SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-29094; File No. S7-27-89]

RIN 3235-AA43

Initiation or Resumption of Quotations Without Specified Information

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: The Commission is adopting amendments to Rule 15c2-11 under the Securities Exchange Act of 1934 ("Exchange Act"). Rule 15c2-11 governs the submission and publication of quotations by brokers or dealers for certain over-the-counter securities. The amendments expressly require a broker-dealer to review the information and documents specified in paragraph (a) of the Rule before publishing a quotation for such securities in a quotation medium, and to have a reasonable basis under the circumstances for believing that the information is accurate in all material respects and obtained from reliable sources. The amendments also require the broker-dealer to have in its records a copy of any trading suspension order, or Exchange Act release announcing a trading suspension, issued by the Commission respecting any of such an issuer's securities during the preceding twelve months, and require the broker-dealer to review the paragraph (a) information together with the information contained in the trading suspension orders or releases and any other material information concerning the issuer in the broker-dealer's knowledge or possession.

The Rule's information gathering requirements in paragraph (a) also are amended. If the issuer of a security that is required to file reports under the Exchange Act ("reporting issuer") has not filed its first annual report, a broker-dealer is required to have in its records a copy of the document subjecting the issuer to reporting obligations under the Exchange Act, together with any subsequently filed reports. Also, the amendments generally require a broker-dealer to obtain a copy of any current report filed with the Commission by a reporting issuer since its latest annual report.

In addition, the Commission is clarifying the period during which broker-dealers must retain the specified information, and amending the time by which broker-dealers must furnish certain information to the interdealer quotation system to commence quotations. Finally, the amendments clarify the exception for NASDAQ securities.

EFFECTIVE DATE: June 1, 1991.

FOR FURTHER INFORMATION CONTACT: Nancy J. Sanow or Jodie J. Kelley, Office of Trading Practices, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549, telephone (202) 272-2848.

SUPPLEMENTARY INFORMATION:

I. Introduction and Summary of Amendments

The Securities and Exchange Commission has adopted amendments to Rule 15c2-11 ("Rule") [1] under the Securities Exchange Act of 1934 ("Exchange Act"), [2] which governs the publication and submission of quotations for certain over-the-counter securities in a quotation medium. [3] As a result of exceptions to its provisions, [4] the Rule applies to the initiation or resumption of quotations for securities traded in the non-NASDAQ market. [5] The Rule requires that brokers and dealers have specified information about a security covered by the Rule ("covered security") and its issuer before publishing quotations for that security.

In the past few years, the Commission has become increasingly concerned about instances of fraudulent and manipulative conduct involving transactions in low-priced securities, commonly referred to as "penny stocks," many of which are traded in the non-NASDAQ market. The Commission is actively addressing penny stock abuses through such measures as educational efforts, [6] regulatory initiatives, [7] enforcement actions, [8] and trading suspensions. [9] In this context, the Commission has focussed on the role of market makers in facilitating the trading of certain penny stocks where, for example, available information about the issuer suggests that a fraudulent or manipulative scheme may be present. Also, there have been a number of instances where broker-dealers, without regard to their obligations under Rule 15c2-11, resumed quotations for penny stocks that recently had been subject to Commission trading suspension orders. [10]

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[1] 17 CFR 240.15c2-11.

[2] 15 U.S.C. 78a *et seq.*

[3] See paragraph (e)(1) of the Rule, 17 CFR 240.15c2-11(e)(1).

[4] See, *e.g.*, paragraph (f)(1) (excluding over-the-counter quotations for exchange-listed securities), paragraph (f)(3) (the "piggyback" exception), and paragraph (f)(5) (excluding quotations for securities authorized for quotation in the NASDAQ system operated by the National Association of Securities Dealers, Inc. ("NASD")) of the Rule, 17 CFR 240.15c2-11(f)(1),(3), and (5).

[5] In this release, the term "non-NASDAQ market" means the market for those securities traded in the over-the-counter market which are neither exchange-listed nor quoted on NASDAQ; the term "non-NASDAQ securities" means those securities traded in the non-NASDAQ market.

Currently, the principal interdealer quotation media for non-NASDAQ securities are the National Daily Quotation Service (commonly referred to as the "pink sheets"), published and distributed by the National Quotation Bureau, Inc. and the OTC Bulletin Board Display Service ("OTC Service"), operated by the NASD. See Securities Exchange Act Release No. 27975A (May 30, 1990), 55 FR 23161 ("Release No. 34-27975A"). The OTC Service and the "pink sheets," as well as certain similar quotation media of a more limited geographic scope, such as Metro Data Company's "white sheets," reflect markets for securities of lesser-known issuers. These markets are generally characterized by low levels of trading activity and dealer competition. Information concerning these issuers often is not readily available to the marketplace, and few analysts regularly follow their securities.

[6] See "Beware of Penny Stock Fraud" (November 1988), SEC Press Release 88-111; "Penny Stock Telephone Fraud" (June 1989), SEC Press Release 89-56; and "New Penny Stock Cold Calling Rule" (December 1989), SEC Press Release 90-3.

[7] See Securities Exchange Act Release No. 29093 (April 17, 1991) (proposing penny stock disclosure rules); Securities Act Release No. 6891 (April 17, 1991) (proposing Rule 419 under the Securities Act of 1933); Securities Exchange Act Release No. 27160 (August 22, 1989), 54 FR 35468 (adopting Rule 15c2-6 under the Exchange Act, 17 CFR 240.15c2-6).

[8] See, *e.g.*, *SEC* v. *Brownstone-Smith Securities Corp.*, No. 89-6249-CIV-GONZALEZ (S.D. Fla. permanent injunction entered May 25, 1989), summarized in Litigation Release Nos. 12126 (June 12, 1989), 43 SEC Docket (CCH) 1748, and No. 12132 (June 16, 1989), 43 SEC Docket (CCH) 1841; *SEC* v. *Kimmes*, No. 89-C-5942 (N.D. Ill. permanent injunctions entered Sept. 13, 1989, Oct. 13, 1989, July 27, 1990, Sept. 13, 1990 and Oct. 2, 1990), summarized in Litigation Release Nos. 12210 (Aug. 9, 1989), 44 SEC Docket (CCH) 467, No. 12254 (Sept. 25, 1989), 44 SEC Docket (CCH) 1162, No. 12290 (Oct. 13, 1989), 44 SEC Docket (CCH) 1571, No. 12582 (Aug. 15, 1990), 46 SEC Docket (CCH) 1442, No. 12632 (Sept. 24, 1990), 47 SEC Docket (CCH) 270, and No. 12685 (Oct. 26, 1990), 47 SEC Docket (CCH) 829; *SEC* v. *Stoneridge Securities, Inc.*, No. CV-S-89-096 PMP (D. Nev. permanent injunctions entered Feb. 2 and March 1, 1989), summarized in Litigation Release Nos. 11995 (Feb. 13, 1989), 42 SEC Docket (CCH) 1260 and No. 12048 (March 29, 1989), 43 SEC Docket (CCH) 912.

[9] See, *e.g.*, *U.S. Assurance Corp.*, Securities Exchange Act Release No. 27354 (October 11, 1989), 44 SEC Docket (CCH) 1280; *Novaferon Labs, Inc.*, Securities Exchange Act Release No. 26797 (May 9, 1989), 43 SEC Docket (CCH) 1245; *Westminster Financial Corp.*, Securities Exchange Act Release No. 26791 (May 8, 1989), 43 SEC Docket (CCH) 1237. See also note 70 *infra*.

[10] See *Bogley Securities, Inc.*, Securities Exchange Act Release No. 27673 (February 5, 1990), 45 SEC Docket (CCH) 590; *William* v. *Frankel & Company*, Securities Exchange Act Release No. 27649 (January 26, 1990), 45 SEC Docket (CCH) 529; *Richfield Securities, Inc.*, Securities Exchange Act Release No. 26129 (September 29, 1988), 41 SEC Docket (CCH) 1235.

To further the goal of preventing fraudulent, deceptive, and manipulative practices in the market for non-NASDAQ securities, including penny stocks, the Commission proposed amendments to the Rule.[11] Specifically, the Commission proposed that broker-dealers be required to review the Rule's specified information; have a reasonable basis for believing that the information is true and correct and obtained from reliable sources; have in its records a copy of any trading suspension order, or Exchange Act release announcing a trading suspension, issued by the Commission with respect to any of the issuer's (or its predecessor's) securities during the previous twelve months; and review the Rule's required information in light of the information contained in that order or release.[12] The Commission also proposed amendments to expand the information gathering requirements of the Rule for reporting issuers; clarify the time period that a broker-dealer must retain the specified information; revise the time period by which a broker-dealer must furnish the necessary form to the interdealer quotation system to initiate or resume a quotation; and clarify the exception for NASDAQ securities. The Proposing Release also sought commenter's views on the Rule's "piggyback" exception.[13] While the amendments were developed in the context of the Commission's concerns regarding penny stocks, the Rule and the present amendments are addressed to the fraudulent and manipulative potential that exists when a broker or dealer submits quotations concerning any non-NASDAQ security in the absence of certain information.[14]

Sixteen comment letters were received in response to the Proposing Release.[15] Commenters generally supported the Commission's efforts to prevent penny stock fraud. Commenters did not object to the requirements that market makers have specified information about a security and its issuer, and review that information, before publishing quotations. Most commenters, however, were concerned about the proposed standard for that review, *i.e.*, that the broker-dealer have a "reasonable basis for believing that the information is true and correct in relation to the date that the quotation is submitted," as they understood that standard. Commenters believed that this proposed amendment represented a significant and burdensome change in a broker-dealer's obligations and might cause a number of broker-dealers to cease making a market for non-NASDAQ securities, thereby impairing the liquidity of these stocks. Commenters favored the proposal to include trading suspension orders among the Rule's information requirements. However, they were divided on the proposed standard for review of the Rule's required information following expiration of a suspension order. After carefully considering the views of the commenters, the Commission has adopted the amendments with certain modifications.

