation initiated a mediation program in 1995 to provide an additional dispute resolution option for parties. The mediation program provides public customers, member firms, and associated persons with an alternative and effective means for resolving their disputes.

NASD Dispute Resolution reviewed its mediation program, which is currently subsidized by the National Association of Securities Dealers, Inc. (NASD<sup>®</sup>), and determined to adjust its mediation fee schedule. The new mediation fee schedule helps offset the operational costs of the mediation program while preserving mediation as a cost-effective alternative to arbitration for parties with claims of any dollar value. Mediation fees remain payable only after opposing parties agree to submit a case to mediation.

The major changes approved by the SEC are summarized in this *Notice*. Attachment A includes all of the textual changes to the Code.

### Mediation Case Filing Fees For Cases Filed Directly In Mediation

About 15 percent of the mediation cases filed annually are filed directly in mediation. NASD Dispute Resolution presently charges \$150

per party for customer cases and \$250 per party for intra-industry cases, regardless of the amount in dispute.<sup>3</sup> NASD Dispute Resolution will replace the flat fee with a sliding scale fee schedule detailed in new Rule 10407(a). The new schedule lists the filing fees for customers and associated persons, as well as the filing fees for member firms. The filing fees are lowest for the smallest claims but increase as the amount in controversy increases. For all claims, regardless of the amount in dispute, customers and members will pay less than the corresponding filing fees for arbitration.

### Mediation Case Filing Fees For Cases Initially Filed In Arbitration

About 85 percent of the mediation cases filed annually are first filed in arbitration and later move to mediation. Under new Rule 10407(b), NASD Dispute Resolution will charge mediation filing fees for cases over \$25,000 to parties choosing mediation after the arbitration case is already filed. For cases of \$25,000 or less, consistent with its efforts to provide incentives for parties to mediate small claims, NASD Dispute Resolution will not impose any filing fees under the new rule. For higher dollar-value

cases, because NASD Dispute Resolution would like to continue to encourage members and investors to mediate although they may have an arbitration case pending, total filing fees will be smaller than for those cases filed directly in mediation.

### Adjourning Arbitration During Mediation

NASD Dispute Resolution will amend Rule 10403 of the Code in two ways. First, new language is added to Rule 10403(a) to make it clear that parties in an arbitration that agree to submit a matter for mediation can also agree to adjourn the arbitration. The parties can do so notwithstanding Rule 10319 that gives arbitrators discretion to adjourn an arbitration proceeding. NASD Dispute Resolution believes that this rule change benefits the parties by saving them time and money and by relieving them of the problems of proceeding in two arenas at the same time. Moreover, this change is consistent with the approach taken by other alternative dispute resolution providers.

Second, NASD Dispute Resolution has added a new provision, Rule 10403(b), that encourages the use of the NASD Dispute Resolution mediation program. Whenever the

mediation is conducted through NASD Dispute Resolution, the parties will avoid payment of arbitration adjournment fees.

### Additional Efforts To Encourage Mediation Of Small Claims

In addition to changing the Code, NASD Dispute Resolution has recently asked its mediators to help reduce the cost of mediation for small cases by agreeing to charge reduced rates to mediate claims involving \$25,000 or less. Over half of all NASD Dispute Resolution mediators have agreed to charge \$50 an hour for mediations in which the disputed amount is \$25,000 or less.

### Endnotes

<sup>1</sup>Exchange Act Release No. 43147 (August 11, 2000) (File No. SR-NASD-00-11), 65 Federal Register 50582 (August 18, 2000).

<sup>2</sup>The new rule will be effective for any mediation filed on or after November 1, 2000, *i.e.*, those filed directly as mediations and those converted from a pending arbitration.

<sup>3</sup>These fees are currently outlined in Rules 10205(j) and 10332(i).

**Attachment A**

**Text Of Amendments**

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

**Rule 10205. Schedule of Fees for Industry and Clearing Controversies**

(a) – (i) No change.

[(j) Each party to a matter submitted to a mediation administered by the Association where there is no Association arbitration proceeding pending shall pay an administrative fee of \$250. The parties to a mediation administered by the Association shall pay all of the mediator’s charges, including the mediator’s travel and other expenses. The charges shall be specified in the Submission Agreement and shall be apportioned equally among the parties unless they agree otherwise. Each party shall deposit with the Association their proportional share of the anticipated mediator charges and expenses, as determined by the Director of Mediation, prior to the first mediation session. Mediator charges, except travel and other expenses, are as follows:

(1) Initial Mediation Session: \$600 or four (4) times the

mediator’s hourly rate agreed to by the parties and the mediator; and

(2) Additional Mediation Sessions: \$150 per hour, or such other hourly rate agreed to by the parties and the mediator.]

