

Notice To Members

National Association of Securities Dealers, Inc.

December 1991

Number 91-78**Suggested Routing:***

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Subject: Request for Comments on Member Participation in Partnership Rollups and Listing of Securities Resulting from Rollups on Nasdaq/NMS; Last Date for Comments: February 1, 1992

EXECUTIVE SUMMARY

The NASD requests comments on proposed amendments to Appendix F under Article III, Section 34 of the Rules of Fair Practice and Schedule D to the NASD By-Laws. The amendments would restrict member participation in unfair rollup transactions and prohibit listing on the Nasdaq National Market System of any security resulting from an unfair rollup transaction. The text of the proposed amendments follows this notice.

BACKGROUND

The NASD has proposed amendments to Appendix F under Article III, Section 34 of the Rules of Fair Practice ("Appendix F") and Schedule D to the NASD By-Laws ("Schedule D") that would limit NASD member participation in unfair rollup transactions and restrict listing of the securities of entities resulting from unfair rollups on the Nasdaq National Market System (Nasdaq/NMS). The amendments respond to the legislative mandate in the proposed Limited Partnership Rollup Reform Act of 1991 (the "Rollup Reform Act"), which would impose on the NASD the responsibility for

developing rules to protect limited partners in rollup transactions.

The Rollup Reform Act is the legislative response to abuses that have occurred in recent rollup transactions. The bill requires the Securities and Exchange Commission (SEC) to amend its rules relating to the proxy process and disclosure to include provisions that benefit limited partners subject to a rollup. NASD rules required by the Rollup Reform Act relate to prohibiting members from participating in a rollup as well as prohibiting the surviving entity from listing its securities on Nasdaq/NMS if certain protections are not afforded limited partners. In particular, general partners or sponsors proposing a rollup must provide limited partners, as alternatives to participation in the rollup, with either the right to receive compensation based on an appraisal of partnership assets or the right to receive or retain a security with rights, privileges, and preferences similar to their partnership units. As elaborated on herein, if the NASD makes a finding that it is infeasible to provide these alternatives, then the general partner can propose other comparable rights designed to protect limited partners.

The Rollup Reform Act also requires the NASD to adopt rules to preclude member participation in a rollup transaction and listing on

Nasdaq/NMS under certain circumstances. Such action could occur if the terms of the transaction unfairly reduce or abridge the voting rights of investors, if investors are required to bear an unfair portion of the costs of the rollup transaction, or if there are not appropriate restrictions on the conversion of general partner or sponsor compensation resulting from the rollup.

The Rollup Reform Act was approved by the House of Representatives November 5, 1991 and is currently awaiting action by the Senate. Although the bill has not yet become law, the NASD believes that it is appropriate to consider amendments to Appendix F and Schedule D prior to final adoption due to provisions in the bill that will effectively prohibit rollup transactions from occurring until all required rules are finalized. While the Rollup Reform Act provides the NASD with an 18-month period to enact rules, prompt action appears to be necessary so that sponsors and general partners considering rollup transactions will not be precluded from the market as a result of the absence of the rules mandated by the legislation.

The proposed amendments to Appendix F and Schedule D will supplement the NASD's recent action prohibiting the receipt of differential compensation in rollup transactions. While the current amendments are being proposed in the context of the pending Rollup Reform Act, the NASD recognizes that additional regulations that are outside the scope of, but not necessarily inconsistent with, the provisions of the Rollup Reform Act may also be appropriate. Therefore, the NASD requests comments and suggestions for rulemaking on any aspect of a rollup transaction that falls within the scope of the NASD's jurisdiction.

EXPLANATION

The proposed amendments to Appendix F and Schedule D define the following terms: limited partner, limited partnership, rollup or rollup of a limited partnership, dissenting limited partner, cash flow, cash available for distribution, management fee, and solicitation expenses.

A "limited partner" is a purchaser of an interest in a direct participation program that is a limited partnership. A "limited partnership" is defined as a direct participation program that is a limited partnership, including any entity determined to be a partnership pursuant to Section 14(h)(4)(B) of the Securities Exchange Act of 1934. The term

"sponsor," also used in the proposed amendments, is defined in Article III, Section 34 of the Rules of Fair Practice as "a person who directly or indirectly provides management services for a direct participation program whether as a general partner, pursuant to contract or otherwise."

The definition of "rollup or rollup of a limited partnership" is proposed to be modified from the current definition in Appendix F to reflect the definition of a rollup that is utilized in the Rollup Reform Act. The definition encompasses the combination or reorganization of one or more limited partnerships, directly or indirectly, whereby investors in the original partnership(s) receive new securities or securities in another entity in exchange for their partnership interests.

A rollup, under the definition, would not include the combination of publicly traded entities; the combination of all private partnerships into a resulting private entity; the reorganization to corporate, trust, or association form or restructuring of a single partnership if there is no significant, adverse change in the voting rights, term of existence of the entity, management compensation, or investment objectives; a reorganization to corporate, trust, or association form or restructuring of a single partnership if each investor is provided an option to retain a security with substantially the same terms and conditions as the original security; or the reorganization to corporate, trust, or association form or restructuring of a partnership if the entity resulting from such reorganization or restructuring is not intended to be publicly traded following the transaction.

"Dissenting limited partner" is defined as a limited partner who has cast a vote against a rollup transaction. If a partner does not vote "no," such partner will not be considered a dissenter. A dissenting limited partner may also be a person who has filed a dissent from the terms of a proposed exchange or tender offer with the party responsible for tabulating the votes or tenders. The "no" vote or the dissent must be received during the period in which the offer is outstanding.

"Cash flow" is defined as cash provided from operations, including lease payments on net leases from builders and sellers, without deduction for depreciation, but after deducting cash funds used to pay all other expenses, debt payments, capital improvements, and replacements.

"Cash available for distribution" is defined as

cash flow less amounts set aside for restoration or creation of reserves.

A "management fee" is a fee paid to a sponsor, general partner, its affiliates, or other persons for management and administration of a limited partnership.

"Solicitation expenses" are defined as direct marketing expenses such as telephone calls, broker/dealer fact sheets, legal and other fees related to the solicitation, and direct solicitation compensation to members.

The proposed rules would prohibit the participation of members and persons associated with members in a rollup transaction unless the transaction includes provisions designed to protect rights of limited partners. The rights of limited partners are presumed to be protected if dissenting limited partners are offered (1) the right to receive compensation for their partnership units based on an independent appraisal of partnership assets, (2) the right to receive or retain a security with substantially the same terms and conditions as the security originally held, or (3) other comparable rights.

The first option, compensation based on appraisal, contemplates an appraisal performed by an independent appraiser unaffiliated with the sponsor or general partner of the program that values the assets as if sold in an orderly manner in a reasonable period of time, plus or minus other balance-sheet items, and less the cost of sale or refinancing. This is to ensure that the appraisal accurately reflects the current value of the assets. The NASD requests specific comment on whether additional standards regarding appraisals or the qualifications of persons performing appraisals should be considered.

Forms of compensation that can be offered to dissenting limited partners are cash, secured debt instruments, unsecured debt instruments, or freely tradeable securities. Debt instruments must provide for a trustee and an indenture, provide the holders with a market rate of interest based on the federal funds rate, may have a term no greater than 10 years, and provide for prepayment with 80 percent of the net proceeds of any sale or refinancing of the assets of the entity. Unsecured debt instruments may be used only when the entity issuing the debt has a limitation on total leverage of 80 percent of the appraised value of its assets.