II. Amendments

A. The Rule's Review Requirements

1. Paragraph (a) Introductory Text

a. The Commission proposed to clarify and enhance the degree of scrutiny that a broker-dealer must give to the required information prior to publishing a quotation. The Rule contained a "double negative" standard regarding the broker-dealer's belief as to the accuracy of the information, *i.e.*, the broker-dealer was required to have "no reasonable basis for believing (that the information) is not true and correct."[16] However, the Rule included an affirmative standard regarding the reliability of the source of the information, *i.e.*, the information had to be "obtained by the [broker-dealer] from sources which he has a reasonable basis for believing are reliable." The double negative language was susceptible to varying interpretation, especially when juxtaposed with the affirmative standard regarding the reliability of the information's source.

As the Commission has noted, the information gathering requirements of the Rule were designed to require the broker-dealer "to give some measure of attention to financial and other information about the issuer of a security before it commences trading in that security."[17] However, the Rule is precise as to the information the broker-dealer must obtain, but was ambiguous as to the relationship between the Rule's information gathering requirements and the obligations of the broker-dealer to review its contents. Thus, the Rule did not expressly require a broker-dealer to review the information in its records prior to entering a quotation for a non-NASDAQ security. Nevertheless, inherent in the prior requirements of paragraph (a)[18] was the obligation that the broker-dealer, at a minimum, inspect the documents to verify that it had received all of the required information and knew the sources of that information. Beyond that basic level, however, the nature of the broker-dealer's review obligations may have been uncertain, for example, where a broker-dealer, in addition to the information required by paragraph (a), also had knowledge or possession of material adverse information regarding the issuer prior to its publication or submission of a quotation. A firm might have argued that it had no duty to incorporate this additional information in the review process, and that this other information was only required to be documented and preserved in the broker-dealer's records by former paragraph (c) of the Rule.[19]

Although the comments generally indicated that some measure of review is appropriate, the substantial majority of commenters stated that the proposed paragraph (a) amendment would not simply clarify the required level of review, but would unduly expand the burdens, responsibilities, and liabilities of a broker-dealer. Many of these commenters believed that the amendments would impose on market makers a "due diligence" standard similar to that imposed on underwriters in a public offering of securities. Some commenters noted that, unlike an underwriter in a securities offering,

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[11] See Securities Exchange Act Release No. 27247 (September 14, 1989), 54 FR 39194 ("Proposing Release").

[12] The Proposing Release also set forth the Commission's interpretive position regarding a broker-dealer's obligations under the Rule following the expiration of a trading suspension. See Proposing Release, 54 FR at 39197–39198.

[13] See paragraph (f)(3) of the Rule, 17 CFR 240.15c2–11(f)(3). The "piggyback" exception is the subject of a companion release issued today by the Commission. See Section III infra.

[14] See Release 34–9310, 36 FR at 18641.

[15] Copies of these letters, as well as a Summary of Comments prepared by the staff, are contained in File No. S7–27–89 and are available for public inspection and copying at the Commission's Public Reference Room.

[16] See former paragraphs (a)(4) and (a)(5) of the Rule.

[17] See Securities Exchange Act Release No. 21470 (November 15, 1984), 49 FR 45117, 45118 ("Release 34–21470").

[18] That is, with respect to the items of information to be obtained and maintained by broker-dealers and with respect to the reliability of their sources of that information.

[19] 17 CFR 240.15c2–11(c) (1990). As discussed *infra*, the Commission has restructured former paragraph (b) of the Rule, 17 CFR 240.15c2–11(b) (1990), and former paragraph (c) to simplify the Rule's structure and to reflect the amendments to the Rule. The content of former paragraph (b) is unchanged. Former paragraph (c) provided in part that "broker-dealer shall maintain in writing as part of his records * * * any other information (including adverse information) regarding the issuer which comes to his knowledge or possession before the publication or submission of the quotation * * *."

market makers do not have a sufficiently substantial relationship with the issuer of the quoted security to permit them to undertake meaningful investigative activities. Even if the broker-dealer were to employ independent counsel or accountants, commenters noted that issuers would be reluctant to grant them access to their books and records. One commenter, the NASD, supported the requirements that the broker-dealer review the Rule's specified information and have a reasonable basis for believing that the information was obtained from a reliable source. The NASD, however, opposed adoption of the requirement that the broker-dealer have a reasonable basis for believing that the information is accurate "in relation to the day the quotation is submitted," because it believed that any such requirement would necessitate the performance of a merit-type review, including independent verification of the issuer's financial statements.

A substantial majority of commenters also suggested that a distinction be made between wholesale market makers [20] and retail firms.[21] Some commenters pointed out that wholesale market makers often ignore fundamentals (i.e., basic information about the issuer) and trade on the basis of perceived supply and demand of the quoted security. They believed that any heightened standard of review might force some market makers, particularly wholesalers, to cease making a market and thus would impair the liquidity of the marketplace. Several commenters maintained that any heightened standard of review is more appropriate for retail broker-dealers, who must satisfy suitability and other requirements when recommending a security to a customer.[22]

[20] A market maker is defined in section 3(a)(38) of the Exchange Act as "any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis." 15 U.S.C. 78c(a)(38). A wholesale market maker holds himself out primarily to other broker-dealers and professionals as being willing to buy and sell securities. See generally Report of Special Study of the Securities Markets of the Securities and Exchange Commission, reprinted in H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 2 at 554–555 (1963) ("Special Study").

[21] A retail firm engages in purchasing and selling securities with public investors, generally involving direct solicitation of buy and sell interest. In essence, the commenters suggest that the Rule should apply only to "integrated" firms, *i.e.*, broker-dealers that act as market makers and transact business with the public. See generally Special Study, pt. 2, 554–555.

[22] Under the general antifraud provisions of the federal securities laws, a broker-dealer that recommends securities to its customers, *i.e.*, a retail firm, is required to have a reasonable basis for those recommendations. See *Hanly* v. *SEC*, 415 F.2d 589 (2d Cir. 1969), *affirming Richard J. Buck & Co.*, 43 S.E.C. 998 (1968).

b. The Commission believes that many of the commenters misapprehend the nature and potential impact of the amendments to paragraph (a). Accordingly, the Commission has revised the proposed provisions to help clarify its intentions in this regard. By including an express review requirement and substituting an affirmative "reasonable basis" standard for the double negative language, the amendments refine the duties of the broker-dealer and thus further the underlying objectives of the Rule. In addition, by incorporating the review and reasonable basis requirements in the introductory portion of paragraph (a), the amendments make it clear that these requirements attach to all information required by that paragraph. As amended, paragraph (a) of the Rule prohibits a broker-dealer from publishing or submitting a quotation for a covered security unless it has reviewed the information specified in subparagraphs (a)(1) through (a)(5) ("paragraph (a) information") together with the information required by paragraph (b) as amended today ("paragraph (b) information"), and based upon such review has a reasonable basis under the circumstances [23] for believing that the required information is accurate [24] in all material respects and that the information was obtained from reliable sources.[25]

[23] The phrase "under the circumstances" relates to the circumstances surrounding the broker-dealer's formation of a reasonable belief that the information is accurate, and not to the particular circumstances of the broker-dealer publishing or submitting quotations for a covered security. For example, a market maker who customarily trades solely on the basis of perceived supply and demand (*i.e.*, trades "by the numbers"), or who lacks the personnel to conduct a reasonable review, could not avoid its obligations under Rule 15c2–11 by asserting that under its circumstances, it was not required to obtain and review the Rule's specified information and have a reasonable basis for believing in the accuracy of the information and the reliability of the source of the information.

[24] Solely for clarity and conciseness, the Commission is replacing the phrase "true and correct" with the word "accurate."

[25] In response to a commenter's recommendation, amended paragraph (a) combines the separate review requirements contained in the Rule as proposed to be amended. Specifically, paragraph (a) incorporates proposed paragraph (h), which pertained to the information review obligations of a broker-dealer publishing or submitting a quotation for a security of an issuer that had been the subject of a trading suspension order issued by the Commission during the twelve months preceding publication or submission of the quotation. See section II.A.2. *infra*.

The Commission contemplates that the review will be performed in accordance with the following basic principles.

Source reliability. As an initial step, the broker-dealer should satisfy itself that it has a reasonable basis for believing that any source of the paragraph (a) information is reliable. This "reasonable belief" standard was required pursuant to subparagraph (a)(5) under the prior formulation of the Rule and is not altered by today's amendments, except that it now applies to subparagraphs (a)(1) through (a)(5). In the absence of any "red flag" (*i.e.*, information that under the circumstances reasonably indicates that the source is unreliable), a broker-dealer would be able to satisfy the Rule's requirements regarding the reliability of the information's source, if that information was provided by the issuer of the securities or its agents, including its officers and directors, attorney, or accountant, or was obtained from an independent information service, such as the Commission's Public Reference Room, a document retrieval service, or standard research sources (*e.g.*, Standard & Poor's *Standard Corporation Descriptions*).

