NASD REGULATORY & COMPLIANCE

ALERT

New NASD Rule Requires Price and Volume Reporting For "Pink Sheet" Stocks

The SEC recently approved an NASD proposal that establishes an electronic system of mandatory price and volume reporting for non-NASDAQ OTC securities, commonly called the "pink sheets" stocks.

To ensure strict adherence to best-execution requirements, a new rule proposal will also require members dealing in these securities to check at least three dealers (or all dealers if less than three) before executing customer orders.

The NASD will soon publish a notice to members with more details on these changes and the date upon which they will take effect.

All members executing principal transactions in non-NASDAQ securities must electronically report price and volume data on a daily basis if aggregate volume of purchases or sales exceeds either a minimum of 50,000 shares or $10,000.

Reporting Both Sides

Members must report price and volume data for both sides of the market if the aggregate share or dollar volume is reached on either side of the market.

For example, if buys total 70,000 shares and sales total 20,000 shares, the member will report both purchase and sale volumes, as well as price data, because the buys exceeded the share-threshold level.

The new NASD rule also requires that a member report the highest price at which it purchased a stock and the lowest price at which it sold a stock. The price to be reported on customer transactions must include the markup or markdown.

Members will be able to transmit trade data from 4 to 6:30 p.m. Eastern Time on trade date or from 7:30 to 9 a.m. Eastern Time the next business day. Members subscribing to NASDAQ Level 2/3 service must use their NASDAQ terminals to report; those without NASDAQ service must use a PC to electronically report non-NASDAQ securities price and volume information.

Intensified Efforts

All of this information will be subject to computerized review and analysis in the non-NASDAQ OTC Regulatory System, which is being designed as a nationwide automated market surveillance program.

This new rule is the latest action in the NASD's intensified effort to control abuses in the non-NASDAQ, over-the-counter, pink-sheet securities market. In conjunction with these stepped-up surveillance programs, the

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Task Force Recommends Enhancements to NASD Regulatory Program

The NASD's principal regulatory programs are "soundly managed and comprehensive in scope," according to a study conducted for the NASD by its Regulatory Review Task Force, which was commissioned in early 1987 and headed by A. A. Sommer, Jr., noted securities lawyer and former SEC Commissioner.

Uniform Standards

But to deter insider trading violations and protect the economic interests of investors and member firms, the securities industry needs uniform standards that prevent misuse of material, non-public information.

While so-called "Chinese Wall" procedures at securities firms seek to restrict access to sensitive information on matters such as pending mer-

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gers and acquisitions, "neither the Securities and Exchange Commission nor any self-regulatory organization has issued regulations establishing minimum standards and requirements for such procedures," the study said.

"The report provides an excellent framework for strengthening our investor protection activities," said Joseph R. Hardiman, NASD President. "The recommendations of the task force are very constructive and will greatly assist the NASD in refining its regulatory policies, practices, and procedures. Each of the recommendations will be acted upon by the appropriate national committees and, where appropriate, the Board."

Other Recommendations

Other major recommendations of the study include:

- Requiring more expeditious announcements of material developments by NASDAQ companies to reduce opportunities for illicit insider trading.
- Enhancing automated market surveillance programs to more quickly isolate trading patterns indicating possible price manipulation or misuse of material, nonpublic information.
- Abolishing limits on fines that may be imposed in NASD disciplinary proceedings and coupling increased fines with disgorgement in appropriate circumstances.
- Expediting referrals of certain matters to state authorities for possible criminal prosecutions.
- Providing a vehicle for public access to pertinent disciplinary information about brokers with whom investors may do business.
- Pursuing legislation to restrict re-entry into the securities business of certain persons previously adjudicated guilty of serious misconduct.
- Exploring mandatory continued education and other requirements for associated persons to avoid regulatory problems caused by an increasingly diversified product mix.
- Establishing requirements for electronic submission of regulatory information by member firms.
- Promoting greater sharing of technological advances and access to regulatory data to enhance the efficiency and effectiveness of regulatory programs administered by the self-regulatory organizations, the SEC, and state securities regulators.
- Intensifying efforts to detect questionable sales and trading practices — such as churning, unsuitable transactions, and manipulation — through routine examinations, closer scrutiny of arbitration awards, and automated surveillance of trading in non-NASDAQ, over-the-counter securities.

To obtain a copy of the Task Force Report, call the NASD Communications Group at (202) 728-6900 or write to the National Association of Securities Dealers, Inc., Communications Group, 1735 K Street, Northwest, Washington, D.C. 20006-1506.