Freely tradeable securities utilized as compensation must be issued by a company that has been

publicly traded prior to the transaction. The number of freely tradeable securities offered in return for partnership interests would be determined by the appraisal of partnership assets in relation to the average last-sale price of the securities in the 20-day period following the transaction.

The second option, to retain a security with substantially the same terms and conditions as the original issue, provides that limited partners must receive or retain a security with substantially the same rights, preferences, and priorities as their current security. There must be no material adverse change as to the business plan or the investment, distribution, and liquidation policies of the partnership.

A general partner or sponsor proposing a rollup may avoid the requirement to offer dissenting limited partners compensation based on an appraisal or the right to retain a similar security only upon a demonstration to the NASD that it is infeasible to provide such protections. To the extent that a general partner or sponsor can make a showing of infeasibility, other comparable rights designed to protect limited partners may be utilized. However, the NASD believes that a clear, convincing, and objective showing of infeasibility must be made. Generalizations, forecasts, or assumptions that cannot be objectively supported will not be acceptable.

Comparable rights may include review of the transaction by an independent committee or other comparable rights as may be proposed by the general partner or sponsor. The comparable rights provisions are intended to provide flexibility for sponsors and general partners to propose other protections for limited partners when the other alternatives are infeasible. If the NASD is unable to determine that the comparable rights offered by sponsors or general partners are sufficient to protect the interests of limited partners, the NASD will require that an independent committee composed of persons not affiliated with the general partner or sponsor be established to review the appropriateness of proposed comparable rights.

The proposed amendments provide that an independent committee will be composed of at least three persons; will, if practicable, contain representation from each entity subject to the rollup, the majority of whom represent the largest equity holders in the partnerships subject to the rollup and the minority of whom may be recommended by the gen-

eral partner or sponsor; will have the authority to negotiate the proposed transaction with the general partner or sponsor on behalf of the limited partners, but not the authority to approve the transaction on behalf of the limited partners; will be ruled by unanimous decision; will deliberate for a period no longer than 60 days unless unanimously extended; will be compensated by the partnerships subject to the rollup and will have the ability to retain independent counsel and financial advisors; and will be entitled to indemnification to the maximum extent permitted by law from the general partners, sponsors, limited partnerships, and rolled-up entities from claims, causes of action, or lawsuits resulting from their decisions. The NASD requests specific comment on the make-up and functioning of an independent committee.

The premise that underlies many of the objections to rollups is that a simple majority of limited partners voting for a rollup can deprive other limited partners of the business and financial opportunities they bargained for when they originally invested. However, this objection may be obviated to some extent if limited partners owning three-fourths of the partnership interests take affirmative action to approve the rollup transaction. Therefore, another comparable right that may be provided is supermajority approval of the rollup. In situations where the sponsors or general partners reasonably believe that a supermajority of 75 percent of the outstanding units of each of the participating partnerships in a rollup will vote to approve the transaction, the provisions of the proposed rules would not be applicable.

The NASD believes that such an overwhelming approval of the transaction is an accurate indication of the fairness and beneficial nature of the rollup, and that such approval would constitute an "other comparable right" within the terms of the proposed legislation. If the 75 percent supermajority is not ultimately reached, however, the rollup would be considered rejected. Should the sponsor or general partner still wish to pursue the rollup, the proposed transaction would then have to be amended to provide the protections to limited partners provided for in the rules.

The proposed amendments to Appendix F and Schedule D also address elements of rollup transactions that are potentially unfair to limited partners. These elements include the conversion and valuation of general partner interests in a rollup, voting

rights, the allocation of transaction costs of a rejected rollup, and the payment of fees in connection with rollup transactions. The proposed rules create a series of presumptions under which these elements are considered unfair if they fail to protect the rights of limited partners.

The proposed amendments establish a presumption that it is unfair and unreasonable for general partners, when determining their interest in the new entity resulting from a rollup, to (1) convert an equity interest in partnerships subject to a rollup into a voting interest in the new entity if consideration had not been paid for such equity interest, (2) fail to follow the valuation methods indicated in the partnership agreements when valuing their partnership interests, or (3) utilize a projected future value of their equity interest rather than the appraised current value of their equity interest when determining their interest in the new entity.

Voting rights will be presumed unfair unless the general partner or sponsor proposes to generally maintain the original voting rights of the partnerships participating in the rollup. However, the NASD recognizes that certain changes to voting rights may be necessary to conform disparate rights that may exist among participating partnerships. Material changes may be effected only if the NASD determines that such changes are not unfair or if an independent committee approves such changes.

The proposed amendments provide that a majority of the interests in an entity resulting from a rollup may vote to amend the limited partnership agreement, articles of incorporation or bylaws, or indenture; dissolve the entity; remove management and elect new management; and approve or disapprove the sale of substantially all the assets of the entity.

The proposed amendments would also require a sponsor or general partner proposing a rollup to clearly delineate the instructions and procedures of voting against or dissenting from a proposed rollup transaction. The general partner or sponsor must utilize an independent third party to receive and tabulate all votes and dissents, and must also undertake to make the tabulation available to the general partner and any limited partner on request at any time during and after voting occurs.

The proposed amendments seek to prevent limited partners from bearing an unfair portion of the transaction costs of a rejected rollup transac-

tion. The allocation of transaction costs in a rejected rollup is presumed fair if the costs are apportioned between general and limited partners according to the final vote on the proposed transaction. The general partner or sponsor would bear costs in proportion to the number of votes to reject the transaction and limited partners would bear costs in proportion to number of votes to approve the transaction. The NASD believes that this allocation of costs is fair to both the general and the limited partners. In the case of a rollup transaction that is approved, the amendments indicate that any partnership(s) that votes not to join the transaction would not have any costs allocated to it.

Finally, the proposed amendments presume that limited partners are not protected if general partners propose to receive or convert unearned management fees discounted to a present value while also proposing to receive new asset-based fees. A similar presumption applies if property management fees and other fees are not appropriate, not reasonable, and not greater than those that would be paid to third parties for performing similar services. Substantial and adverse changes in fees are presumed unreasonable if not submitted to and approved by an independent committee.

REQUEST FOR COMMENTS

The NASD Board of Governors encourages comment from all members and other interested persons. Comments should be forwarded to:

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

Comments must be received **no later than February 1, 1992**. Comments received by this date will be considered by the Direct Participation Programs/Real Estate Committee and the NASD Board of Governors. If the Committee and the Board approve the amendments to Appendix F and Schedule D, they must be filed with and approved by the SEC before becoming effective.

Questions concerning this notice may be directed to Charles L. Bennett, Director, or Richard J. Fortwengler, Associate Director, NASD Corporate Financing Department, at (202) 728-8258.

AMENDMENTS TO APPENDIX F TO ARTICLE III, SECTION 34 OF THE RULES OF FAIR PRACTICE AND SCHEDULE D TO THE BY-LAWS

(Note: Language is in the form of an amendment to Appendix F. Language will be conformed to Part III of Schedule D to the By-Laws. New language is underlined; deleted language is in brackets.)

Sec. 1.

No member or person associated with a member shall participate in a public offering of a direct participation program or a rollup of a direct participation program that is a limited partnership except in accordance with this Appendix.

Sec. 2

Definitions

* * * * *

(b) The following terms shall have the stated meaning when used in this Appendix:

* * * * *

(2) Limited Partner — the purchaser of an interest in a direct participation program that is a limited partnership.

(3) Limited Partnership — a direct participation program that is a limited partnership, including any entity determined to be a "partnership" pursuant to Section 14(h)(4)(B) of the Securities Exchange Act of 1934, as amended.