\* \* \*

**Rule 10332. Schedule of Fees for Customer Disputes**

(a) – (h) No change.

[(i) Each party to a matter submitted to a mediation administered by the Association where there is no Association arbitration proceeding pending shall pay an administrative fee of \$150.]

[(j) The parties to a mediation administered by the Association shall pay all of the mediator’s charges, including the mediator’s travel and other expenses. The charges shall be specified in the Submission Agreement and shall be apportioned equally among the parties unless they agree otherwise. Each party shall deposit with the Association their proportional share of the anticipated mediator charges and expenses, as determined by the Director of Mediation, prior to the first mediation session. Mediator charges, except travel and other

expenses, are as follows:

(1) Initial Mediation Session: \$600 or four (4) times the mediator’s hourly rate agreed to by the parties and the mediator; and

(2) Additional Mediation Sessions: \$150 per hour, or such other hourly rate agreed to by the parties and the mediator.]

\* \* \*

**Rule 10403. Arbitration Proceedings**

(a) Unless the parties agree otherwise, the submission of a matter for mediation shall not stay or otherwise delay the arbitration of a matter pending under this Code. When all parties agree to stay the arbitration in order to mediate the claim, the arbitration proceeding shall be stayed, notwithstanding any provision to the contrary in this Code.

(b) If mediation is conducted through NASD Dispute Resolution, no adjournment fees will be charged for staying the arbitration proceeding in order to mediate.

\* \* \*

## **NASD Notice to Members 00-64**

### **Rule 10407. Mediation Fees**

#### **(a) Filing Fees: Cases Filed Directly in Mediation**

Each party to a matter submitted directly to a mediation administered by the Association shall pay an administrative fee to the Association in the amounts indicated in the schedule below, unless such fee is specifically waived by the Director of Mediation.

<b><u>Amount in Controversy</u></b>	<b><u>Customer and Associated Person Fees</u></b>	<b><u>Member Fee</u></b>	<b><u>Total Fees</u></b>
<b><u>\$.01-\$25,000</u></b>	<b><u>\$ 50</u></b>	<b><u>\$150</u></b>	<b><u>\$200</u></b>
<b><u>\$25,000.01-\$100,000</u></b>	<b><u>\$150</u></b>	<b><u>\$300</u></b>	<b><u>\$450</u></b>
<b><u>Over \$100,000</u></b>	<b><u>\$300</u></b>	<b><u>\$500</u></b>	<b><u>\$800</u></b>

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#### **(b) Filing Fees: Cases Initially Filed in Arbitration**

When a matter is initially filed in arbitration and subsequently submitted to a mediation administered by the Association, each party shall pay an administrative fee to the Association in the amounts indicated in the schedule below, unless such fee is specifically waived by the Director of Mediation.

<b><u>Amount in Controversy</u></b>	<b><u>Customer and Associated Person Fees</u></b>	<b><u>Member Fee</u></b>	<b><u>Total Fees</u></b>
<b><u>\$.01-\$25,000</u></b>	<b><u>\$ 0</u></b>	<b><u>\$ 0</u></b>	<b><u>\$ 0</u></b>
<b><u>\$25,000.01-\$100,000</u></b>	<b><u>\$100</u></b>	<b><u>\$150</u></b>	<b><u>\$250</u></b>
<b><u>Over \$100,000</u></b>	<b><u>\$250</u></b>	<b><u>\$500</u></b>	<b><u>\$750</u></b>

#### **(c) Mediator Fees and Expenses**

The parties to a mediation administered by the Association shall pay all of the mediator's charges, including the mediator's travel and other expenses. The charges shall be specified in the Submission Agreement and shall be apportioned equally among the parties unless they agree otherwise. Each party shall deposit with the Association its proportional share of the anticipated mediator charges and expenses, as determined by the Director of Mediation, prior to the first mediation session.

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### INFORMATIONAL

# Primex Auction System

## Nasdaq Is Establishing The Primex Auction System As A New Facility

### SUGGESTED ROUTING

*The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.*

- Legal & Compliance
- Operations
- Senior Management
- Technology
- Trading & Market Making

### KEY TOPICS

- Trading Systems

### Executive Summary

The National Association of Securities Dealers, Inc. (NASD<sup>®</sup>) and Nasdaq<sup>®</sup> Boards have agreed to establish the Primex Auction System<sup>™</sup>, a new trading system designed to replicate a competitive trading crowd in an extended electronic environment. Nasdaq will operate the system as a facility of The Nasdaq Stock Market<sup>®</sup> under an agreement between Nasdaq and Primex Trading N.A., L.L.C., the venture that holds the license to the system. Nasdaq is offering the system as an additional execution service to any NASD member, further enhancing opportunities for price and size improvement. The system, which is scheduled to start operating at the end of the first quarter of 2001, will be available for Nasdaq-listed securities and exchange-listed securities traded in the Nasdaq InterMarket.<sup>SM</sup>