Occasionally, a broker-dealer may receive Rule 15c2–11 information about an issuer from another market maker or from someone other than the issuer or its agents or an independent information service. In these situations, while the broker-dealer might be aware of the identity of the immediate source of the specified information, it might not have any knowledge about the person that actually prepared the Rule 15c2–11 information. To satisfy the Rule's requirements regarding source reliability, the broker-dealer would have to ascertain the reliability of the preparer of the Rule 15c2–11 information. Where the broker-dealer is informed by the immediate source that the issuer has prepared or approved the Rule's specified information, a broker-dealer should generally verify that representation by contacting the issuer directly. Where the broker-dealer receives the information, however, from an independent and objective source, such as a bank but not a market maker in the security, which represents that it prepared the information or received the information directly from the issuer, the broker-dealer typically may rely on that representation as to the source. Additionally, when a "red flag" regarding the source's reliability exists, the broker-dealer would have to conduct the inquiry called for by the circumstances to reasonably determine

whether the information's source is reliable.[26]

Document review. Once the broker-dealer has a reasonable belief as to the source's reliability, it should examine the materials in its records to make certain that all of the required information has been obtained. Paragraph (a) as amended requires this review process for the information required by each of its subparagraphs. For the particular subparagraph on which the broker-dealer is relying to publish quotations, the broker-dealer should review the categories of information listed in subparagraph (a)(5).[27] Next, the broker-dealer should review the paragraph (a) information in the context of all other information about the issuer in its knowledge or possession, *i.e.*, paragraph (b) information.[28] Ordinarily, the broker-dealer need not take any further steps, *e.g.*, there would be no requirement to look behind the financial statements or any other information required to be obtained.[29] However, in its review, the broker-dealer must be alert to any "red flags" (*i.e.*, information under the circumstances that reasonably indicates that one or more of the required items of information is materially inaccurate).[30] "Red flags" would be indicated, for example, by material inconsistencies in the paragraph (a) information, or material inconsistencies between that information and other information in the broker-dealer's knowledge or possession.[31] Examples of "red flags" would include a qualified auditor's opinion resulting from management's failure to provide all of the information relevant to prepare the financial statements, or financial statements of a development stage issuer that lists as the principal component of its net worth an asset wholly unrelated to the issuer's lines of business. Warning signs such as these may call into question the accuracy of the information to be relied upon by a broker-dealer to satisfy the Rule's requirements.

Where no "red flags" appear during this review process, the broker-dealer would have a reasonable basis for believing that the information is accurate. However, if "red flags" appear at any stage of the review process, the broker-dealer may not publish quotations unless and until those "red flags" are reasonably addressed. The broker-dealer's specific efforts to satisfy itself with respect to the accuracy of the information will vary with the circumstances, and may require the broker-dealer to obtain additional information or seek to verify existing information.[32] For example, the broker-dealer may reasonably believe that the information is accurate after questioning the issuer directly. When information from the issuer is not adequate, or raises reasonable doubts on the part of the broker-dealer, the broker-dealer may wish to consult independent sources, *e.g.*, an attorney or accountant.[33]

The Rule requires that a market maker have a reasonable basis under the circumstances for believing that paragraph (a) information, in light of any other documents and information required by paragraph (b), is accurate in all material respects. If the market maker is aware that information required under paragraph (a) is inaccurate, it may nevertheless submit quotations without violating the Rule, as long as it is able to supplement the paragraph (a) information with additional information that it believes is accurate. Thus, for example, a market maker who is aware that information required pursuant to paragraph (a) is inaccurate could simply produce a written record reflecting the supplemental, accurate information that would then be maintained pursuant to paragraph (b). Similarly, the paragraph (a) information, coupled with, *e.g.*, more recent Forms 8–K, or press releases maintained pursuant to paragraph (b)(3), would permit the market maker to satisfy the Rule's requirement.

There are important differences between the obligations imposed by the Rule upon broker-dealers publishing quotations and the obligations of an underwriter. Because of its special relationship with the issuer, other distribution participants, and the investing public, an underwriter is subject to a largely separate, broad set of investigative responsibilities (commonly referred to as "due diligence" responsibilities) under both the securities laws and the standards of the profession.[34] In contrast, the revised requirements of the Rule do not contemplate that, before submitting or publishing quotations for a covered security, a market maker must routinely conduct any independent "due diligence" investigation concerning the

[26] See, e.g., Section II.A.2. *infra.*

[27] With respect to registration statements that incorporate other documents by reference, *e.g.*, Form S–3 under the Securities Act of 1933 ("Securities Act"), 17 CFR 239.13, the broker-dealer may be required to obtain some of the incorporated documents in order to satisfy the information gathering and review requirements. For example, where the registration statement required by paragraph (a)(1) incorporates another document containing a description of "the nature of the issuer's business" (see paragraph (a)(5)(x)) or "the name of the chief executive officer and members of the board of directors" (see paragraph (a)(5)(xi)), the broker-dealer would have to obtain that other document.

[28] The Commission has amended paragraph (b) to require the broker-dealer to maintain as part of its written records any other material information about the issuer, including adverse information, that comes to its knowledge or possession that would be considered important in determining whether there is a reasonable basis for believing in the accuracy (and the reliability of the source) of the paragraph (a) information. However, paragraph (b) does not require the broker-dealer to maintain trivial information or information from an uncertain source. Also, paragraph (b) does not require a broker-dealer routinely to affirmatively seek additional information about the issuer. However, if material information about the issuer comes to the broker-dealer's knowledge or possession (orally or in writing) from an authoritative source, the broker-dealer must include that information in its files (*i.e.*, documents should be retained, and oral information should be recorded and maintained).

[29] Because of the liabilities attaching to documents filed with the Commission, see, *e.g.*, sections 11 and 24 of the Securities Act, 15 U.S.C. 77k and 77x, and sections 18 and 32 of the Exchange Act, 15 U.S.C. 78r and 78ff, a broker-dealer generally could reasonably have stronger belief as to the accuracy of information contained in such documents than information in documents not so filed. Of course, the presence of "red flags," as discussed herein, must be considered in the review of any information.

[30] Moreover, the presence of "red flags" can alert the broker-dealer that fraudulent or manipulative activities are taking place in the market for the security. See *Bunker Securities Corporation*, 48 S.E.C. 859, 865 (1987).

[31] As suggested by a commenter, the phrase "in all material respects" has been added to paragraph (a). Consistent with the prior operation of the Rule, broker-dealers may have a reasonable basis for believing that the paragraph (a) information is accurate despite the presence of insignificant errors or discrepancies in the information. *Cf. Basic Inc.* versus *Levinson*, 108 S.Ct. 978, 983 (1988).

[32] *Cf. Bunker Securities Corporation*, 48 S.E.C. 859, 865 (1987).

[33] Pursuant to recent amendments to Schedule H of the NASD By-Laws, prior to initiating or resuming quotations, NASD member firms are required to provide the NASD with a copy of the paragraph (a) information. See Section II.C. *infra.* The NASD reviews the furnished information before a member firm may publish the quotation. This NASD review does not alter a broker-dealer's obligations to have a reasonable belief as to the accuracy of the information and the reliability of its source, *i.e.*, a broker-dealer may not claim to have any such reasonable belief on the basis that the NASD reviewed the Rule 15c2–11 information and did not raise any objection to such information prior to the broker-dealer's publication of the quotation. *Cf. Melvin Y. Zucker*, 46 S.E.C. 731, 733 (1976).

[34] See, *e.g.*, Securities Act Release No. 5275 (July 26, 1972), 37 FR 16011 ("The Obligations of Underwriters, Brokers and Dealers in Distributing and Trading Securities, Particularly of New High Risk Ventures"), and Securities Exchange Act Release No. 26100 (September 22, 1988), 53 FR 37778 (providing the Commission's interpretation of underwriter responsibilities under the antifraud provisions of the securities laws, with particular reference to offerings of municipal securities) and cases cited therein. See also Klinges, "Expanding the Liability of Managing Underwriters Under the Securities Act of 1933," 53 Fordham L. Rev. 1063 (1985); NASD, *Due Diligence Seminars: Special Report* (1981).

issuer or its business operations and financial condition such as the investigation expected to be conducted by an underwriter. [35] A market maker publishing quotations for a non-NASDAQ security may have no relationship with the issuer of the security. The Rule does not demand that the market maker develop such a relationship in order to obtain information about the issuer. Rather, as described above, the Rule specifies the information that must be gathered, and the Rule's requirements are satisfied if the market maker has a reasonable basis for believing that the information is accurate and obtained from a reliable source, after reviewing that information. In short, a reasonable basis for belief in the accuracy of the information can be founded solely on a careful review of the paragraph (a) information together with paragraph (b) information, provided that the paragraph (a) information was obtained from sources reasonably believed to be reliable and there are no "red flags." When "red flags" are initially present, the broker-dealer may upon inquiry obtain additional information that provides a reasonable basis for believing that the information is accurate.

In brief, although the amendments make the review requirement explicit, the Commission believes that the review procedures necessary to comply with amended paragraph (a) will not begin to approach the depth and breadth of an underwriter's due diligence investigation. In light of these considerations, the Commission views the dangers to market efficiency suggested by commenters that could result from the adoption of the amendments as unlikely to arise.

c. After considering the comments, the Commission believes that the proposed inclusion of the requirement that the broker-dealer have a reasonable basis for believing that the information is accurate "in relation to the day that the quotation is submitted" may have suggested a more extensive level of review than was intended. The proposed phrase was designed to require the broker-dealer to incorporate the information formerly required by paragraph (c), which will often be more current than the paragraph (a) information, into the review process. [36] As described above, paragraph (a) does not require the broker-dealer to question any information unless the information contains apparent material discrepancies, or other material information in the broker-dealer's knowledge or possession (*i.e.*, paragraph (b) information) reasonably indicates that the paragraph (a) information is materially inaccurate. Accordingly, the proposed phrase has been deleted.

d. With respect to the comments discussing the respective market roles of retail firms and wholesale firms, the Commission does not agree with those commenters who suggested that the concerns set out in the Proposing Release would more properly be addressed by adopting or raising standards only as to retail firms. The Rule is directed at the fraudulent, deceptive, or manipulative potential of a broker-dealer's quotations, [37] and does not focus on whether the broker-dealer also engages in retail activity. [38] The securities laws already distinguish between retail and wholesale firms by placing fiduciary and other obligations on retail firms because they deal with the public. [39]

Some securities traders have stated that in setting a price for a security they rely on their "feel" for the market in the security. [40] While such market information is undoubtedly important in establishing quotations, in situations where the Rule applies, a broker-dealer must nevertheless review the required information before publishing a quotation. Accordingly, a claim to be trading solely "by the numbers" [41] will not excuse a failure to comply with the Rule's requirements, or support an argument that the Rule's information requirements are not relevant or "material" to the publication of quotations. [42]

The Commission reaffirms its view that the Rule provides a necessary and appropriate means to prevent fraudulent, deceptive, and manipulative quotations by any broker or dealer. [43]

2. Review Following a Trading Suspension

The Commission proposed adding paragraph (h) to the Rule, which would have pertained specifically to a broker-dealer's obligation to review information in its files prior to publishing or submitting a quotation for the security of an issuer that had been the subject of a trading suspension order issued by the Commission during the preceding twelve months. [44] Proposed paragraph (h) would not have imposed standards of review different from those envisioned by amended paragraph (a), but the problem of post-suspension market making was of sufficient concern that the Commission thought that it would be appropriate to treat it separately in the Rule. As discussed above, the Commission is simplifying the Rule by incorporating the requirements of proposed paragraph (h) into revised paragraph (a).