[(3)] (5) Organization and Offering Expenses — (no change)

[(4)] (6) Participant — the purchaser of an interest in a direct participation program.

[(5)] (7) Person — (no change)

[(6)] (8) Registration Statement — (no change)

[(7)] (9) Rollup or Rollup of a [Direct Participation Program] Limited Partnership — [a transaction involving an acquisition, merger or consolidation of at least one direct participation program, not currently listed on a registered national securities exchange or the Nasdaq System, into another public direct participation program or a public corporation or a public trust] the combination or reorganization of one or more limited partnerships, either directly or indirectly, whereby investors in the original limited partnership(s) receive new securities or securities of another public entity in exchange for their existing interests. This term shall not include a transaction:

(i) involving one or more limited partnerships

all of the securities of which are, prior to the transaction, securities for which transactions are reported under a transaction reporting plan declared effective before January 1, 1991, by the Securities and Exchange Commission under Section 11A of the Securities Exchange Act of 1934;

(ii) involving only those issuers not required to register or report under Section 12 of the Securities Exchange Act of 1934 where the resulting issuer is also not required to register or report under Section 12; or

(iii) involving the reorganization to corporate, trust, or association form or restructuring of a single limited partnership if, as a consequence of the proposed transaction there will be no significant, adverse change in any of the following: voting rights, the term of existence of the entity, management compensation, or investment objectives;

(iv) involving the reorganization to corporate, trust, or association form or restructuring of a single limited partnership if each investor is provided an option to retain a security under substantially the same terms and conditions as the original issue; or

(v) involving the reorganization to corporate, trust, or association form or restructuring of a single limited partnership if transactions in the security issued as a result of the reorganization or restructuring are not reported under a transaction reporting plan declared effective before January 1, 1991, by the Securities and Exchange Commission under section 11A of the Securities Exchange Act of 1934.

(10) Dissenting Limited Partner — a holder of a beneficial interest in a limited partnership that is the subject of a rollup transaction who casts a vote against the rollup transaction, except that for purposes of an exchange or tender offer such term means any person who files a dissent from the terms of the transaction with the party responsible for tabulating the votes or tenders, to be received in connection with the transaction during the period in which the offer is outstanding.

(11) Cash Flow — program cash funds provided from operations, including lease payments on net leases from builders and sellers, without deduction for depreciation, but after deducting cash funds used to pay all other expenses, debt payments, capital improvements and replacements.

(12) Cash Available For Distribution — cash flow less amount set aside for restoration or cre-

ation of reserves.

(13) Management Fee — a fee paid to the sponsor, general partner(s), their affiliates, or other persons for management and administration of the limited partnership.

(14) Solicitation Expenses — direct marketing expenses such as telephone calls, broker/dealer fact sheets, legal and other fees related to the solicitation, as well as direct solicitation compensation to members.

* * * * *

Sec. 6 Participation In Rollup

(a) No member shall receive compensation for soliciting votes or tenders from [participants] limited partners in connection with a rollup of a [direct participation program or programs] limited partnership or limited partnerships, irrespective of the form of the entity resulting from the rollup transaction (i.e., a partnership, real estate investment trust or corporation), unless such compensation:

(1) is payable and equal in amount regardless of whether the [participant] limited partner votes affirmatively or negatively in the proposed rollup;

(2) in the aggregate, does not exceed 2% of the exchange value of the newly-created securities; and

(3) is paid regardless of whether the [participants] limited partners reject the proposed rollup transaction.

(b) No member or person associated with a member shall participate in the solicitation of votes or tenders in connection with the rollup of a [direct participation program] limited partnership unless the general partner(s) or sponsor(s) proposing the rollup agrees to pay all solicitation expenses related to the rollup, including all preparatory work related thereto, in the event the rollup transaction is not approved.

(c) No member or person associated with a member shall participate in any rollup transaction unless the transaction includes provisions designed to protect the rights of limited partners.

(1) The rights of limited partners will be presumed to be protected if the rollup transaction provides for the right of dissenting limited partners:

(i) to receive compensation for their limited partnership units based on an appraisal of the limited partnership assets performed by an independent appraiser unaffiliated with the sponsor or general partner of the program and which value the

assets as if sold in an orderly manner in a reasonable period of time, plus or minus other balance sheet items, and less the cost of sale or refinancing. Compensation to dissenting limited partners of rollup transactions may be cash, secured debt instruments, unsecured debt instruments, or freely-tradeable securities; provided, however, that:

(A) rollups which utilize debt instruments as compensation provide for a trustee and an indenture to protect the rights of the debt holders and provide a market rate of interest based upon the federal funds rate;

(B) rollups which utilize unsecured debt instruments as compensation, in addition to the requirements of subparagraph (A), limit total leverage to 80% of the appraised value of the assets;

(C) all debt securities have a term no greater than 10 years and provide for prepayment with 80% of the net proceeds of any sale or refinancing of the assets of the entity or any part thereof; and

(D) freely-tradeable securities utilized as compensation to dissenting limited partners must be issued by a company listed on a national securities exchange or the Nasdaq National Market System prior to the transaction, and the number of securities to be received in return for limited partnership interests must be determined by an appraisal of limited partnership assets, conducted in a manner consistent with subparagraph (c)(1)(i) hereof, in relation to the average last sale price of the freely-tradeable securities in the 20-day period following the transaction.

(ii) to receive or retain a security with substantially the same terms and conditions as the security originally held. Securities received or retained will be considered to have the same terms and conditions as the security originally held if:

(A) there is no material adverse change to dissenting limited partners' rights with respect to the business plan or the investment, distribution and liquidation policies of the limited partnership, and

(B) the dissenting limited partners receive substantially the same rights, preferences and priorities as they had pursuant to the security originally held.

(iii) to receive, upon an acceptable demonstra-

tion to the NASD that the provisions of subparagraphs (i) and (ii) hereof are infeasible, other comparable rights. Comparable rights may include, but are not limited to:

(A) review of the rollup transaction by an independent committee of persons not affiliated with the general partner(s) or sponsor. If deemed necessary for the protection of the rights of limited partners, the NASD may require that such a committee be established. Whenever utilized, the independent committee:

a. shall be approved by the NASD; shall be composed of at least three persons; shall, if practicable, contain representation from each entity subject to the rollup, the majority of whom represent the largest equity holders in the limited partnerships subject to the rollup and the minority of whom may be recommended by the general partner or sponsor; and all of its determinations shall be unanimous;

b. shall have the authority to negotiate the proposed transaction with the general partner or sponsor on behalf of the limited partners, but not the authority to approve the transaction on behalf of the limited partners;

c. shall not deliberate for a period longer than 60 days, although extensions will be permitted if unanimously agreed upon by the members of independent committee;

d. shall be compensated by the limited partnerships subject to the rollup and shall have the ability to retain independent counsel and financial advisors to represent all limited partners at the limited partnerships' expense provided the fees are reasonable; and

e. shall be entitled to indemnification to the maximum extent permitted by law from the general partners, sponsors, limited partnerships and rolled up entities from claims, causes of action or lawsuits initiated by any party in interest, including any limited partnership or limited partner subject to the rollup or the rolled up entity for any action or decision made in furtherance of

their responsibilities.

(B) a rollup transaction where the sponsor or general partner(s) reasonably believes that 75% of the outstanding units of each of the participating limited partnerships will vote to approve the transaction. Failure to obtain approval of the transaction by 75% of the outstanding units shall result in rejection of the transaction and the rights of limited partners shall be presumed not to be protected. The third party appointed to tabulate votes and dissents pursuant to subparagraph (2)(ii)(D) shall submit the results of such tabulation to the NASD.