The Nasdaq-operated Primex facility will allow, on a voluntary basis, market makers and others, including order entry firms and electronic communications networks (ECNs), to enter market orders and executable limit orders into the system for exposure to a broad electronic crowd. These orders may immediately interact with other interest or orders already resident within the Primex Auction System, or may elicit other responses from the crowd during the exposure, all dynamically priced within the context of the best publicly displayed bid and offer. Participants entering orders into the system may place minimum price improvement conditions on the orders they enter to attempt to obtain prices for those orders superior to the best publicly displayed prices. All interaction of trading interest within Primex will be anonymous until the end of the day. Customer orders that do not result in an execution in Primex may be internalized by the firm that entered

the order or routed to another Nasdaq execution system.

The system has been designed to increase order exposure and interaction, and provides an effective means for the market at-large to independently price customer orders, particularly in the coming decimal environment. While participation in the Primex Auction System is voluntary, Nasdaq believes it will provide a useful means for seeking price and size improvement in the Nasdaq Stock Market and therefore should assist firms in satisfying their best execution duties. Moreover, the Primex Auction System will provide benefits and incentives for market makers to participate. Market makers that use the system for their customers can still maintain control of their order flow and commit capital for the benefit of their customers' orders.

Primex would be open to any NASD member in good standing and to non-NASD members that an NASD member is willing to sponsor and authorize.

### Questions/Further Information

The NASD and Nasdaq Boards want to provide members with information regarding the way the Primex Auction System will operate and the rules that will govern its use. This synopsis is intended to provide members with a detailed overview of the System and its rules.

If you have questions or comments on how the Primex Auction System will operate, please contact Eugene Lopez, Senior Vice President, Department of Trading and Market Services, Nasdaq, at (202) 728-6998; or Richard C. Strasser, Director, Department of Trading and Market Services, Nasdaq, at

(202) 728-8338 **no later than October 16, 2000.**

## **HOW THE PRIMEX AUCTION SYSTEM AND ITS RULES WILL WORK**

This *Notice* is intended to provide NASD members with a descriptive overview of how the Primex Auction System will operate and how the rules governing its use will work. The Primex Auction System will be made available on a voluntary basis to any interested NASD member that is in good standing and has executed the necessary agreements and forms with Nasdaq or its affiliate. Non-NASD members may access Primex through a Participant by becoming a sponsored Subscriber of the Participant. Users will be permitted to access Primex through: a Primex Auction Workstation service; an Application Programming Interface; a FIX programming interface; a Computer to Computer Interface; and possibly, in the future, through an Internet browser. The system will be available through a new network, independent of Nasdaq's existing network. The system offering the Primex facility will interface, however, with other Nasdaq services, such as the Small Order Execution System<sup>SM</sup> (SOES<sup>SM</sup>), Computer Assisted Execution System<sup>SM</sup> (CAES<sup>SM</sup>), Automated Confirmation Transaction Service<sup>SM</sup> (ACT<sup>SM</sup>), and when it becomes available, Super-Montage.

### ***Voluntary Nature Of The System***

Nasdaq will offer the Primex facility to any NASD member that chooses to use this type of system to obtain price improvement or enhanced liquidity for its customer or principal orders. The facility is meant to serve as a means, but certainly not as the exclusive acceptable means, for obtaining price improvement. No NASD rule will require an NASD

member to use Primex in meeting a member's best execution obligations.

### ***Types Of Primex Participants***

There will be two categories of participants in the Primex Auction System: Crowd Participant and Primex Auction Market Maker (PAMM).<sup>1</sup> Becoming a Participant automatically entitles that entity to be a Crowd Participant for **any** eligible security. Crowd Participants may expose orders to the Primex Crowd or respond to the orders of other Participants during an auction. A Participant also may choose to register as a PAMM, on a stock-by-stock basis, which entitles that Participant to certain privileges and subjects it to certain responsibilities for those stocks, as discussed below. All users may expose orders to the Primex Crowd, regardless of their status. The remainder of this *Notice* is divided into three parts: the first part describes the way Participants may enter orders seeking price improvement; the second part describes the way Crowd Participants may respond to orders seeking price improvement; and the third part explains trade processing, anonymity, and sponsored access.

## **1. Primex Order Entry**

### ***Types Of Orders Accepted And Exposure Duration***

The Primex Auction System will not be a display facility for limit orders and thus will not be an ECN Display Alternative. The System will accept only market orders and executable limit orders.<sup>2</sup> Only the size and side of an order will be communicated to the Crowd, and only for the time during which the order is available for execution.