Commenters were divided on whether the Commission should adopt proposed paragraph (h). Six commenters opposed the amendment, particularly because they believed it would unfairly delegate to broker-dealers the task of verifying the accuracy of available information about an issuer following a trading suspension. On the other hand, six commenters generally supported the need for broker-dealers to review available information when entering quotations after expiration of a trading suspension for the issuer's securities.

The Commission recently has concluded enforcement actions involving two broker-dealers, who, following the expiration of a trading suspension covering 46 issuers, published quotations for a number of those issuers' securities without complying with the requirements of Rule 15c2-11. [45] In ordering the trading

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[35] It should be noted that a possible source of confusion in this area is the fact that the material gathered to satisfy the requirements of Rule 15c2-11 often is referred to as a "due diligence file." The Commission believes that this is a misnomer.

[36] See Proposing Release, 54 FR at 39199.

[37] *Cf.* Special Study, pt. 2, at 605-609; *Halsey, Stuart & Co., Inc.*, 30 S.E.C. 106, 126-129 (1949).

[38] See Proposing Release, 54 FR at 39196.

[39] See *id.* at 39197; NASD Rules of Fair Practice Article III, section 2, NASD Guide (CCH) ¶ 2152.

[40] See, *e.g.*, Special Study, pt. 2, at 569.

[41] See Proposing Release, 54 FR at 39202.

[42] The addition of the phrase "in all material respects" to paragraph (a) of the Rule, see note 31 *supra*, does not alter any broker-dealer's obligation to gather and review the required information.

[43] Rule 15c2-11 was adopted under Section 15(c)(2) of the Exchange Act, 15 U.S.C. 78*o*(c)(2), among other sections. Section 15(c)(2) provides the Commission with broad authority to promulgate rules that prescribe means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices in the over-the-counter securities markets. The Commission is amending paragraph (a) to reflect that it has employed its full authority under section 15(c)(2).

[44] The Commission is authorized under section 12(k) of the Exchange Act, 15 U.S.C. 78*l*(k), to suspend summarily trading in any security, other than an exempted security, for a period not exceeding 10 days. The Commission may issue such an order if in its opinion the public interest and the protection of investors so require.

The situation in which broker-dealers may be precluded from publishing quotations for a security because they lack the information required by the Rule should be distinguished from a trading suspension in the security. See Proposing Release, 54 FR at 39198 n.51.

[45] See *Bagley Securities, Inc.* and *William V. Frankel & Company*, note 10 *supra* (firms consented to findings without admitting or denying the allegations contained therein).

[46] 15 U.S.C. 77a *et seq.*

suspensions, the Commission cited possible false statements by the issuers concerning the issuers' corporate history, stock ownership, financial condition, and claims for exemption from the registration provisions of the Securities Act [46] pursuant to which the issuers' securities were trading. Prior to submitting quotations for four of those issuers' securities, one broker-dealer failed either to obtain any new information concerning the issuers, or to determine the accuracy and completeness of the information it already had in its files about those issuers.[47] Thus, the concerns raised in the Commission's suspension order were either ignored or disregarded. Although both broker-dealers had obtained new information for a number of the issuers after the suspensions expired, they failed to examine the new information before resuming quotations for the securities of those issuers to determine whether the new information addressed the concerns raised in the suspension order.[48]

These cases highlight the fact that a trading suspension should alert a broker-dealer to the possibility that information in its possession concerning the issuer may no longer be accurate. The cases also underscore the requirement that a broker-dealer review the Rule's required information in light of the information contained in a trading suspension order, and, if necessary, obtain updated information.

In this context, the broker-dealer should, at a minimum, receive assurances or additional information with respect to matters cited in the suspension order or with respect to other matters affecting the broker-dealer's reasonable belief as to the accuracy of the information. Reliance on new information or assurances from prior sources of information in these circumstances, however, requires caution.[49] In exceptional cases, where the source (typically, the issuer or its agents) is unable to provide reasonable assurances about the reliability of the information, consultation with an independent accountant or attorney may be warranted.

The Commission does not agree that it is impermissibly delegating its enforcement responsibilities to broker-dealers, who, commenters asserted, are in no better position than the Commission to determine after a trading suspension whether or not available issuer information is accurate. As the Commission observed in the Proposing Release, the factors cited in its order as the basis for the trading suspension do not constitute an adjudication of fact or law with respect to those matters.[50] It is necessary and appropriate that a broker-dealer consider the Commission's concerns regarding the trading of an issuer's securities when the broker-dealer reviews the paragraph (a) information to determine whether it has a reasonable basis for believing that the information is accurate and the source is reliable.

In sum, the Commission believes that requiring review of paragraph (a) information together with the information contained in a trading suspension order will not result in any appreciable change in the application of the Rule. Rather, the Commission views amended paragraphs (a) and (b) (incorporating the requirements of proposed paragraph (h)) as explicitly setting forth a broker-dealer's previously implicit obligations following a trading suspension.

B. Revisions to the Rule's Information Gathering Requirements

1. Paragraph (a)(3)

Paragraphs (a)(1) through (a)(5) of the Rule [51] specify the information that a broker-dealer must have before publishing a quotation for a covered security. Prior to the adoption of today's amendment, paragraph (a)(3)(iii) required a broker or dealer submitting quotations for a security of an issuer required to file reports under Sections 13 or 15(d) of the Exchange Act ("reporting issuer") to have in its records the issuer's most recent annual report [52] together with any other reports required to be filed at regular intervals thereafter, *i.e.*, quarterly reports on Form 10–Q [53] under the Exchange Act.[54] The Commission has amended paragraph (a)(3) in two respects.

a. *Reporting Issuer That Has Not Filed Its First Annual Report.* Although every reporting issuer has a continuing obligation to file detailed information with the Commission, a broker-dealer seeking to publish quotations for a reporting issuer could not comply with the terms of paragraph (a)(3) until the issuer filed its first annual report. Therefore, the broker-dealer had to look to the less comprehensive information requirements of paragraph (a)(5) of the Rule.[55] Under the amendment adopted today, if a reporting issuer has not filed its first annual report, the broker-dealer may satisfy paragraph (a)(3) by having in its records the prospectus included in the registration statement that caused the issuer to become a reporting company,[56] or the Form 10,[57] which was filed and became effective, together with any subsequent reports filed with the Commission by the issuer.[58] The three commenters that addressed this issue favored this revision to paragraph (a)(3). One commenter suggested that the amendment as proposed be reworded to parallel paragraph (a)(1), which permits broker-dealers to retain the prospectus specified by section 10(a) of the Securities Act rather than the entire registration statement as had been proposed. The Commission has incorporated this suggestion into the amendment as adopted.

b. *Current Reports.* Paragraph (a)(3) also is amended to require broker-dealers publishing or submitting quotations for reporting issuers to have in their records copies of any current reports filed with the Commission on Form 8–K [59] since the issuer's latest annual report.

Six commenters opposed the amendment. Some commenters suggested that, unless the broker-dealer has a substantial relationship with the issuer or engages a private search service, the broker-dealer would not know whether the issuer had filed a Form 8–K. One commenter, the NASD, supported the amendment, adding that the broker-dealer should have all current reports filed as of one business day prior to submitting the quotation.

The Commission is adopting this amendment because the events triggering the Form 8–K filing

[47] See *William V. Frankel & Company*, note 10 *supra*.

[48] See *Bagley Securities Inc.* and *William V. Frankel & Company*, note 10 *supra*.

[49] Cf. Securities Act Release No. 5128 (July 7, 1971), 3 Fed. Sec. L. Rep. (CCH) ¶ 22,760.

[50] 54 FR at 39198.

[51] 17 CFR 240.15c2–11(a)(1)–(a)(5).

[52] See 17 CFR 249.310.

[53] See 17 CFR 249.308a.

[54] In the event the issuer should change its fiscal year, the broker-dealer must also obtain and review any transitional reports filed with the Commission pursuant to Rule 15d–10 under the Exchange Act, 17 CFR 240.15d–10.

[55] 17 CFR 240.15c2–11(a)(5). Paragraph (a)(5) specifies the information, including financial information, that a broker-dealer must have in its records before initiating or resuming a quotation for a covered security that does not fall within the other provisions of paragraph (a).

[56] Paragraph (a)(1) of the Rule permits a broker-dealer to initiate or resume quotations based on a registration statement that became effective less than 90 days before publication or submission of the quotation. Under amended paragraph (a)(3), the broker-dealer could enter quotations based on a registration statement during the period between 90 days after effectiveness of the registration statement and the filing of the first annual report.

[57] 17 CFR 249.210.

[58] This would include quarterly reports and current reports. See Section II.B.1.b *infra*.