(C) any other comparable rights proposed by general partners or sponsors, provided, however, that the general partner(s) or sponsor demonstrates to the satisfaction of the NASD or, if the NASD determines appropriate, to the satisfaction of an independent committee, that the rights proposed are comparable.

(2) The rights of limited partners shall be presumed not to be protected:

(i) if the general partner(s):

(A) converts an equity interest in the limited partnerships subject to a rollup for which consideration was not paid and which was not otherwise provided for in the limited partnership agreement and disclosed to limited partners, into a voting interest in the new entity (provided, however, an interest originally obtained in order to comply with the provisions of Internal Revenue Service Revenue Proclamation 89-12 may be converted);

(B) fails to follow the valuation provisions in the limited partnership agreements of the subject limited partnerships when valuing their limited partnership interests;

or

(C) utilizes a future value of their equity interest rather than the current value of their equity interest, as determined by an appraisal conducted in a manner consistent with paragraph (c)(1)(i) hereof, when determining their interest in the new entity.

(ii) as to voting rights, if:

(A) the voting rights in the entity result-

ing from a rollup do not generally follow the original voting rights of the limited partnerships participating in the rollup transaction; provided, however, that changes to voting rights may be effected if the NASD determines that such changes are not unfair or if the changes are approved by an independent committee;

(B) a majority of the interests in an entity resulting from a rollup transaction may not, without concurrence by the sponsor, general partner(s), board of directors or trustee, depending on the form of entity, vote to:

a. amend the limited partnership agreement, articles of incorporation or by-laws, or indenture;

b. dissolve the entity;

c. remove management and elect new management; and

d. approve or disapprove the sale of substantially all of the assets of the entity.

(C) the general partner(s) or sponsor(s) proposing a rollup is not required to provide each person whose equity interest is subject to the rollup transaction with a document which instructs the person on the proper procedure for voting against or dissenting from the rollup transaction;

(D) the general partner(s) or sponsor(s) does not utilize an independent third party to receive and tabulate all votes and dissents, and require that the third party make the tabulation available to the general partner and any limited partner upon request at any time during and after voting occurs.

(iii) as to transaction costs:

(A) if limited partners bear an unfair portion of the transaction costs of a proposed rollup transaction that is rejected. For purposes of this provision, transaction costs are defined as the costs of printing and mailing the proxy, prospectus or other documents; legal fees not related to the solicitation of votes or tenders; financial advisory fees; investment banking fees; appraisal fees; accounting fees; independent committee expenses; travel ex-

penses; and all other fees related to the preparatory work of the transaction, but not including costs that would have otherwise been incurred by the subject limited partnerships in the ordinary course of business, or solicitation expenses.

(B) if transaction costs of a rejected rollup transaction are not apportioned between general and limited partners of the subject limited partnerships according to the final vote on the proposed transaction as follows:

a. the general partner(s) or sponsor(s) bears all rollup transaction costs in proportion to the number of votes to reject the rollup transaction; and

b. limited partners bear transaction costs in proportion to the number of votes to approve the rollup transaction.

(C) if dissenting limited partnership(s) is required to pay any of the costs of the rollup transaction and the general partner or sponsor is not required to pay the rollup transaction costs on behalf of the

dissenting limited partnerships in a rollup in which one or more limited partnerships determines not to approve the transaction, but where the rollup transaction is consummated with respect to one or more approving limited partnerships.

(iv) as to fees of general partners, if:

(A) general partners are not prevented from receiving both unearned management fees discounted to a present value (if such fees were not previously provided for in the limited partnership agreement and disclosed to limited partners) and new asset-based fees,

(B) property management fees and other general partner fees are not appropriate, not reasonable and not greater than what would be paid to third parties for performing similar services, and

(C) changes in fees which are substantial and adverse to limited partners are not approved by an independent committee according to the facts and circumstances of each transaction.

Notice To Members

National Association of Securities Dealers, Inc.

December 1991

Number 91-79

Suggested Routing:*

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| <input checked="" type="checkbox"/> Senior Management | <input type="checkbox"/> Internal Audit | <input type="checkbox"/> Operations | <input type="checkbox"/> Syndicate |
| <input type="checkbox"/> Corporate Finance | <input checked="" type="checkbox"/> Legal & Compliance | <input type="checkbox"/> Options | <input type="checkbox"/> Systems |
| <input type="checkbox"/> Government Securities | <input checked="" type="checkbox"/> Municipal | <input type="checkbox"/> Registration | <input type="checkbox"/> Trading |
| <input type="checkbox"/> Institutional | <input checked="" type="checkbox"/> Mutual Fund | <input type="checkbox"/> Research | <input type="checkbox"/> Training |

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

Subject: Request for Comments on Recision of the Guidelines Regarding Communications With the Public About Investment Companies and Variable Contracts (Guidelines) And Proposed Amendments to the NASD Rules of Fair Practice to Incorporate Items From the Guidelines; Last Date for Comments: January 20, 1992

EXECUTIVE SUMMARY

The NASD requests comments on a proposal to rescind the Guidelines and to amend Article III, Section 35 of the Association's Rules of Fair Practice to include items that were contained in the Guidelines regarding disclosure about tax free/tax exempt returns, comparisons, and projections of performance. The text of the proposed amendments and a copy of the Guidelines follow this notice.

BACKGROUND

In 1979, the Securities and Exchange Commission (SEC) rescinded the Statement of Policy on Investment Company Sales Literature (SOP) that for many years had governed the content of advertising and sales literature used in the sale of investment company shares. To provide guidance to members in the preparation of such communications with the public, the NASD developed the Guidelines, which were adopted in 1982 and are included at ¶5286 of the *NASD Manual*. Since then, the SEC has amended Rule 482 under the Securities

Act of 1933 and adopted Rule 34b-1 under the Investment Company Act of 1940 regarding the portrayal of investment company performance in communications with the public. This has rendered much of the content of the Guidelines obsolete.

The remaining content, except for three areas, is covered by the standards already set forth in Article III, Section 35 of the Rules of Fair Practice. The NASD therefore proposes to rescind the Guidelines and to retain three sections (claims of tax free/tax exempt returns, comparisons, and prohibitions on projections of performance) that would become part of Article III, Section 35 of the Rules of Fair Practice, the NASD rule governing communications with the public.

THE GUIDELINES

The NASD Guidelines, published February 8, 1982, were primarily designed to assist NASD members in complying with the NASD rules governing communications with the public, especially in view of the withdrawal of the SOP. The Guidelines are divided into five sections:

1. General Considerations
2. Special Considerations in Presenting Investment Results
3. Specific Considerations in Presenting Capi-

tal Results or Total Return Illustrations

4. Specific Considerations in Presenting Yield Data or Illustrations

5. Considerations Regarding Comparisons

The Investment Companies and Insurance Affiliated Member Committees were asked to consider the status of the Guidelines in light of the 1988 amendments to SEC Rule 482 and adoption of SEC Rule 34b-1, and in light of standards already contained in Article III, Section 35. The SEC rules created new requirements governing the presentation of performance in investment company advertising and sales literature. The revisions have made many aspects of the Guidelines obsolete as they apply to open-end investment companies and variable annuities. The rule revisions do not apply to unit investment trusts, closed-end funds, or variable life insurance. The standards in Section 35 render the remaining portions of the Guidelines redundant and duplicative, as these standards overlap with the considerations set forth in the Guidelines.