Participants will have a range of alternatives regarding the manner

in which their orders may be exposed, depending on the characteristics of those orders and the way Participants choose to use the system for their customers. Participants that enter orders will specify the maximum exposure period, which can be "zero" seconds (*i.e.*, immediate), 15 seconds, or 30 seconds. This duration effectively is the **maximum time of the auction** for that order, which is in keeping with a goal of the Primex Auction System to speed the execution process while providing meaningful opportunities for price improvement and enhanced liquidity. Thus, an order may be executed well before the maximum exposure time has expired provided it can be matched with other interest that satisfies any conditions placed on the order by the Participant that entered it, such as a minimum amount of price improvement. Orders entered with a specified price may only be exposed to seek an immediate execution in whole or in part (referred to in the System as a "zero second" auction). Unpriced market orders for at least 10,000 shares or \$200,000 in market value may be exposed for immediate execution in a zero second auction as well.

In a zero second auction an order exposed to the Crowd would interact with other orders on the opposite side of the market already being exposed within the System or Indications that respond automatically to orders during an auction. Any unexecuted portion of any order will be returned to the entering Participant at which time it may be internalized, or routed to other Nasdaq execution systems for execution as would be consistent with the Participant broker/dealer's best execution responsibilities. Choices regarding unexecuted portions of orders are

## NASD Notice to Members 00-65

decided by the Participant entering an order at the time of order entry.

### **Crowd Participant Watch List For Eligible Securities**

Crowd Participants may monitor the availability of orders exposed in an auction through the use of a Watch List. Nasdaq will notify a Crowd Participant electronically when an order in a security on that Participant's Watch List is exposed during an auction and available for response by the Crowd Participant.

### **Conditions And Match Parameters**

The Primex Auction System will allow a Participant to place certain conditions and match parameters on the orders that it enters into the System. These vary depending on whether the Participant is a Crowd Participant or a PAMM. All Participants may enter orders (as principal, riskless principal, or agent) and all may place a Minimum Relative Price Improvement condition on agency and riskless principal orders they expose to the System. This condition establishes the minimum amount of price improvement, relative to the best publicly displayed bid or offer (NBBO), that the order must receive before it will be executed against in whole or in part by any Crowd interest.

In addition, PAMMs (but not Crowd Participants) are entitled, but not obligated, to place match parameters on the orders that they expose to the Primex Auction System in stocks in which they are registered as a PAMM. These match parameters provide a PAMM with a level of control over its order flow, allowing the PAMM to commit capital and provide executions to its customer orders in conjunction with the exposure process. There are three types of match parameters: (1) Two Cent Match; (2) 50 Percent Match; and (3) Block Facilitation

Match. In addition, PAMMs may expose clean cross orders to the Crowd.

### **Two Cent Match Parameter:**

Orders entered with this parameter will be executed against any interest in the Crowd during its exposure, at the time such interest is available, provided such Crowd interest would provide price improvement that is more than two cents superior to the NBBO at that time. If there is Crowd interest that would provide more than two cents price improvement to the order, in whole or in part, that interest will execute against the order accordingly. If there is Crowd interest for any part of the order but such interest does not satisfy the Two Cent Match parameter, then the entire order will be immediately executed against the PAMM that entered it at the best price that was nonetheless offered by the Crowd, at the time such Crowd interest is available and regardless of the size of that interest. If at the end of the exposure any portion of an order remains unexecuted, that portion will be executed against the PAMM that entered the order at the NBBO at that time.

For example: The NBBO for a security is \$20 – 20.10. A PAMM enters a customer order to buy 2,000 shares and has placed a Two Cent Match Parameter on that order. The PAMM selects a maximum exposure period of 15 seconds for the order. A Crowd Participant responds with an offer to sell 1,000 shares for two cents superior to the NBBO (*i.e.*, \$20.08). Because the PAMM that entered the original order is willing to match the price of any Crowd interest within two cents of the NBBO, the entire 2,000 shares of the original customer order will be executed against the PAMM that entered it at the improved price of \$20.08. Had

the Crowd offered a Response to sell at a price equivalent to \$20.07 or less, such Crowd interest would execute against the customer order. If an unexecuted balance still remained at the end of the 15 seconds, such balance of the customer's order would be executed against that PAMM at the best displayed offer at that time.

**50 Percent Match:** Orders entered with this parameter will be executed against any interest in the Crowd during its exposure at the price(s) and size of such Crowd interest for no more than 50 percent of the order. Any execution with the Crowd will immediately cause the Primex Auction System to provide the order with an additional execution of like size and price against the PAMM that entered it. Any unexecuted portion of the order will be executed immediately against the PAMM that entered it at the NBBO at that time.