[59] 17 CFR 249.308.

requirements generally involve material events affecting the issuer.[60] Market makers for non-NASDAQ securities should be aware of these material events when initiating or resuming quotations for the issuer's securities. A broker-dealer has several means of obtaining information regarding, or copies of, current reports on a timely basis.[61] The Commission is not persuaded that the burden of obtaining current reports outweighs the benefit of the amendment, namely that market makers will have the most current information available when establishing quotations for non-NASDAQ securities.[62]

Unlike annual and quarterly reports, however, current reports are not filed at regular intervals. In the Proposing Release, the Commission recognized that it may be difficult for a broker-dealer to determine contemporaneously with its quotation submission whether an issuer had filed a current report with the Commission. To alleviate this potential problem, the Proposing Release stated that a broker-dealer would be deemed in compliance with paragraph (a)(3) if the broker-dealer obtains all Forms 8–K filed with the Commission by the issuer as of a date reasonably in advance of the date of submission of the quotation to the quotation medium. The Commission noted in the Proposing Release that a period of up to five business days is reasonable.

The Commission is modifying this interpretive position to account for a recent amendment to Schedule H of the NASD By-Laws, which requires a broker-dealer to submit Rule 15c2–11 information to the NASD at least three days prior to the publication or submission of a quotation for a non-NASDAQ security.[63] Moreover, as suggested by some commenters, the position has been incorporated in the Rule as adopted. Under paragraph (d)(2)(i), broker-dealers need obtain only those Forms 8–K filed by the issuer as of a date that is up to five business days prior to the earlier of the broker-dealer's submission of the quotation to the quotation medium or submission to the NASD of the information required by Schedule H.[64] This amendment should alleviate the problem of the unpredictability of the filing of Forms 8–K, and eliminate a potential timing problem under the amendment as proposed.

The Commission understands that market makers often are included on an issuer's mailing list, and regularly receive documents publicly disseminated by the issuer. In the Commission's view, a broker-dealer that has made arrangements to receive all of the issuer's reports when they are filed, and the broker-dealer regularly has received the issuer's filed reports on a timely basis over a reasonable period of time (*e.g.*, six months) may reasonably assume that it has satisfied and continues to satisfy the information gathering requirements of amended paragraph (a)(3), unless the broker-dealer has reason to believe that the issuer has failed to file a required report or has filed a report but has not sent it to the broker-dealer. The Commission has incorporated this position in paragraph (d)(2)(ii). In determining whether it receives current reports on a timely basis, a broker-dealer may compare the dates of the reports and the date of the broker-dealer's receipt of those forms. If the broker-dealer receives the reports shortly after their filing, it would be reasonable to assume that they are being received on a timely basis.

One commenter requested clarification concerning whether a broker-dealer would be precluded from publishing a quotation for a reporting issuer, if it had a reasonable basis to believe that the issuer was delinquent in filing its annual, quarterly, or current reports. When paragraph (a)(3) information is not reasonably available,[65] *e.g.*, because the issuer is delinquent in its filing obligations, the broker-dealer may substitute the information specified by paragraph (a)(5) in order to publish or submit quotations.[66] If the paragraph (a)(5) information is unavailable, the broker-dealer may not publish or submit a quotation, unless an exception to the Rule is applicable.

2. Proposed Paragraph (a)(6)

The Commission proposed to add paragraph (a)(6) to the Rule, which would have required a broker-dealer initiating or resuming quotations to have in its records a copy of any trading suspension order, or Exchange Act release announcing that trading suspension, issued by the Commission respecting any securities of the issuer (or its predecessor) during the preceding twelve month period. The majority of commenters responded favorably to this new requirement.

The Commission believes that the information in trading suspension orders is important for broker-dealers because they will be apprised of questions the Commission has raised regarding the issuer or its securities that should be considered when they determine to publish quotations. Therefore, the Commission has determined to incorporate the substance of proposed paragraph (a)(6) in the Rule, but has revised the structure of the Rule so that the requirement now appears in paragraph (b).

Information regarding trading suspensions is readily available from the Commission and from other

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[60] For example, a report on Form 8–K must be filed upon the occurrence of a change in control (Item 1); acquisition or disposition of assets (Item 2); bankruptcy or receivership (Item 3); change in accountants (Item 4); and resignations of directors (Item 6). A reporting issuer also may file voluntarily a Form 8–K to report other events that the issuer "deems of importance to security holders" (Item 5).

[61] The Commission's Public Reference Room, telephone (202) 272–7450, can advise a broker-dealer whether an issuer has filed a report under the Exchange Act. Also, the daily SEC News Digest includes a listing of issuers that recently filed Form 8–K reports, including the Form 8–K Item Number pursuant to which the report is filed and the date of the event triggering the report. See note 67 *infra*.

There are three principal means for a broker-dealer to obtain a copy of a report filed with the Commission by an issuer: from the issuer itself; from one of the user organizations that reproduce and distribute reports filed with the Commission; and from the Commission's Public Reference Room. Market makers frequently are on an issuer's mailing list and regularly receive copies of issuer filings. User organizations provide copies of reports for a fee, on a subscription basis, or usually within a short time from the date of a telephone or written request. The Public Reference Room will provide copies for a fee in response to written requests (the response time can be significantly longer than that of the user organizations).

[62] The Commission also notes that reporting issuers file an average of one Form 8–K per issuer per year. See Proposing Release, 54 FR at 39201 n.84.

Also, the Commission recognizes that the requirement to obtain current reports could be viewed as burdensome if the Commission should adopt a proposal to abolish the Rule's piggyback exception, as recommended in Securities Exchange Act Release No. 29095 (April 17, 1991) ("Release 34–29095"), published today. See section III *infra*. The Commission seeks comment in Release 34–29095 whether any difficulties are posed by requiring a broker-dealer to obtain current reports on a regular basis in order to publish quotations.

[63] See Section II.C. *infra*.

[64] However, if prior to the publication of the quotation in a quotation medium, information comes to the knowledge or possession of the broker-dealer that an issuer has filed a more recent Form 8–K, the broker-dealer would have to obtain and review that report.

[65] Any such statement or report is deemed to be "reasonably available" when it is filed with the Commission. Paragraph (a)(5) is not applicable to the quotations for securities of an issuer included in paragraph (a)(3) where a statement or report of that issuer which is required under paragraph (a)(3) is reasonably available to the broker-dealer.

[66] See Securities Exchange Act Release No. 21914 (November 15, 1984), 49 FR 45117. The Commission observes that a broker-dealer's knowledge that an issuer is delinquent in its filing obligations is a significant fact concerning the issuer that must be recorded pursuant to paragraph (b), and considered in reviewing other Rule 15c2–11 information and satisfying the "reasonable basis" requirements of amended paragraph (a). See Section II.A. *supra*.

sources.[67] Moreover, to facilitate compliance with this requirement, the Commission has instituted a telephone service to provide broker-dealers and others with information about trading suspensions recently ordered by the Commission.[68] Callers also can obtain upon request a written list of all trading suspensions ordered within the past twelve months prior to the request.[69] A few commenters suggested that the Commission's telephone service provide a recorded listing of all trading suspensions issued within the past year. While any such enhancement could prove unwieldy if the number of suspensions were large,[70] the telephone service will provide callers with information about the last fifteen trading suspensions or all trading suspensions within the previous 30 days, which ever is greater, ordered by the Commission.

C. Amendments to Paragraphs (c) and (d)

The Commission proposed to amend Rule 15c2–11(c) to require that the broker-dealer preserve the Rule's required information for the period specified in paragraph (b) of Rule 17a–4 [71] under the Exchange Act, namely, for at least a three-year period, the first two years in an easily accessible place. Previously, paragraph (c) stated that the information must be preserved "for the periods specified in Rule 17a–4." However, none of the time periods specified in that rule for retention of various categories of books and records referred directly to Rule 15c2–11 of its recordkeeping requirements.

Five commenters supported this revision; however, one suggested incorporating in the Rule the required retention period. The Commission has followed this suggestion in paragraph (c) as adopted.

The Commission also has amended Rule 15c2–11(d) to extend from two days to three business days the period between the time the broker-dealer submits to the interdealer quotation system the information required by Rule 15c2–11(a)(5) and the time the quotation may be published. This amendment is adopted to afford the interdealer quotation system and regulators sufficient time to obtain and review the information in advance of publication of quotations.

Four commenters supported the proposed revision. One of these commenters, the NASD, proposed that broker-dealers also be required to submit the Rule's required information for review to that association, and believed it should be given the authority to extend the review period for an additional seven business days if it determined further inquiry was necessary. The Commission recently approved an amendment to Schedule H of the NASD By-Laws [72], which requires NASD member firms, before initiating or resuming quotations for non-NASDAQ securities, to provide the NASD with a copy of the Rule's specified information.[73] Under revised Schedule H, the NASD will conduct a review of the member firms' Rule 15c2–11 information. The NASD will notify the broker-dealer if the submission is deficient, and the NASD will act on any amended submission within seven business days of receipt. In light of this revision to Schedule H, the Commission believes it is unnecessary to consider modifying the Rule as recommended by the NASD.

D. Amendment to Paragraph (f)(5)

The Commission has adopted the amendment clarifying that the exception from the Rule afforded by paragraph (f)(5) is limited to securities authorized for inclusion in NASDAQ. Previously, the exception covered "[t]he publication or submission of a quotation respecting a security that is authorized for quotation in an interdealer quotation system sponsored and governed by the rules of a registered securities association * * *."

When paragraph (f)(5) was added to the Rule in 1985, only the NASDAQ system was comprehended within this description. Today, however, other interdealer quotation systems, such as the NASD's OTC Service [74] and PORTAL system [75] could fit within the terms of the exception. It is clear from the release adopting paragraph (f)(5), however, that its scope was intended to be limited to NASDAQ securities.[76] In adopting the exception, the Commission took cognizance of those NASDAQ qualification standards regarding the issuer and the security which tended to promote the public availability of information about the issuer and helped to inhibit the fraudulent trading of shell company securities and similar abuses.[77] Two commenters favored the proposal, although they also urged that quotations for the securities of all reporting issuers be excluded from the Rule's coverage. [78]

The Commission believes that the amendment is necessary to provide notice to broker-dealers regarding the scope of the exception provided in paragraph (f)(5), and conforms the language to its original intent.