Analysis of the Guidelines

Section 1. General Considerations

This section sets forth general factors to be considered in determining whether a communication may be misleading. Those factors include:

1. "Overall context in which statements are made," which urges balance in the treatment of risks and benefits;
2. "Audience to which the communication is directed," which reminds members that the content should be appropriate for the readership; and
3. "Overall clarity of the communication," which cautions against misleading the reader through overly technical or oversimplified information, or relegating material information to footnotes.

Section 35(d)(1) requires that communications be based on principles of fair dealing and good faith. Such communications must provide a sound basis for evaluating the facts and must not mislead the reader by omitting material information. The section prohibits exaggerated, unwarranted, or misleading statements and requires that the risks inherent in any investment be considered in the preparation of a communication with the public.

The considerations set forth in Section 1 of

the Guidelines are covered by the standards currently set forth in Section 35 and, thus, it is not necessary to retain them.

Section 2. Special Considerations in Presenting Investment Results

This section sets forth basic principles designed to reduce the risk of a reader attributing unwarranted predictive value to data concerning investment results.

■ **Investment Objectives and Policies as Related to Data Provided** — This principle stresses the need for performance illustrations to show the relationship of such performance to investment objectives and cautions that material changes in objectives, policies, management, etc. during the time period illustrated should be described.

SEC Rule 482, as amended, requires that performance be calculated in a specified manner, and if such changes have occurred, it requires the fund's performance to reflect such changes. Thus, the Guidelines are superseded by the requirements of the SEC rule.

■ **Appropriateness and Fairness of Time Periods Illustrated** — This principle addresses the need to show performance for appropriate time periods and sets forth recommendations of what those periods should be.

SEC Rule 482, as amended, requires that performance be shown for one-, five-, and ten-year time periods. Thus, the Guidelines are superseded by the requirements of the SEC rule.

■ **Adequacy of Information Concerning the Relevance of Results Illustrated to Probable Future Results** — This principle stresses, "Investment results cannot be predicted or projected. . . ." and it urges that long-term illustrations make clear that short-term fluctuations exist.

The requirement that the risk of fluctuation be disclosed is covered by existing standards of Section 35. The prohibition on projections or predictions of investment management results is not and, therefore, it is proposed as a new standard to be incorporated into Section 35.

■ **The Clarity of a Chart or Table Format** — This principle addresses the need to present statistical data in a clear, complete, and not misleading format.

Section 35(d) prohibits misleading information or the omission of material facts. Thus, this

principle is already addressed in the current standards.

■ **The Adequacy of Summary Results and the Need for Supporting Data** — This principle urges that summary results be accompanied by year-by-year supporting data.

SEC Rule 482 requires summary results for one, five, and ten years and does not require supporting information. Thus, this section is rendered obsolete by the rule.

■ **Inclusion of Relevant Charges and Expenses** — This principle addresses the need to show performance results net of applicable charges and expenses.

SEC Rule 482 requires that performance results be calculated by a standardized formula, which takes into account expenses. In addition, Section 35 prohibits the omission of material information. Therefore, performance calculations, whether pursuant to the restrictions of Rule 482 or to the standards of Section 35, are required to reflect expenses. Thus, this section is rendered both obsolete and redundant.

Section 3. Specific Considerations in Presenting Capital Results in Total Return Illustrations

This section sets forth specific guidelines for presenting total return information, including time periods illustrated, disclosures to accompany such illustrations, and recommended components of these illustrations.

Rule 482 requires that total return information, calculated by standardized methods, be provided for specific time periods. It further sets forth specific disclosures regarding fund performance that must be included in every communication illustrating such performance. Since these disclosures satisfy the SEC, it would appear unnecessary to require any additional information as suggested by this section.

Section 4. Specific Considerations in Presenting Yield Data or Illustrations

This section sets forth principles governing income or yield illustrations. Included among these principles are disclosures concerning risk of fluctuation of income and capital value as well as information about the portfolio. The section recommends methods for calculating historic, current, and annualized yields. Finally, the section ad-

dresses the concern that yields or income should not be described as free or exempt from income taxes in situations where liability is postponed or deferred.

The provisions of Rule 482 clearly restrict the methods by which current yields may be calculated, both for money market and non-money market funds. These restrictions are in direct contradiction to the considerations set forth in the Guidelines and, therefore, the latter should be rescinded.

The principle regarding the need to disclose any relevant taxes when describing yields or income as tax-free or tax-exempt is not addressed by SEC rules. While the general standards of Section 35 prohibit the omission of material information or the inclusion of misleading standards, the recommendations set forth in this section are not clearly addressed. Therefore, the NASD proposes to incorporate this principle as a new standard in Section 35.

Section 5. Considerations Regarding Comparisons

This section of the Guidelines stresses the necessity that comparisons of investment products or services be complete, fair, and balanced, and that they clearly explain any material differences between the subjects in order to make the comparisons not misleading.

While these recommendations concerning comparisons are supported by the general standards of Section 35, the Board believes that a section should be added to the rule that clearly explains specific points to be addressed when developing complete and fair comparisons.

SUMMARY

The Board of Governors believes that it is appropriate to withdraw the Guidelines altogether and amend Article III, Section 35 to incorporate standards addressing the three areas mentioned directly above. In addition to eliminating the inconsistencies and redundancies by rescinding the Guidelines, the incorporation of the three outstanding issues would consolidate the regulations under one rule. Also, the standards relating to tax free/tax exempt claims, comparisons, and predictions or projections would equally apply to all types of securities, not just to registered investment companies.

The NASD encourages all members and other

interested parties to comment on the proposal to rescind the Guidelines and to simultaneously amend Article III, Section 35 of the Rules of Fair Practice to include standards addressing these three concerns. The new standards would be included as Specific Standards under Section (d)(2) of Section 35, as (d)(2)(L), (d)(2)(M), and (d)(2)(N). Comments should be forwarded to:

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

Comments should be received **no later than January 20, 1992.**

Questions concerning this notice should be directed to R. Clark Hooper, Director, Advertising Department, at (202) 728-8330.

GUIDELINES REGARDING COMMUNICATIONS WITH THE PUBLIC ABOUT INVESTMENT COMPANIES AND VARIABLE CONTRACTS

(Note: The entire text of the Guidelines is proposed to be deleted.)

1. General Considerations

In judging whether a communication, or a particular element of a communication, may be misleading, several factors should be considered, including, but not limited to:

The Overall Context in Which the Statement or Statements Are Made

A statement made in one context may be misleading even though such a statement could be perfectly appropriate in another context. An essential test in this regard is the balance of treatment of risks and potential benefits.

The Audience to Which the Communication is Directed

Different levels of explanation or detail may be necessary depending on the audience to which a communication is directed, and the ability of the member, given the nature of the media used, to restrict the audience appropriately. If the statements made in a communication would be applicable

only to a limited audience, or if additional information might be necessary for other audiences, it should be kept in mind that it is not always possible to restrict the readership of a particular communication.

The Overall Clarity of the Communication

A statement or disclosure made in an unclear manner obviously can result in a lack of understanding of the statement, or in a serious misunderstanding. A complex or overly technical explanation may be worse than too little information. Likewise, material disclosure relegated to legends or footnotes realistically may not enhance the reader's understanding of the communication.