For example: The NBBO for a security is \$20 – 20.10. A PAMM for that security enters into the Primex Auction System an order to buy 2,000 shares for a customer and places a 50 Percent Match parameter on that order. The PAMM selects an exposure time of 15 seconds. During its exposure, the order elicits the following executions by other Crowd Participants (which could be in the form of Indications, Responses, or contra-side orders to sell): 200 shares at \$20.04 and 500 shares at \$20.05. Primex will execute these transactions and immediately match each one as they occur by executing an additional 200 shares and 500 shares, at \$20.04 and \$20.05, respectively, against the PAMM that entered the original customer order. If there is no other interest from the Crowd at the end of the 15-second exposure period, Primex will cause the remaining



balance of 600 shares to be automatically executed against the PAMM that entered the order at the best publicly displayed offer at that time. If the best offer publicly displayed were still \$20.10 at this time, this would result in the PAMM selling the balance of 600 shares to the customer at \$20.10.

**Block Facilitation Match:** This parameter is similar to the 50 Percent Match parameter, but it applies to orders that are for at least 10,000 shares. A PAMM entering an order with the Block Facilitation Match can specify a maximum exposure time of 0, 15 or 30 seconds whereas orders with the 50 Percent Match parameter (unless they are of block size) must be exposed for a maximum of 15 or 30 seconds. Any unexecuted portion of an order with this parameter will be executed immediately against the PAMM that entered it at the NBBO.

#### ***Clean Cross Exposure***

Finally, a PAMM may enter Clean Cross orders for the accounts of two separate customers where the cross is for at least 10,000 shares. Clean Cross orders are exposed in a zero second auction. The two sides of the Clean Cross will execute against each other at the midpoint of the NBBO unless there is superior-priced interest in the Primex Auction System that breaks up either or both sides of the cross. To break up a side of a cross the resident Crowd interest must total at least 10,000 shares in the aggregate and be at a price or prices that are all superior to the bid-ask midpoint by at least a whole cent. Any unexecuted interest will be returned to the PAMM unexecuted.

#### ***Market Maker Guarantees***

PAMMs may choose to establish pre-set execution guarantees for

each customer order they enter. This guarantee allows a PAMM to automatically provide an execution to its own customers within the system, at size levels established by the PAMM, for any unexecuted portion of an order at the end of its exposure.

#### ***Phase-In Of Primex Auction Market Maker Obligations***

In addition to being able to enter the match parameters and clean cross exposure discussed above, it is anticipated that a PAMM in a given security will be entitled to share in the execution revenues that the Primex Auction System generates. To maintain its status as a PAMM, however, a Participant must demonstrate its commitment to the System and the Crowd, after a brief phase-in period, by exposing a certain minimum number of its customer orders to the System.

Specifically, for the first calendar quarter in which the System is operational, any Participant may become a Primex Auction Market Maker (and thus be entitled to the benefits of being a PAMM) without regard to the percentage of its customer orders it submits to the System. Beginning with the second calendar quarter in which the System is operational, a Participant may maintain its status as a PAMM only if it exposed to the System at least 50 percent of its eligible customer orders (*i.e.*, those under 1100 shares) during the previous calendar quarter. Beginning with the third calendar quarter in which the System is operational, and each calendar quarter thereafter, a Participant may maintain its status as a PAMM only if it submitted at least 80 percent of its eligible customer orders during the previous calendar quarter. Of course, a Nasdaq market maker that chooses not to become a PAMM for any stock will never be

prevented from using the System at any time by either entering orders or responding to auctions as a Crowd Participant.

## **2. Responding To Orders Seeking Price Improvement**

Any Crowd Participant may submit (either as principal or agent) either Indications or Responses to the Primex Auction System to interact with orders that become available in Primex. These Indications or Responses are not exposed or communicated to any Participant, except to the extent they result in an execution with an order. Responses may be either a fixed-price Response (*e.g.*, sell 1,000 shares at \$20) or a relative-priced Response (*e.g.*, buy 1000 at the bid plus three cents).

#### ***Types Of Indications***

There are two types of Indications: (1) Predefined Relative Indication (PRI) and Go-Along Indication. A Crowd Participant may use PRIs to act as "intelligent agents" in the System that respond automatically, at dynamically updated prices, to an order that becomes available during an auction. PRIs have no specific, fixed price. Rather, they are expressed, at the time of their entry, in terms relative to the best bid or offer that exists when the System activates the PRI against orders in an auction. PRIs must be for a certain minimum number of shares depending on the amount of price improvement over the NBBO (if any) that the PRI would offer. For example, a PRI that would respond at the NBBO must be for at least 3000 shares when it is entered, whereas a PRI that offers three cents or more price improvement superior to the NBBO may be for as few as 1,000 shares. The Primex Auction System will never execute an order at a price outside of the current NBBO.