III. The Piggyback Exception

The "piggyback" exception of paragraph (f)(3) permits broker-dealers, under specified conditions, to publish or

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[67] SEC Today, published by the Washington Service Bureau, Inc., contains the SEC News Digest, which includes information about trading suspensions recently ordered by the Commission.

[68] The Commission's Information Line, at (202) 272–3100, offers the public general information about the Commission. Callers are directed to press "95" to obtain information concerning trading suspensions. After pressing that number, they will receive further instructions on how to reach a recorded message detailing recent trading suspensions and how to obtain from the Commission's Public Reference Room a list of all trading suspensions ordered during the previous twelve months.

[69] Since the broker-dealer must obtain and review specified information regarding a trading suspension for any of the issuer's securities ordered during the twelve months prior to publication or submission of the quotation, it must remain alert to the Commission's issuance of any trading suspension order regarding the issuer's securities after the time it requests the list of trading suspensions from the Commission.

[70] As an atypical but relevant example, within a six-month period in 1988, the Commission suspended trading in the securities of more than 100 pink sheet issuers. See Securities Exchange Act Release No. 25550 (April 15, 1988), 40 SEC Docket (CCH) 841; Securities Exchange Act Release No. 25813 (June 21, 1988), 41 SEC Docket (CCH) 276; Securities Exchange Act Release No. 26064 (September 7, 1988), 41 SEC Docket (CCH) 1021.

[71] 17 CFR 240.17a–4.

[72] NASD By-Laws, Schedule H, Section 4, NASD Manual (CCH) ¶ 1935.

[73] See Securities Exchange Act Release No. 27968 (May 1, 1990), 55 FR 19132.

[74] See Release No. 34–27975A. See also *Letter regarding OTC Bulletin Board Display Service*, Securities Exchange Act Release No. 27976 (May 1, 1990) (granting exemptions from the information gathering and furnishing requirements of Rule 15c2–11 for certain securities eligible for quotation in the OTC Service during its first 60 days of operation).

[75] See Securities Exchange Act Release No. 27928, (April 19, 1990), 55 FR 17933 (approving the PORTAL System). See also *Letter regarding the Private Offering, Resale and Trading through Automated Linkages ("PORTAL") System*, Securities Exchange Act Release No. 27964 (April 30, 1990), (granting an exemption from the information gathering and furnishing requirements of Rule 15c2–11 for certain securities eligible for quotation in the PORTAL System).

[76] The Commission in adopting paragraph (f)(5) stated that an "exception from the Rule has been established for the publication of quotations for securities authorized to be quoted in the NASDAQ system * * *." Securities Exchange Act Release No. 21470 (November 15, 1984), 49 FR 45117, 45119 ("Release 34–21470").

[77] Release No. 34–21470, 49 FR at 45118–45119. Unlike the NASDAQ system, the OTC Service and the PORTAL System will not impose any substantive qualification criteria concerning the issuer or the security quoted.

[78] Because the Commission did not propose to exclude reporting issuers' securities from the Rule, it does not believe that it would be appropriate to consider adopting this recommendation at this time. The Commission notes, however, that the Rule has never excepted from its coverage securities solely based on the fact that the issuers were reporting issuers. *Cf.* Rule 15c2–11(a)(3).

submit quotations for a security without having the information otherwise required by the Rule. For this exception to apply, the security must have been quoted in an interdealer quotation system with the frequency and for the duration specified in the Rule, *i.e.*, quotations must have appeared on at least 12 days during the prior 30 calendar days, with no more than four consecutive business days elapsing without any quotations. Because the Commission is concerned that permitting broker-dealers to piggyback on existing quotations for a security may be inconsistent with, and thus undermine certain of the fundamental goals of the Rule, the Commission solicited comment on whether the piggyback exception should be retained, modified, or eliminated.[79]

After reviewing the comments received on this issue, the Commission today is proposing Rule amendments to narrow substantially the piggyback exception.[80] As described in greater detail in Release 34–29095, the Rule would continue to provide only for a modified version of "self-piggybacking," *i.e.*, where a broker-dealer satisfied the Rule's informational requirements upon initiation or resumption of its quotation for a security, and thereafter published quotations with a specified frequency. The firm also would have an annual information gathering and review requirement.

IV. Final Regulatory Flexibility Analysis

The Commission has prepared a Final Regulatory Flexibility Analysis ("FRFA") in accordance with 5 U.S.C. 604 regarding the proposed amendments to Rule 15c2–11. No comments were received on the Commission's Initial Regulatory Flexibility Analysis, although commenters raised concerns regarding the economic burden associated with the amendments to the Rule. The FRFA notes that commenters generally supported the Commission's efforts to strengthen and clarify the obligations of broker-dealers in the penny stock area. The FRFA points out that the review procedures necessary to comply with the revised Rule will not differ appreciably from those expected under the Rule prior to its amendment, and are distinct from an underwriter's due diligence investigation. In addition, the FRFA states the Commission is amending the Rule to require broker-dealers to obtain copies of current reports on Form 8–K because events triggering the filing requirements involve material events affecting the issuer.

The FRFA states that the revised provisions of Rule 15c2–11 are not so burdensome as to outweigh the perceived benefits, namely, that market makers have and review the most current information available when establishing quotations for non-NASDAQ securities.

A copy of the Final Regulatory Flexibility Analysis may be obtained by contacting Jodie J. Kelley, Division of Market Regulation, Securities and Exchange Commission, Washington, DC 20549, (202) 272–2848.

V. Effects on Competition

Section 23(a)(2) of the Exchange Act [81] requires the Commission, in adopting rules under the Exchange Act, to consider any anticompetitive effects of such rules and to balance these effects against the regulatory benefits gained in furthering the purposes of the Exchange Act. The Commission received no comments on any specific competitive burdens that might result from the amendments described in this release. The Commission views the amendments to Rule 15c2–11 as causing no burden on competition unnecessary or inappropriate in furtherance of the purposes of the Exchange Act.

List of Subjects in 17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

VI. Statutory Basis and Text of Rule Amendments

The Commission is amending part 240 of chapter II of title 17 of the Code of Federal Regulations as follows:

PART 240—GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for part 240 is amended by adding the following citation:

Authority: 15 U.S.C. 77c, 77d, 77s, 78c, 78d, 78i, 78j, 78l, 78m, 78n, 78o, 78p, 78s, 78w, 78x, 79q, 79t, 80a–29, 80a–37, unless otherwise noted.

* * * * *

Section 240.15c2–11 also issued under 15 U.S.C. 78j(b), 78o(c), 78q(a), and 78w(a).

§ 240.15c2–11 [Amended]

2. The authority citation following § 240.15c2–11 is removed.

3. By amending § 240.15c2–11 by adding a Preliminary Note preceding paragraph (a), by revising paragraph (a) introductory text, paragraphs (a)(1)–(4), and introductory text of paragraph (a)(5), by amending (a)(5)(i) through (xvi) by setting out each paragraph as an individual paragraph, by revising the remaining text after paragraph (a)(5)(xvi) as flush text, and revising paragraphs (b), (c), (d), and (f)(5) to read as follows:

§ 240.15c2–11 Initiation or resumption of quotations without specified information.

Preliminary Note:

Brokers and dealers may wish to refer to Securities Exchange Act Release No. 29094 (April 17, 1991), for a discussion of procedures for gathering and reviewing the information required by this rule and the requirement that a broker or dealer have a reasonable basis for believing that the information is accurate and obtained from reliable sources.

(a) As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for a broker or dealer to publish any quotation for a security or, directly or indirectly, to submit any such quotation for publication, in any quotation medium (as defined in this section) unless such broker or dealer has in its records the documents and information required by this paragraph (for purposes of this section, "paragraph (a) information"), and, based upon a review of the paragraph (a) information together with any other documents and information required by paragraph (b) of this section, has a reasonable basis under the circumstances for believing that the paragraph (a) information is accurate in all material respects, and that the sources of the paragraph (a) information are reliable. The information required pursuant to this paragraph is:

(1) A copy of the prospectus specified by section 10(a) of the Securities Act of 1933 for an issuer that has filed a registration statement under the Securities Act of 1933, other than a registration statement on Form F–6, which became effective less than 90 calendar days prior to the day on which such broker or dealer publishes or submits the quotation to the quotation medium, *Provided* That such registration statement has not thereafter been the subject of a stop order which is still in effect when the quotation is published or submitted; or

(2) A copy of the offering circular provided for under Regulation A under the Securities Act of 1933 for an issuer that has filed a notification under Regulation A and was authorized to commence the offering less than 40 calendar days prior to the day on which such broker or dealer publishes or

[79] See Proposing Release, 54 FR at 39202–39204.

[80] Release 34–29095.