NASD Aids State Enforcement with Referrals for Criminal Prosecution

At the recommendation of the Regulatory Review Task Force, the NASD is expediting the referral of cases to state and local prosecutors for possible criminal prosecution.

Absent unusual circumstances, this expedited procedure extends to clear instances of misappropriation, conversion, or embezzlement committed by associated persons.

When one of the district offices uncovers violations of this type, the District Director will review the evidence in the case. If the evidence supports a reasonable cause to believe that a violation has occurred, the Director — after obtaining the concurrence of the District Business Conduct Committee chairman — will refer the matter to the appropriate authorities for criminal prosecution.

NASD Makes More Information About Member Firms, Registered Representatives Available to Investors

To increase the information available to investors about the stockbrokers with whom they deal, the NASD recently expanded the disclosure of the disciplinary histories of its member firms and the disciplinary histories and prior affiliations of their associated persons.

Until now, the NASD has disclosed only the current affiliation of associated persons. NASD disciplinary actions have been the subject of press releases only if they led to fines of $10,000 or more, the suspensions of affiliated persons and firms, the barring of associated persons with any NASD member, and the expulsion of firms from the NASD.

Under the new policy, the NASD upon written inquiry discloses information regarding past and present affiliations of associated persons.

It also discloses criminal convictions and final disciplinary actions taken by federal and state agencies and the NASD as well as other self-regulatory agencies that relate to sesecurities or commodity transactions, as reported by firms and individuals to the NASD.

Call Information Services at (301) 738-6500 or write to NASD, P.O. Box 9401, Gaithersburg, Maryland 20898-9401, to obtain a disclosure request form.

$200,000 in Fines for Trade-Reporting Violations

NASD Penalizes First Boston and Managing Director of Firm

The NASD Market Surveillance Committee recently imposed $200,000 in fines on The First Boston Corporation and James B. Raphalian, a managing director, for trade-reporting and supervisory violations.

Under an Offer of Settlement, the committee censured and fined the firm $150,000. It also censured Raphalian, fined him $50,000, and suspended him for three years from supervising compliance with the regulatory and trade-reporting requirements for OTC securities.

The violations centered on improper trade-reporting practices in NASDAQ National Market System (NASDAQ/NMS) securities and inadequate supervision of First Boston employees.

Under the NASDAQ/ NMS trade-reporting requirements all transactions in these securities must be reported within 90 seconds of execution.

Accurate and timely trade reporting lets participants in the NASDAQ market know the number of shares and the price involved in the latest transaction in a NASDAQ/ NMS security.

Because this information provides investors with current market data, the NASD considers overall compliance with its trade-reporting rules to be essential to maintaining confidence in the integrity of the NASDAQ market.

In the disciplinary action against First Boston and Raphalian, First Boston allegedly failed to report, or reported incorrectly, a substantial number of NASDAQ/NMS securities transactions during several periods in 1985 and 1987.

For its part, First Boston agreed:

- to adopt and implement specific procedures to supervise its associated persons in the Over-the-Counter Trading Department with respect to the reporting of NASDAQ/ NMS securities;
- to designate a Managing Director to supervise regulatory compliance in the Over-the-Counter Trading Department; and,
- to file through 1988 quarterly reports with the NASD to monitor compliance with trade-reporting requirements.

Managing Director's Failure

As a Managing Director, Raphalian managed the firm's OTC Trading Department during the period in question.

The NASD alleged that he failed, in his delegated responsibility, to establish, maintain, and enforce written procedures so that First Boston could properly supervise the trade-reporting activities of its associated persons.

Along with the other terms of the settlement Raphalian, for five years, must inform any other NASD member employing him as an associated person that it must send a letter to the NASD acknowledging familiarity with these allegations, the terms of suspension, and the existence of procedures to govern his conduct.

Schedule C Requires Members to Notify the NASD When Taking Certain Disciplinary Actions Against Employees

Schedule C, Part IV of the NASD By-Laws requires members to notify the NASD, promptly and in writing, of any disciplinary actions taken by any clearing corporation, self-regulatory organization, commodity futures market, or government regulatory agency against them or their associated persons.

When reporting disciplinary actions taken by others, the member must file an amended Form BD for actions against the firm and an amended Form U-4 for actions against registered persons.

When a registered person is terminated for cause, the member must file a Form U-5. For an internal disciplinary action taken by a member against a registered or nonregistered associated person or a "termination for cause" of a nonregistered associated person, the member must notify the NASD by completing a "Notice of Disciplinary Actions" form.