2. Special Considerations in Presenting Investment Results

Presentations of investment results require special care to insure that they are not misleading. While it is not possible to prevent every reader of a communication which illustrates investment results from attributing unwarranted predictive value to the data, adequate consideration of certain basic principles can reduce this risk. Among these basic principles are:

Investment Objectives and Policies as Related to Data Provided

Generally speaking, illustrations of investment results should be designed to illustrate the relationship of investment performance to stated investment objectives over meaningful periods. If material changes in objectives, policies, management, or other characteristics have occurred during or since the time period illustrated, these changes should be described.

Appropriateness and Fairness of the Time Periods Illustrated

In general, the appropriate time periods for illustrations of results are those which are of sufficient duration that the relevance of the data to the investment objectives can be determined. Thus yield or performance data may cover a variety of different periods for different types of investments. The selection of a specific time period solely for the purpose of illustrating performance "at its best" is likely to mislead. Illustrations should generally include the last full calendar or fiscal year, or the last twelve months.

Adequacy of Information Concerning the Relevance of Results Illustrated to Probable Future Results

Investment results cannot be predicted or projected and historical illustrations should reflect this. Presentations of investment results should be made in a context that makes clear that within the longer periods illustrated there have been short term fluctuations, often counter to the overall trend of investment results, and that no single period of any length is to be taken as "typical" of what may be expected in future periods. This is a simple principle, and not one which should require a great deal of boiler plate language but rather a simple, straightforward explanation.

The Clarity of a Chart or Table Format

In selection of a format for illustration of investment results in either chart or table form, consideration should be given not only to the completeness and accuracy of the data, but also to the clarity and meaningfulness of the overall presentation. Careful consideration should be given to the overall visual impact of data presented in chart form, since the reader may not go beyond a scanning of the "trend" shown by a chart. It should be recognized that the reader who is confused by having been buried in masses of unclear, although statistically relevant, data may be misled just as badly as the reader who is given too little information.

The Adequacy of Summary Results and the Need for Supporting Data

While a summary of investments results is often necessary in order to make sales literature readable and understandable, it must be recognized that the reader may not look beyond the summary data presented. Consequently, the preparer of such illustrations should take into account that the summary data must be fair in all respects and not likely to mislead, either directly or by distracting the reader from other necessary information. Generally speaking, all summary data covering periods longer than one year should be supported by full year-by-year data over the same or longer periods and should include reference to that supporting data. If supporting data is not included in the same piece of sales literature, members should carefully consider supplying the data in another document.

Inclusion of Relevant Charges and Expenses

Illustrations of income and/or capital results should reflect the results which would have been achieved by the reader for whom the illustration is designed. Actual sales charges, account charges or deductions, and any other relevant expenses which would have been applicable should be taken into account in the illustration, unless such current charges are different, in which case the current charges should be described. Illustrations of gross investment results may be appropriate under certain limited circumstances, but such illustrations should normally be accompanied by an explanation of how such results would be affected by all applicable charges and expenses.

3. Specific Considerations in Presenting Capital Results in Total Return Illustrations

Application of the foregoing principles to illustrations involving capital results, either alone or as part of a "total return" illustration, results in the following specific considerations.

Capital results illustrations, including "total return" data, should generally cover a period long enough to reflect variations in value through different market conditions. A period of ten years, or if shorter, the life of the company or account, is the recommended minimum illustration period, with periods longer than ten years being in five year increments. In illustrations of other periods, particularly shorter periods, members should consider whether to include with such illustration an explanation of the reason for selecting such period and whether data for the recommended ten year or life minimum period should be included with such illustration or in another specifically referenced document, such as a prospectus or shareholder report. Generally, data for full calendar or fiscal years should be reflected. A discussion of the general trends of relevant securities prices during the period may be desirable to lend proper perspective to such illustrations. Illustrations dealing solely with capital results should explain the relative significance of income.

Illustrations of "total return" (i.e. illustrations which reflect the combined results of capital and income) should reflect dollar and/or percentage changes for each year covered by the illustration, as well as for the total period. The illustration should, except for variable contracts, show the breakdown of the income and capital components

at least for the total period covered. Where such a breakdown for the total period would not adequately convey the significance of annual variations in the components, consideration should be given to including annual income and capital data. If dividends are assumed to have been reinvested, the illustration should reflect the actual frequency and results of such reinvestments during the period. Illustrations of performance results in chart form may be misleading because of the scale on which they are displayed. Generally, if an illustration of capital results or of total return is in chart form, a semi-log (ratio) format is recommended.

4. Specific Considerations in Presenting Yield Data or Illustrations

Application of the foregoing general principles to income or yield illustrations results in the following specific considerations.

Any illustration or statement of yield should be accompanied by an explanation of how the yield is computed, along with any additional information necessary to fairly evaluate the yield, including a reference to such risks as may be involved in ownership of the security. Depending on the circumstances, one or more of the following may be appropriate:

- a statement concerning the variability of income;
- a statement of the variability of capital value, e.g., the net asset value at the beginning and end of the previous calendar or fiscal year, or during a recent market advance or decline;
- information about the general characteristics of the portfolio and any material portfolio changes which are anticipated.

Historic yields should be calculated by dividing the company's annual dividends from net investment income by the maximum offering price of the company's shares, using either the average price during the year or the price at the beginning or end of the year.

Current yields should generally be calculated by dividing the company's dividend income for the previous twelve months by the current maximum offering price. However, annualized yields based on periods of less than one year may be appropriate in some cases, e.g., money market funds, funds with less than a full year's history, and funds where the current rate of dividend income varies significantly from the dividends paid in the previ-

ous twelve months. Such annualized yield should be based on the company's gross income less actual expenses for the period.

Yields or income should not be characterized as tax sheltered or as free or exempt from income tax where tax liability is merely postponed or deferred. Unless income is free from all income taxes, references to tax exemption should indicate which taxes apply or specify which taxes do not apply. For example, if income from an investment company investing in municipal bonds may be subject to state or local income taxes, this should be stated, or the illustration should otherwise make it clear that income is free from federal income tax.

5. Considerations Regarding Comparisons

Comparisons of investment products or services may be valuable or useful to investors but care must be taken to insure that comparisons are fair and balanced. Comparisons generally should include explanation of the purpose of the comparison and explanation of any material differences between the subjects of the comparison.

Comparisons involving investment companies and variable contracts are often related to yield or performance, but may also relate to structure, fees, tax features and other matters. It is essential that a comparison be as complete as practicable and that no fact be omitted which, if disclosed, would likely alter materially the conclusions reasonably drawn or implied by the comparison. This point is particularly important with respect to selection of time periods for comparison of investment results. Data for each subject of the comparison should also be presented on the same basis, i.e., for the same period in terms of both aggregate and year by year data.

Comparisons with alternative investment or savings vehicles should explain clearly any relevant differences in guarantees, fluctuation of principal and/or return, insurance, tax features, and any other factors necessary to make such comparisons fair and not misleading.

A comparison of investment performance with a market index or average generally should, if appropriate in view of the nature of the comparison, include a clear indication of the purpose of the comparison and the reason or purpose for selection of the index or average, and a description of the index and the fact that it is unmanaged. The extent

of the explanation necessary will vary, depending upon the degree of general recognition of the particular index. If there are material differences between the composition of the index and the composition of the portfolio, this should be pointed out. If the comparison is not on a total return basis, the relative impact of differences in income or capital changes, whichever is applicable, should also be explained.