[81] 15 U.S.C. 78w(a)(2).

submits the quotation to the quotation medium, *Provided* That the offering circular provided for under Regulation A has not thereafter become the subject of a suspension order which is still in effect when the quotation is published or submitted; or

(3) A copy of the issuer's most recent annual report filed pursuant to section 13 or 15(d) of the Act or a copy of the annual statement referred to in section 12(g)(2)(G)(i) of the Act, in the case of an issuer required to file reports pursuant to section 13 or 15(d) of the Act or an issuer of a security covered by section 12(g)(2)(B) or (G) of the Act, together with any quarterly and current reports that have been filed under the provisions of the Act by the issuer after such annual report or annual statement; *Provided, however,* That until such issuer has filed its first annual report pursuant to section 13 or 15(d) of the Act or annual statement referred to in section 12(g)(2)(G)(i) of the Act, the broker or dealer has in its records a copy of the prospectus specified by section 10(a) of the Securities Act of 1933 included in a registration statement filed by the issuer under the Securities Act of 1933, other than a registration statement on Form F-6, that became effective within the prior 16 months, or a copy of any registration statement filed by the issuer under section 12 of the Act that became effective within the prior 16 months, together with any quarterly and current reports filed thereafter under section 13 or 15(d) of the Act; and *Provided further,* That the broker or dealer has a reasonable basis under the circumstances for believing that the issuer is current in filing annual, quarterly, and current reports filed pursuant to section 13 or 15(d) of the Act, or, in the case of an insurance company exempted from section 12(g) of the Act by reason of section 12(g)(2)(G) thereof, the annual statement referred to in section 12(g)(2)(G)(i) of the Act; or

(4) The information furnished to the Commission pursuant to § 240.12g3-2(b) since the beginning of the issuer's last fiscal year, in the case of an issuer exempt from section 12(g) of the Act by reason of compliance with the provisions of § 240.12g3-2(b), which information the broker or dealer shall make reasonably available upon request to any person expressing an interest in a proposed transaction in the security with such broker or dealer; or

(5) The following information, which shall be reasonably current in relation to the day the quotation is submitted and which the broker or dealer shall make reasonably available upon request to any person expressing an interest in a proposed transaction in the security with such broker or dealer:

(xvi) * * *

If such information is made available to others upon request pursuant to this paragraph, such delivery, unless otherwise represented, shall not constitute a representation by such broker or dealer that such information is accurate, but shall constitute a representation by such broker or dealer that the information is reasonably current in relation to the day the quotation is submitted, that the broker or dealer has a reasonable basis under the circumstances for believing the information is accurate in all material respects, and that the information was obtained from sources which the broker or dealer has a reasonable basis for believing are reliable. This paragraph (a)(5) shall not apply to any security of an issuer included in paragraph (a)(3) of this section unless a report or statement of such issuer described in paragraph (a)(3) of this section is not reasonably available to the broker or dealer. A report or statement of an issuer described in paragraph (a)(3) of this section shall be "reasonably available" when such report or statement is filed with the Commission.

(b) With respect to any security the quotation of which is within the provisions of this section, the broker or dealer submitting or publishing such quotation shall have in its records the following documents and information:

(1) A record of the circumstances involved in the submission of publication of such quotation, including the identity of the person or persons for whom the quotation is being submitted or published and any information regarding the transactions provided to the broker or dealer by such person or persons;

(2) A copy of any trading suspension order issued by the Commission pursuant to section 12(k) of the Act respecting any securities of the issuer or its predecessor (if any) during the 12 months preceding the date of the publication or submission of the quotation, or a copy of the public release issued by the Commission announcing such trading suspension order; and

(3) A copy or a written record of any other material information (including adverse information) regarding the issuer which comes to the broker's or dealer's knowledge or possession before the publication or submission of the quotation.

(c) The broker or dealer shall preserve the documents and information required under paragraphs (a) and (b) of this section for a period of not less than three years, the first two years in an easily accessible place.

(d)(1) For any security of an issuer included in paragraph (a)(5) of this section, the broker or dealer submitting the quotation shall furnish to the interdealer quotation system (as defined in paragraph (e)(2) of this section), in such form as such system shall prescribe, at least 3 business days before the quotation is published or submitted, the information regarding the security and the issuer which such broker or dealer is required to maintain pursuant to said paragraph (a)(5) of this section.

(2) For any security of an issuer included in paragraph (a)(3) of this section,

(i) a broker-dealer shall be in compliance with the requirement to obtain current reports filed by the issuer if the broker-dealer obtains all current reports filed with the Commission by the issuer as of a date up to five business days in advance of the earlier of the date of submission of the quotation to the quotation medium and the date of submission of the paragraph (a) information pursuant to Schedule H of the By-Laws of the National Association of Securities Dealers, Inc.; and

(ii) a broker-dealer shall be in compliance with the requirement to obtain the annual, quarterly, and current reports filed by the issuer, if the broker-dealer has made arrangements to receive all such reports when filed by the issuer and it has regularly received reports from the issuer on a timely basis, unless the broker-dealer has a reasonable basis under the circumstances for believing that the issuer has failed to file a required report or has filed a report but has not sent it to the broker-dealer.

* * * * *

(f) * * *

(5) The publication or submission of a quotation respecting a security that is authorized for quotation in the NASDAQ system (as defined in § 240.11Ac1-2(a)(3) of this chapter), and such authorization is not suspended, terminated, or prohibited.

* * * * *

By the Commission.

Dated: April 17, 1991.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 91-9415 Filed 4-24-91; 8:45 am]

BILLING CODE 8010-01-M

NASD

Notice To Members

National Association of Securities Dealers, Inc. June 1991

Number 91-37

Suggested Routing:*

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

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

Subject: Market-Maker Obligations With Regard to Display of Size in Quotations

EXECUTIVE SUMMARY

Since December 1, 1990, Nasdaq market makers that are also market makers in the Small Order Execution System (SOES) have been required to display sizes in their quotations equal to or greater than the SOES tier size of the security. At the same time, because of a temporary exemption from the Securities and Exchange Commission's (SEC) firm-quote rule, market makers did not have to execute more than 100 shares against competing market makers in the same issues. That exemption has now expired. As of June 1, 1991, Nasdaq market makers must execute any order at their displayed quotations.

BACKGROUND AND DISCUSSION

In response to a recommendation by the NASD's Quality of Markets Committee, the NASD on December 1, 1990, implemented a rule to require Nasdaq market makers that are also market makers in SOES to display size in Nasdaq at least equal to the maximum size of an order eligible for execution in SOES. Market makers were also required to extend such size to all parties except firms that are market makers in the same security.[1]

The order-size limits in SOES are currently set at 200, 500, and 1,000 shares, depending on the trading characteristics of the security. The NASD believes that the mandatory display of size provides a realistic picture of the actual size of executions available from market makers as well as the depth of the market in each security.

The mandatory display of size applies to all Nasdaq National Market securities and to market makers in regular Nasdaq securities that are registered as market makers in those securities in SOES. The rule, as implemented in December 1990, contained an exemption from the SEC's firm-quote rule for orders from competing market makers, requiring executions of only 100 shares. Although the firm-quote rule obligates a market maker to execute any order presented at its quoted price and size, the NASD requested a temporary exemption from the rule because of concerns about the impact on market-making risk should market makers be required to execute sizeable orders from competitors. The SEC approved the exemption for six months, expiring June 1, 1991.

As of June 1, 1991, market makers must execute all orders at their displayed sizes, regardless of whether the orders are from other market makers in the security. Moreover, market makers

[1] See *Notice to Members 90-75*, November 1990.

are no longer able to avail themselves of the exemption from the firm-quote rule for orders from competing market makers.

Questions concerning this notice may be directed to Beth E. Mastro, Office of General Counsel, at (202) 728-6998.

(**Note:** Deleted language is in brackets.)

Schedule D

Part VI
Sec. 2 Character of Quotations

(b) Firm Quotations. A market maker that receives an offer to buy or sell from another member of the Association shall execute a transaction for at least a normal unit of trading at its displayed quotation as disseminated through the Nasdaq system at the time of receipt of any such offer. If a market maker displays a quotation for a size greater than a normal unit of trading, it shall, upon receipt of an offer to buy or sell from another member of the Association, [other than a member who is a market maker registered in the security,] execute a transaction at least at the size displayed.

NASD

Notice To Members

National Association of Securities Dealers, Inc. June 1991

Number 91-38

Suggested Routing:*

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

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

Subject: Market-Maker Obligations in SelectNet℠

EXECUTIVE SUMMARY

Since November 1990, members have been able to negotiate transactions through the SelectNet℠ service, which was enhanced from the original Order Confirmation Transaction (OCT) service. The enhancements to SelectNet were approved by the Securities and Exchange Commission (SEC) in November for six months with three operational rules in place. The NASD has requested that the SEC extend the SelectNet rules for an additional six-month period in order to consider whether to make the rules permanent or to recommend additional modifications to SelectNet. The rules are described below.

BACKGROUND AND DISCUSSION

On November 21, 1990, the SEC approved certain modifications to Nasdaq's OCT service, renamed SelectNet. Among other things, SelectNet was enhanced to permit easier negotiation of trades, including counteroffers and broadcasts of orders to all market makers in a security. In addition, the NASD implemented three operational rules to ensure the integrity of SelectNet as a trading system with negotiation features.

The SelectNet rules are:

- SelectNet will be available only for agency or principal orders that are greater than the SOES tier size.
- Market makers receiving orders through SelectNet will not be required to execute partial orders, but may elect to execute partials at their discretion.
- In the event of an emergency or during extraordinary market conditions, either one or both of the aforementioned conditions may be eliminated pursuant to the authority granted to the Board of Governors and its designees in Article VII, Section 3 of the NASD By-Laws.

The NASD believes that SelectNet should retain its current operational structure to allow more time to evaluate whether the rules should be made permanent or be modified in any way. These rules were implemented for SelectNet in November because the mandatory display of size that requires market makers to post quotations at the Small Order Execution Service (SOES) tier level took effect on December 1, 1990, and the SEC firm-quote rule requires broker-dealers to execute orders presented to them at their quoted size. The NASD believed that the same sort of abuse taking place in SOES might occur in SelectNet, especially since SelectNet allows principal as well as agency orders, and therefore sought Commission approval of these rules.

The NASD believes that SelectNet should continue operating as it does today — voluntary for market makers posting the mandatory SOES tier size in their quotations. SelectNet should retain its interactive, negotiation features, with market-maker participation truly voluntary — as opposed to a system that takes on the characteristics of an automatic execution system with mandatory participation requirements — recognizing that, during emergency market conditions, the fundamental nature of the system may be modified to include mandatory market-maker obligations.

The NASD notes that, although SelectNet is available for orders larger than the SOES tier size, smaller orders are not precluded by the system and, although market makers are encouraged to execute those orders, they are not required to do so.