A Crowd Participant may submit a Go-Along Indication to the Primex Auction System to respond automatically to orders that become available during an auction where there has been at least one other contemporaneous Crowd execution at the NBBO. Go-Along Indications have no specific price but will match against orders at the best publicly displayed bid or offer that exists when the Go-Along Indication is activated (provided there is no other interest available within the System). A Go-Along Indication must be for at least 10,000 shares.

### **Crowd Participant Restrictions On Order Interaction**

Crowd Participants may restrict the types of orders with which their Indications and Responses will interact. Specifically, they may elect to have their Responses and Indications interact with all available orders or only with public customer orders (*i.e.*, no proprietary orders). Participants that enter orders, however, may **not** limit the type of interest that may respond to those orders.

### **Order Interaction**

Orders entered by two or more Participants may interact with one another (as well as with Responses and Indications). Responses and Indications may not interact with one another. Market orders that are matched against other market orders being auctioned are executed at the midpoint of the NBBO.

### **3. Trade Processing, Anonymity And Sponsored Access**

The Primex Auction System will process all trade activity among Participants on an anonymous basis until the end of the day. After facilitating an execution, Primex will send an execution report to all Participants involved. The execution report will indicate the details of the transaction but will not contain the identity of the contra-party. For regulatory and other necessary purposes, the NASD, Nasdaq, and the National Securities Clearing Corporation (NSCC) will have the ability to determine the identity of the actual contra-parties at any time. At the end of each trading day, the actual original contra-party for executions obtained within Primex will be made available to the Participants involved through Nasdaq's systems.

Matches within the Primex Auction System are executed and reported through Nasdaq systems for public tape reporting and forwarding to NSCC for clearing, where necessary. Participants (or their clearing firms) will be responsible for the clearance and settlement of all trades executed through the Primex Auction System to the extent permitted by their clearing firm. Thus, for Participants that are correspondents of other clearing firms, such correspondents must be authorized by their clearing firm before using the System. The System provides tools for clearing

firms to establish, monitor, and modify clearing limits on a real-time basis. Executions within Primex cannot be re-allocated to different clearing firms after the execution.

Non-NASD members may access Primex through an NASD member Participant by becoming a sponsored Subscriber of that NASD member Participant, to the extent authorized by the member. For Participants that sponsor other Subscribers, the Primex Auction System provides tools for sponsors to establish, monitor, and modify credit limits for their Subscribers on a real-time basis. Firms that sponsor non-NASD members may always monitor all activity and execution reports involving the sponsored entity in real-time through the System.

### **Endnotes**

<sup>1</sup>A PAMM in a Nasdaq-listed security must be registered as a Nasdaq market maker in that security. A PAMM in an ITS/CAES eligible security must be registered as an ITS/CAES market maker in that security.

<sup>2</sup>Executable limit orders include marketable limit orders as well as orders priced at-the-quote or between-the-quote.

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**INFORMATIONAL****Confidential  
Customer  
Information**

NASD Regulation  
Withdraws Proposed  
Rule Regarding  
Confidential Customer  
Financial Information;  
SEC Issues Regulation  
S-P, "Privacy of  
Consumer Financial  
Information"

**SUGGESTED ROUTING**

*The Suggested Routing function is meant to aid the reader of this document. Each NASD member firm should consider the appropriate distribution in the context of its own organizational structure.*

- Legal & Compliance
- Senior Management

**KEY TOPICS**

- Consumer Information
- SEC Regulation S-P

**Executive Summary**

In light of recently enacted federal law, NASD Regulation, Inc. (NASD Regulation<sup>SM</sup>) has withdrawn its rule proposal announced in *Notice to Members 97-12* (March 1997) regarding the use and release of confidential customer financial information. The new law mandates rulemaking governing the privacy of consumer financial information by federal agencies, including the Securities and Exchange Commission (SEC), thereby eliminating the need for NASD Regulation to pursue its own rules.

On June 22, 2000, the SEC issued Regulation S-P, "Privacy of Consumer Financial Information." Regulation S-P goes into effect on a voluntary basis starting November 13, 2000; it becomes mandatory on July 1, 2001. A copy of Regulation S-P is included with this *Notice*.

**Questions/Further Information**

Legal questions or comments concerning this *Notice* may be directed to Gregory Dean, Assistant General Counsel, Office of General Counsel, NASD Regulation, at (202) 728-8159. Other questions or comments concerning this *Notice* may be directed to Paul Voketaitis, Member Regulation, NASD Regulation, at (202) 728-8843.

**Background**

In *Notice to Members 97-12*, NASD Regulation proposed requirements regarding the use of confidential financial information obtained from a customer by a member firm, either directly or through a business affiliate, and the release of such information to any third party, whether affiliated or nonaffiliated. In general, the proposal prohibited the release by a member (or its

affiliate) of confidential customer financial information unless prior written consent was obtained from the customer or proper notification was given to the customer about the intended release of the information.