Unless the comparison clearly explains the material relevant differences, a comparison with an index, average, or group of investment companies or accounts should relate to an index, average, or group of investment companies or accounts with investment objectives similar to that of the company compared. Where possible, it is advisable to use an independently prepared and published index, average or group. The smaller or less widely recognized the group or category selected, the greater the importance of explaining the reason for the selection. Since overall investment company industry averages generally include diverse portfolios and objectives, comparisons with such averages should generally not be used.

**PROPOSED AMENDMENTS TO
ARTICLE III, SECTION 35 OF THE
NASD RULES OF FAIR PRACTICE**

(Note: New text is underlined.)

COMMUNICATIONS WITH THE PUBLIC

Sec. 35

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(d) Standards Applicable to Communications with

the Public

(1) General Standards

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(2) Specific Standards

In addition to the foregoing general standards, the following specific standards apply:

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(L) Claims of Tax Free/Tax Exempt Returns: Income or investment returns may not be characterized as tax free or exempt from income tax where tax liability is merely postponed or deferred. If taxes are payable upon redemption, that fact must be disclosed. References to tax free/tax exempt current income must indicate which taxes apply and which do not unless income is free from all applicable taxes.

(M) Comparisons: In making a comparison, either directly or indirectly, the member must make certain that the purpose of the comparison is clear and must provide a fair and balanced presentation, including any material differences between the subjects of comparison. Such differences include investment objectives, sales and management fees, liquidity, guarantees or insurance, fluctuation of principal and/or return, tax features, and any other factors necessary to make such comparisons fair and not misleading.

(N) Predictions and Projections: Investment results cannot be predicted or projected. Investment performance illustrations may not imply that future gain or income realized in the past will be repeated in the future.

Notice To Members

National Association of Securities Dealers, Inc.

December 1991

Number 91-80

Suggested Routing:*

- | | | | |
|---|--|---------------------------------------|--|
| <input checked="" type="checkbox"/> Senior Management | <input type="checkbox"/> Internal Audit | <input type="checkbox"/> Operations | <input type="checkbox"/> Syndicate |
| <input type="checkbox"/> Corporate Finance | <input checked="" type="checkbox"/> Legal & Compliance | <input type="checkbox"/> Options | <input type="checkbox"/> Systems |
| <input type="checkbox"/> Government Securities | <input checked="" type="checkbox"/> Municipal | <input type="checkbox"/> Registration | <input type="checkbox"/> Trading |
| <input type="checkbox"/> Institutional | <input checked="" type="checkbox"/> Mutual Fund | <input type="checkbox"/> Research | <input checked="" type="checkbox"/> Training |

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

Subject: Request for Comments on Proposed Amendments to Article III, Section 15 of the NASD Rules of Fair Practice Re: Exemption from the Rule for Negative Comment Letters Used in Certain Bulk Exchanges of Money Market Mutual Funds; Last Date For Comments: January 15, 1992

EXECUTIVE SUMMARY

The NASD requests comments on proposed amendments to Article III, Section 15 of the NASD Rules of Fair Practice. The amendments would exempt certain bulk exchanges of money market mutual funds utilizing negative response letters from the provisions of the rule. The text of the proposed amendments follows this notice.

BACKGROUND

The NASD Board of Governors, in *Notice to Members 91-39*, June 1991, reminded members that the use of negative response letters to facilitate the exchange of mutual fund shares may violate the provisions of Article III, Section 15 of the NASD Rules of Fair Practice.

Such a violation would occur if a member executed an exchange automatically for a nonreplier to the letter without prior written authority from the shareholder giving the member discretion over the account.

Following the distribution of the notice, the NASD received a number of comments requesting that an exemption from the rule be adopted for the

bulk transfer of money market mutual funds using negative response letters in certain situations. Such instances would include mergers and acquisitions, changes of clearing members, and exchanges of money market mutual funds used in sweep accounts where investment performance is not the primary reason for the exchange.

In these situations, it is often necessary to notify hundreds and, sometimes, several thousand money market mutual fund shareowners of an impending exchange. It would be an almost impossible task to contact each nonreplier to a negative response letter and solicit approval of the exchange, as well as cause considerable time delays and added cost in effecting the exchange.

SUMMARY OF PROPOSED AMENDMENT

The NASD is proposing to permit the use of negative response letters in the limited situations outlined above by adopting an exemption from the provisions of Article III, Section 15. Such an exemption would require that certain standards be adopted governing the use of negative response letters.

The NASD is proposing to create an exemption for bulk exchanges of money market mutual funds utilizing negative response letters provided the following conditions are met: (1) that bulk ex-

changes be limited to mergers and acquisitions of funds, changes of clearing members, and exchanges of funds used in sweep accounts; (2) that the negative response letter includes a tabular comparison of the nature and amount of fees charged by each fund (e.g., management fees, fees under Rule 12(b)-1 of the Investment Company Act of 1940, and similar fees); (3) that the negative response letter includes a comparative description of the investment objectives of each fund; and (4) that the negative response feature not be activated until at least 30 days after the date on which the letter was mailed. In addition, the NASD proposes that a prospectus of the fund to be purchased accompany the letter.

REQUEST FOR COMMENTS

The Board of Governors asks members and other interested persons to comment on the proposed amendments to Article III, Section 15 of the NASD Rules of Fair Practice. Comments should be directed to:

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

Comments must be received **no later than January 15, 1992**. Comments received by this date will be considered by the NASD Investment Companies Committee and the Board of Governors. Prior to becoming effective, the amendments must be adopted by the Board of Governors and the membership and then filed with the Securities and Exchange Commission for its approval.

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

AMENDMENTS TO ARTICLE III, SECTION 15 OF THE NASD RULES OF FAIR PRACTICE

(Note: New text is underlined.)

Discretionary Accounts

Sec. 15.

Excessive transactions

(a) No member shall effect with or for any

customer's account in respect to which such member or his agent or employee is vested with any discretionary power any transactions of purchase or sale which are excessive in size or frequency in view of the financial resources and character of such account.

Authorization and acceptance of account

(b) No member or registered representative shall exercise any discretionary power in a customer's account unless such customer has given prior written authorization to a stated individual or individuals and the account has been accepted by the member, as evidenced in writing by the member or the partner, officer or manager, duly designated by the member, in accordance with Section 27 of these rules.

Approval and review of transactions

(c) The member or the person duly designated shall approve promptly in writing each discretionary order entered and shall review all discretionary accounts at frequent intervals in order to detect and prevent transactions which are excessive in size or frequency in view of the financial resources and character of the account.

Exceptions

(d)(1) This section shall not apply to discretion as to the price at which or the time when an order given by a customer for the purchase or sale of a definite amount of a specified security shall be executed.

(d)(2) This section shall not apply to bulk exchanges of money market mutual funds ("funds") utilizing negative response letters provided:

(i) The bulk exchange is limited to situations involving mergers and acquisitions of funds, changes of clearing members and exchanges of funds used in sweep accounts.

(ii) The negative response letter contains a tabular comparison of the nature and amount of the fees charged by each fund.

(iii) The negative response letter contains a comparative description of the investment objectives of each fund and a prospectus of the fund to be purchased.

(iv) The negative response feature will not be activated until at least 30 days after the date on which the letter was mailed.

Notice To Members

National Association of Securities Dealers, Inc.