Market-maker obligations when responding to orders in SelectNet must also be clarified, the NASD believes. When market makers are displaying size in their quotations that is **larger** than the SOES tier size**, they are obligated to execute orders directed to them in SelectNet when the orders are larger than SOES tier size up to and including the market maker's posted size.** For example:

- If a market maker in a 1,000-share tier size stock quotes 1,000 shares in its displayed size, it does not have to execute any order through SelectNet.
- If the market maker is quoting 2,000 shares in the same issue and an order greater than 1,000 shares up to and including 2,000 shares is directed to it at its bid or offer quote through SelectNet, such as for 1,100 shares, 1,500 shares, or 2,000 shares, it is obligated to execute that order, pursuant to the firm-quote rule and SelectNet operational rules.
- An order larger than the market maker's posted size, for example an order of 2,500 shares when the market maker is quoting 2,000 shares, would not be required to be executed in SelectNet, because market makers are not required to execute partial orders.

Market makers should be aware of these obligations in SelectNet as well as in dealings over the telephone when quoting in sizes larger than SOES tier size, especially because market makers are now required to execute orders at their posted size from all members, including competing market makers. (See *Notice to Members 91-37.*)

Questions regarding SelectNet operational rules and market-maker obligations should be addressed to Jeff Englander, Market Surveillance Department, at (301) 590-6450.

NASD

Notice To Members

National Association of Securities Dealers, Inc. June 1991

Number 91-39

Suggested Routing:*

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

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

Subject: Limitations on Use of "Negative Response" Letters in Switching Customers From One Mutual Fund to Another

The NASD has recently received information about the increasing use of so-called "negative response" letters. These letters are used to facilitate members' recommendations that customers switch from one mutual fund to another.

The letters contain a recommendation that customers redeem mutual fund shares and invest the proceeds in another fund. The reasons for the recommendation, which usually are related to investment performance, are stated. And the letter also says that if the customer does not respond by a specific date, the exchange will be executed automatically (the negative response feature).

The NASD reminds members that engage in this practice that, in addition to the suitability, prospectus delivery, and disclosure requirements governing such recommendations, no member may exercise discretion in a customer's account without obtaining prior written authorization from the customer (Article III, Section 15, NASD Rules of Fair Practice).

Thus, the lack of a response would preclude the automatic exchange of shares unless the member has on file prior written authorization from the customer permitting the member to exercise discretion in the account.

Discretionary authority would not be required in situations where a mutual fund states in the prospectus that it reserves the right to redeem shares without customer permission if the value of the shares owned by the customer falls below a specific minimum amount.

Questions regarding this notice may be directed to A. John Taylor, Vice President, Investment Companies/Variable Contracts at (202) 728-8328.

NASD

Notice To Members

National Association of Securities Dealers, Inc. June 1991

Number 91-40

Suggested Routing:*

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

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

Subject: SEC Approval of Amendment Regarding Disclosure of Contingent Deferred Sales Charges on Confirmations

EXECUTIVE SUMMARY

The Securities and Exchange Commission has approved an amendment to Article III, Section 26 of the NASD Rules of Fair Practice that requires members selling investment company shares to disclose the existence of deferred sales charges on the front of the customer's purchase confirmation. The amendment will take effect October 1, 1991. The text of the amendment follows this notice.

BACKGROUND

On April 11, 1991, the Securities and Exchange Commission (SEC or "Commission") approved an amendment to Article III, Section 26 of the NASD Rules of Fair Practice (SEC Release No. 34-29069) that adds a new subsection (n) to Section 26. Subsection 26(n) requires member firms selling investment company shares to disclose the existence of deferred sales charges on the front of a customer's purchase confirmation.

In April 1989, the NASD published *Notice to Members 89-35* advising members that it would be a violation of the NASD Rules of Fair Practice for a registered representative to state or imply to a prospective investor that an investment company with a contingent deferred sales charge is a "no load fund." The notice resulted from a number of complaints received by the NASD from investors who claimed they were unaware of the existence of a sales charge on redemption and that they had been advised that the companies were "no load" or "no initial load" funds.

In that notice, the NASD indicated that a contingent deferred sales load is a sales load that is charged on redemption on a declining-percentage basis annually and is usually reduced to zero percent by the sixth or seventh year of share ownership. The NASD stated that to assert that a mutual fund with a contingent deferred sales load is a "no load" fund is an unacceptable misrepresentation and that to state that there is "no initial load" without explanation of the nature of the contingent deferred sales load is an omission of material information.

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

closure on confirmations of the possibility of a deferred sales charge on redemption would help to alert prospective investors to the existence of such charges before they have paid for the shares. Many investors apparently do not study the prospectus thoroughly before making a purchase of investment company shares and often rely on the oral representations of a registered representative. Thus, through inadvertence or design, they may not be aware of the possibility of a sales charge on redemption.

EXPLANATION

Because of the continuing potential for investors to be unaware of deferred sales charges and the NASD's continuing concern that reliance on disclosures of sales loads in prospectuses may not be sufficient to alert investors to the existence of a deferred sales charge at the time of the purchase, the NASD is adding a new subsection (n) to Section 26 of the Rules of Fair Practice. The new subsection requires that a short, simple disclosure statement be included on all confirmations for investment company shares that impose a deferred sales charge on redemption. The amendment to Section 26 was approved by a vote of the membership in *Notice to Members 90-27* (May 1990).

The amendment originally was proposed as an amendment to Section 12. The comments on the amendment to Section 12 received from the membership, however, indicated that applying the requirement to insurance company variable contracts would not advance the purposes of the proposed rule change. The disclosure problem that the amendment was designed to solve was related exclusively to mutual funds, not insurance company variable contracts. Therefore, the NASD decided to make the requirement a part of Section 26, which specifically applies to investment companies.

The disclosure requirement in Section 26(n) applies only to "sales charges" — charges and fees that are used to finance sales-related expenses. Nominal and short-term charges that are not used to pay for sales-related expenses and that are returned to the mutual fund as a credit to the net assets of the fund are not covered by the new disclosure requirement.[1]

In order to provide sufficient time for members to modify their procedures to comply with the new disclosure request, the amendment will take effect October 1, 1991. Any questions regarding this amendment should be directed to A. John Taylor, Vice President, Investment Companies/Variable Contracts, at (202) 728-8329.

TEXT OF NEW SUBSECTION 26(n) TO ARTICLE III, SECTION 26 OF THE NASD RULES OF FAIR PRACTICE

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

Investment Companies

Sec. 26

* * * * *

Disclosure of Deferred Sales Charges

(n) In addition to the requirements for disclosure on written confirmations of transactions contained in Section 12 of the NASD Rules of Fair Practice, if the transaction involves the purchase of shares of an investment company that imposes a deferred sales charge on redemption, such written confirmation shall also include the following legend: "On selling your shares, you may pay a sales charge. For the charge and other fees, see the prospectus." The legend shall appear on the front of a confirmation and in, at least, 8-point type.

[1] See SR-NASD-90-69, published for comment in *Notice to Members 90-26* (April 16, 1990), proposing amendments to Article III, Section 26 of the Rules of Fair Practice relating to asset-based sales charge limits, for a discussion of the term "sales charge."

NASD

Notice To Members

National Association of Securities Dealers, Inc. June 1991

Number 91-41

Suggested Routing:*

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

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

Subject: Department of Treasury Proposes Significant Amendments to the Regulations Issued on July 24, 1987 Under the Government Securities Act of 1986; Last Date for Comments: June 17, 1991

EXECUTIVE SUMMARY

On April 17, 1991, the Department of Treasury issued 56 FR 15529-15532 containing proposed amendments to 17 CFR Part 403 ("Protection of Customer Securities and Balances"). The proposal would implement a buy-in requirement for mortgage-backed securities that are in fail status for more than 60 calendar days and all government securities that are needed to complete a sell order of a customer (other than a short sale) if the securities have not been received from the customer within 10 business days after the settlement date. The change would apply to all firms that are required to be registered or provide notice of their status as government securities brokers or dealers pursuant to Section 15C(a)(1) of the Securities Exchange Act of 1934. The Treasury Department's comment period expires June 17, 1991. The text of 56 FR 15529-15532 follows this notice.

SUMMARY OF PROPOSED CHANGES

I. PROTECTION OF CUSTOMER SECURITIES AND BALANCES

A. Buy-ins for Fails to Receive

Presently under 17 CFR 403.4(g), all government securities except for mortgage-backed securities are subject to the buy-in requirements of paragraph (d)(2) of SEC Rule 15c3-3. The Treasury Department proposes to amend the rule by adding a paragraph that requires all registered brokers or dealers to take prompt steps to buy in or otherwise obtain mortgage-backed securities that are in a fail-to-receive status longer than 60 calendar days.

B. Buy-ins for Customer Sell Orders

Presently, paragragh (m) of SEC Rule 15c3-3 does not apply to transactions in government securities. The Treasury Department proposes to add paragraph 403.4(l) that will adopt, with certain modifications, paragraph (m) of SEC Rule 15c3-3 for government securities. This would require any registered broker or dealer that executes a customer sell order (other than a short sale) and that has not obtained the securities from the customer within 10 business days after the settlement date to close out the transaction with the customer by purchasing securities of like kind and quantity.

NASD members that wish to comment on the proposed rule change should do so **by June 17, 1991**. Comment letters should be sent to:

Government Securities Regulations Staff
Public Debt, Department of the Treasury
999 E Street, NW, Room 209
Washington, DC 20239-0001.

All comment letters received will be made available for public inspection and copying at the Treasury Department Library, Room 5030, Main Treasury Building, 1500 Pennsylvania Avenue, NW, Washington, DC 20220.

Members are requested to send copies of their comment letters to:

Stephen D. Hickman
Corporate Secretary
National Association of
Securities Dealers, Inc.
1735 K Street, NW
Washington, DC 20006-1506.

Questions concerning this notice may be directed to Walter Robertson, NASD Associate Director, Financial Responsibility, at (202) 728-8236 or Samuel Luque, Associate Director, Financial Responsibility at (202) 728-8472.