NASD Regulation received approximately 50 comments in response to the proposal in *Notice to Members 97-12*. Many of the comments raised significant concerns about the proposed rule. Because of the substantial opposition to the proposed rule and due to potential congressional action in this area, NASD Regulation did not take any action on the proposal.

**Gramm-Leach-Bliley Act**

On November 12, 1999, the President signed into law the Gramm-Leach-Bliley Act (GLB).<sup>1</sup> Title V of the GLB sets forth privacy requirements for use of nonpublic personal financial information by banks, securities industry members, insurance companies, and other financial institutions. The GLB required the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision (collectively known as the "federal banking regulators"), the SEC, the National Credit Union Administration (NCUA), and the Federal Trade Commission (FTC) to coordinate the issuance of regulations governing the collection, use, and safeguarding of nonpublic personal financial information. In addition, the law recommended that the federal regulators work with state insurance commissioners on the regulations. The federal banking regulators, NCUA, and FTC issued proposed regulations in February 2000 and issued final regulations in

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## NASD Notice to Members 00-66

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May 2000. The SEC's final regulation, Regulation S-P, "Privacy of Consumer Financial Information," was issued in June 2000.

Due to the privacy provisions of GLB and the SEC's issuance of Regulation S-P, NASD Regulation believes that its proposed rule regarding confidential customer financial information is no longer necessary. On July 26, 2000, the NASD Regulation Board approved a measure to withdraw *Notice to Members 97-12*.

### SEC Regulation S-P

On March 2, 2000, the SEC issued a proposed regulation, Regulation S-P,<sup>2</sup> and on June 29, the SEC's final regulation was published in the *Federal Register*.<sup>3</sup> Regulation S-P will go into effect on November 13, 2000, on a voluntary basis, and will become mandatory on July 1, 2001.

Regulation S-P is built around an "opt-out" policy. This means that as long as certain notices are given to consumers and customers, then financial institutions<sup>4</sup> (broker/dealers) are permitted to share their clients' financial information with the broker/dealers' affiliated and non-affiliated third parties unless the consumers and customers opt out of the information sharing arrangement. The SEC defines a "consumer" as an individual who obtains or has obtained a financial product or service from a financial institution. Typically, a consumer has no further contact with the financial institution other than the one-time delivery of products or services. In addition, the SEC defines a "customer" as a consumer who has developed a continuing relationship with a financial institution to provide products or services.<sup>5</sup>

According to the SEC, in the first year a broker/dealer becomes subject to the rule, a broker/dealer must comply with the following requirements:

- (1) prepare notices describing the firm's privacy policies;
- (2) provide an initial privacy notice and opt-out notice to each consumer;
- (3) provide an initial privacy notice to each new customer (who did not receive a notice when he or she was a consumer);
- (4) provide an annual privacy notice to each existing customer; and
- (5) adopt policies and procedures that address the protection of customer information and records.

The SEC also recommends that broker/dealers review their contracts with third parties for administrative services and joint marketing agreements to ensure that the contracts reflect the firms' privacy policies. After the first year, broker/dealers would be required to revise notices only to reflect changes in their privacy policies. Similarly, these firms would have to revise their policies and procedures on safeguarding customer information as appropriate to ensure the protection of the information.

### Privacy Notices

For the privacy notices, the rule requires broker/dealers to disclose details on the broker/dealers' information sharing arrangements. Specifically, the rule requires broker/dealers to disclose:

- the categories of nonpublic personal information that a broker/dealer may collect;

- the categories of nonpublic personal information that a broker/dealer may disclose;
- the categories of affiliates and nonaffiliated third parties to whom a broker/dealer discloses nonpublic personal information other than service providers and third parties that aid in fulfilling the service requested by a consumer;
- the broker/dealer's policies with respect to sharing information about former customers;
- the categories of information that are disclosed under agreements with third party service providers and joint marketers and the categories of third parties providing the services;
- a consumer's right to opt out of the disclosure of nonpublic personal information to nonaffiliated third parties;
- any disclosures regarding affiliate information sharing opt outs a financial institution is providing under the Fair Credit Reporting Act; and
- the institution's policies and practices with respect to protecting the confidentiality, security, and integrity of nonpublic personal information.

Essentially, consumers and customers must be given notice when information is going to be shared and then be given the opportunity to opt out of that sharing arrangement.

In certain circumstances, Regulation S-P permits broker/dealers to use "short-form" initial notices for consumers with whom the broker/dealer does not

have a customer relationship. The short-form notice must be accompanied by an opt-out notice and information on where the consumer may obtain additional information on the firm's privacy policies.