December 1991

Number 91-81

Suggested Routing:*

- | | | | |
|--|--|--|--|
| <input type="checkbox"/> Senior Management | <input type="checkbox"/> Internal Audit | <input checked="" type="checkbox"/> Operations | <input type="checkbox"/> Syndicate |
| <input type="checkbox"/> Corporate Finance | <input checked="" type="checkbox"/> Legal & Compliance | <input type="checkbox"/> Options | <input type="checkbox"/> Systems |
| <input type="checkbox"/> Government Securities | <input type="checkbox"/> Municipal | <input checked="" type="checkbox"/> Registration | <input type="checkbox"/> Trading |
| <input type="checkbox"/> Institutional | <input type="checkbox"/> Mutual Fund | <input type="checkbox"/> Research | <input checked="" type="checkbox"/> Training |

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

Subject: Reporting Information on Form BD

EXECUTIVE SUMMARY

After several years of discussion, the Securities and Exchange Commission (SEC), NASD, and North American Securities Administrators Association (NASAA) have resolved their differing views regarding disclosure requirements relating to matters reportable on Form BD. This notice explains the background of the matter, as well as the approach that is now being developed to achieve a uniform standard of disclosure.

BACKGROUND

The Central Registration Depository (CRD) was expanded in 1989 to enable firms to file one Form BD for both NASD membership and state licensing requirements. In the operation of this CRD system, it became evident that states and the SEC and NASD differed in their disclosure requirements regarding the reporting of matters classified under the term "proceeding" found on Form BD, Item 7G. Since 1989, these differing interpretations have had a significant impact on members attempting to identify and to comply with a uniform filing standard. This issue was previously reported in *Notice to Members 90-46*, July 1990.

The NASD has followed the SEC's interpreta-

tion of the term "proceeding," first stated by the SEC in release number 12078 (February 6, 1976) and restated in 1985. The SEC interpretation included proceedings brought by the Commission, regulators, and self-regulators and *did not* include investigations, arrests without convictions, and civil litigation not conducted by a regulatory or self-regulatory body.

Many states had interpreted the term "proceeding" in a different way. In 1989 NASAA issued a resolution that stated the term "proceeding" included pending administrative and civil proceedings initiated by self-regulatory, regulatory, and governmental agencies *as well as* pending criminal charges and civil litigation.

RESOLUTION OF ISSUE

The SEC, NASD, and NASAA have been meeting since the winter of 1990 to reach agreement on the interpretation of the term "proceeding." The parties have recently agreed to a new interpretation of the term "proceeding" to include formal administrative and civil actions initiated by self-regulatory and governmental agencies and formal criminal charges, including felony indictments, felony criminal informations, and formal felony criminal charges equivalent to a criminal indictment or information, and any formal misdemeanor criminal information (or equivalent charge) involving matters listed in Item 7A(1) of Form BD.

The interpretation *does not include* criminal arrests effected in the absence of a formal written charge, investigations, or civil litigation.

This new interpretation differs from the SEC's 1976 release in that it includes formal criminal charges. The difference between the new interpretation and the NASAA resolution is that the new in-

terpretation does not include private civil litigation.

These changes will be reflected in upcoming revisions to Form BD. Questions regarding this notice should be directed to Ellen Badler, Assistant Director, Special Registration Review, at (301) 590-6743, or Craig Landauer, Office of General Counsel, at (202) 728-8291.

Notice To Members

National Association of Securities Dealers, Inc.

December 1991

Number 91-82

Suggested Routing:*

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|---|--|---------------------------------------|------------------------------------|
| <input checked="" type="checkbox"/> Senior Management | <input type="checkbox"/> Internal Audit | <input type="checkbox"/> Operations | <input type="checkbox"/> Syndicate |
| <input type="checkbox"/> Corporate Finance | <input checked="" type="checkbox"/> Legal & Compliance | <input type="checkbox"/> Options | <input type="checkbox"/> Systems |
| <input type="checkbox"/> Government Securities | <input type="checkbox"/> Municipal | <input type="checkbox"/> Registration | <input type="checkbox"/> Trading |
| <input type="checkbox"/> Institutional | <input type="checkbox"/> Mutual Fund | <input type="checkbox"/> Research | <input type="checkbox"/> Training |

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

Subject: Proposed Revision of *NASD Manual*

EXECUTIVE SUMMARY

The NASD, on the recommendation of its Legal Advisory Board (LAB), has undertaken a reorganization of the *NASD Manual* in order to make the *Manual* easier to use. As a first step in the *Manual* revision project, the LAB proposed an outline of the *Manual*. The LAB contemplates that, ultimately, the text of the *Manual* will be reorganized to conform to the outline and that the text of the *Manual* will then be edited to eliminate redundancies and inconsistencies. Because the outline itself is useful in locating relevant provisions contained in the *Manual*, however, a copy follows this notice for the benefit of NASD members. The outline was distributed as part of the November 1991 supplement to the looseleaf edition of the *Manual* and will be included in the next paper-bound *NASD Manual*.

BACKGROUND

In 1988, the NASD's Board of Governors approved the creation of the LAB, a group of attorneys who are prominent members of the securities bar. The LAB offers guidance to the NASD's Board of Governors on legal and policy issues. In 1989, the LAB recommended a project to reorgan-

ize the *NASD Manual*. Members of the LAB were in general agreement that the *NASD Manual* is currently organized in an awkward manner that makes it difficult for users to locate provisions relevant to a given topic. The NASD proposes to follow a two-step process with respect to the reorganization of the *Manual*. As a part of step one, the LAB prepared an outline for a proposed reorganization of the *Manual*. The LAB contemplated that, following the completion of the outline, the NASD, after review by appropriate committees of the Board of Governors, would physically reorder the existing text of the *Manual* to conform to the outline. As step two, the LAB contemplated that the NASD would undertake a substantive review of the *Manual* so as to eliminate inconsistencies and redundancies that would become more apparent when the text of the *Manual* was reordered.

To date, the LAB has completed its proposed outline for the revised *Manual* and has prepared a mock-up of the reordered text. Because the outline itself is useful in locating relevant sections of the *Manual*, the NASD has arranged to publish the outline along with the latest update to the *Manual*. Accordingly, the outline was included in a November 1991 mailing that transmitted updated pages to persons who subscribe to Commerce Clearing House's looseleaf version of the *Manual*. The outline will also be included in the next edition of the paper-bound *Manual* reprint. The outline, which is

denominated as a "Guide to the Manual," is found on pages 21 through 24 of the looseleaf version of the *Manual*.

The NASD also decided to publish the outline in this *Notice to Members* so as to allow the greatest possible number of *Manual* users to benefit from the outline. Page numbers reflected on the attached outline refer to pages contained in the looseleaf version of the *Manual*, as of November 1991.

The NASD and the LAB welcome any sugges-

tions that users of the *Manual* may wish to offer with respect to improvements to the outline. Written comments or suggestions regarding the outline should be directed to Anne H. Wright, Senior Attorney, Office of General Counsel, National Association of Securities Dealers, Inc., 1735 K Street, NW, Washington, DC 20006-1506. Any comments that the staff receives regarding the outline will be relayed to the members of the LAB.

**NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.
OUTLINE OF THE MANUAL**

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By-Laws	1045
Schedule A — Assessments and Fees	1501
Schedule B — District Boundaries	1521
Schedule C — Applications for Membership, Registration of Principals and Representatives, etc.	1531
Limitations Upon Use of Association Name (Resolution)	1651
NASD to Furnish Current List of Membership (Rules of Fair Practice, Article VI, first and last sentences)	2219
 CONDUCT STANDARDS	
Adoption and Application (Rules of Fair Practice, Article I)	2011
Interpretations and Explanations (Resolution)	1651
Definitions (Rules of Fair Practice, Article II)	2012
Business Conduct (General)	2014
Standards of Honor and Principles of Trade (Rules of Fair Practice, Article III, § 1)	2014
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