Under Regulation S-P, any information given by consumers or customers to broker/dealers to obtain a product or service will generally be considered to be nonpublic financial information. In addition, any list, description, or other grouping of consumers and customers that is derived from this information also may be considered nonpublic information. A broker/dealer may consider the information received to be publicly available (and therefore not subject to the restrictions of Regulation S-P) if the broker/dealer reasonably believes that the information is lawfully available from three sources:

- (1) federal, state, or local government records;
- (2) widely distributed media; or
- (3) disclosures to the general public that are required to be made by federal, state, or local law.

### **Information Sharing Arrangements**

Another important aspect of Regulation S-P concerns the information sharing arrangements broker/dealers may have with their affiliates and with nonaffiliated third parties.

#### *Affiliates*

Generally, broker/dealers may share consumers' and customers' information with the broker/dealers' affiliates as long as that fact is disclosed in the privacy notices. Consumers and customers may not

opt out of that information sharing arrangement.

#### *Nonaffiliated Third Parties*

If, however, a broker/dealer has an information sharing agreement with nonaffiliated third parties, then that fact must be disclosed, and consumers and customers may generally opt out of having their information shared under that agreement.

The GLB does provide a series of exceptions that permit broker/dealers to share information with nonaffiliated third parties and in which consumers and customers may not opt out of those sharing arrangements. These exceptions include, but are not limited to, arrangements with joint marketers and service providers. While consumers and customers may not opt out of these information sharing arrangements, these arrangements must be disclosed in the privacy statements.

#### *Introducing And Clearing Brokers*

With regard to the information sharing arrangements between introducing brokers and clearing brokers, the regulation considers introducing brokers and clearing brokers as each having an individual relationship with consumers and customers. In other words, Regulation S-P recognizes that either the introducing broker or the clearing broker could share nonpublic consumer or customer financial information with third parties outside of the introducing/clearing relationship. The regulation will, however, permit the introducing brokers and clearing brokers to send one joint privacy notice to consumers and customers as long as the introducing and clearing brokers' privacy policies and notices are accurate for each institution.

### **Delivery Of Initial Privacy Notices**

The delivery of the initial privacy notices to consumers and customers is another important aspect to Regulation S-P. For a consumer, the privacy notice must be delivered by broker/dealers before any nonpublic information is to be disclosed to third parties. For a customer, the privacy notice must be delivered by broker/dealers prior to the establishment of the customer relationship. Recognizing that many customer relationships with broker/dealers may be established through telephone calls, Regulation S-P will permit the initial privacy notices to be given as part of a Customer Agreement Form even if the form is sent out after the request for service by a consumer or customer. This may only be permitted when the sending of the notice prior to the establishment of a customer relationship "would substantially delay the consumer's transaction" and the customer agrees to receive the notice at a later time.

As Regulation S-P highlights the use of electronic communications and Web sites, the privacy policies, initial and annual notices, and opt-out notices may, under certain conditions, be delivered through e-mail and the Internet.

### **Small Firm Compliance**

With regard to small firms, the SEC believes that compliance will be relatively simple. As stated in the SEC's release, since most small firms do not share nonpublic consumer financial information other than with service providers, the SEC believes that a simple set of model notices will assist small firms in their compliance. The SEC includes examples and model disclosure forms as part of the *Federal Register* release; **however, unlike the federal banking regulators', NCUA's, and FTC's**

rules, the SEC will not permit the use of the examples and model forms as a safe harbor by firms.

### **Regulation S-P And Other Federal Agencies' Regulations**

While Regulation S-P is substantially similar to the final regulations issued by the federal banking regulators, NCUA, and FTC, there are differences (e.g., the SEC's lack of a safe harbor for the use of the SEC's model forms). Firms that are affiliated with banks and/or other financial entities should pay particular attention to the differences between these regulations and adopt procedures concerning the release of consumer and customer financial information that ensure compliance with all applicable requirements.

### **GLB And State Law**

GLB was not intended to alter or supersede any state law, and expressly permits states to adopt any statute, regulation, order, or interpretation that affords persons greater protection than is provided under GLB's privacy provisions.

### **Endnotes**

<sup>1</sup>Public Law 106-102.

<sup>2</sup>Privacy of Consumer Financial Information (Regulation S-P), Exchange Act Release No. 42484 (March 2, 2000), 65 Fed. Reg. 12354 (March 8, 2000).

<sup>3</sup>Exchange Act Release No. 42974 (June 22, 2000), 65 Fed. Reg. 40333 (June 29, 2000).

<sup>4</sup>For the term "financial institution," the SEC uses the definition contained in the GLB law which is any institution that engages in financial activities as described in section 4(K) of the Bank Holding Company Act of 1956. For Regulation S-P, the term includes broker/dealers, investment advisers, investment companies, and other entities engaging in activities that are financial in nature or incidental to such financial activities.

<sup>5</sup>Generally, references in Regulation S-P to "consumers" also apply to "customers."

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