Under Schedule C, these internal disciplinary actions include any matters involving suspension, termination, the withholding of commissions or imposition of fines in excess of $2,500, or any other significant limitation imposed by the firm on a person's activities. Members may report all other disciplinary actions or terminations on Forms BD, U-4, and U-5.

Since other self-regulatory organizations also require their members to report internal disciplinary actions, the NASD will accept the filing of similar forms from those firms, i.e., NYSE members filing Form RE-3.

Failing to comply with these requirements may subject a member to action by a District Business Conduct Committee.

District examiners routinely review for compliance with these reporting requirements during field inspections. Failure to properly file when required could subject a member to possible action by a DBCC.

Members should direct their questions on these filings, as well as requests for copies of the Notice of Disciplinary Actions form, to their local NASD District Office.

Implementation Planned for June 30

SEC Approves Changes That Strengthen NASDAQ's Market

The Securities and Exchange Commission approved a series of NASD proposals to strengthen the NASDAQ market through enhancements to the Small Order Execution System (SOES).

These changes will improve investor access to market makers in NASDAQ/NMS securities — particularly during fast-moving, active markets — and strengthen the commitment of market makers in these issues. The NASD plans to implement the approved changes on June 30th.

The major changes to SOES are:

- To increase the depth of market making and to facilitate the execution of orders for individual investors, participation in SOES will become mandatory for all market makers in NASDAQ/NMS securities.
- To ensure continuous investor access to NASDAQ market makers in periods of high volume and volatile prices, SOES will provide for the public dissemination of quotations and the execution of orders in a NASDAQ/NMS security in locked or crossed markets.
- To create affirmative obligations for market makers to make continuous markets, a market maker who withdraws from making a market in a NASDAQ security, except for very narrowly defined legal or equipment reasons, will not be able to resume market making in that security for 20 business days.

To make certain that SOES properly reflects the trading characteristics of NASDAQ/NMS issues, the new rules establish order-size limits based on an issue's daily non-block volume, average bid price, and average number of market makers.

Exposure Limits

The limits are 1,000 shares for the most active NASDAQ/NMS securities, 500 shares for the less active issues, and 200 shares for the least active.

Market makers will be subject to a minimum exposure limit requirement equal to five times the order-size limit for an issue, on both sides of the market.

"The SEC's approval of our program is a very real service to individual investors, who hold approximately two-thirds of the market value of NASDAQ/NMS issues," NASD President Joseph R. Hardiman said.

Investor Access

"By removing the limitations of telephone contact to direct orders, investors, via their brokers, will have much better access to NASDAQ market makers," he continued. "Investors and their brokers will also find that the other changes being made will assure investors that market makers are there when they need them, especially in fast-moving, volatile markets like those of last October."

NASD Will Introduce Electronic Filing System to Ease Member Reporting

The NASD will soon offer a nationwide, PC-based electronic filing and reporting system for members to use when filing various regulatory reports with the NASD. Initially, members can use the service to file monthly NASDAQ short-interest reports directly to the NASD, thereby avoiding use of the NS-1 Form. Later this year, the NASD's new service will include Regulation T and 15c3-3 extension requests filings.

To help monitor activities in these areas, the NASD will produce routine reports on members' extension requests. With this service, members will get immediate notification of approval or denial of extension requests, elimination of mail delays, and increased filing accuracy with on-line editing.

Future enhancements will incorporate many of the other filings members send to the NASD. Details on the service will be available shortly but till then members may direct questions to Joseph Blumka at (202) 728-8964 or Elizabeth Wollin at (301) 738-6887.

NASD Bars New Orleans RR

Without admitting or denying the NASD's allegations, Howard H. Hampton recently consented to a bar and $50,000 fine for sales practice violations involving option transactions.

A registered representative in New Orleans, Hampton was working for E.F. Hutton & Company, Inc., and Prudential-Bache Securities, Inc., both of which also submitted offers of settlement. The NASD found that both firms and their branch office managers had failed to properly supervise Hampton's activities.

Without admitting or denying the NASD's allegations, E.F. Hutton & Company, Inc., and the firm's branch office manager in New Orleans — John O. Roy, Jr. — consented to a censure and fine of $20,000, jointly and severally.

Prudential-Bache Securities, Inc., consented to a $25,000 fine and censure; its branch manager, Lawrence A. Grolemund, consented to a suspension from association with any NASD member as a registered options principal from May 16 to June 6, 1988, a $7,500 fine, and censure. Both managers must also requalify as registered options principals.

SEC Approves NASD Proposal to Halt Trading by Members Pending Dissemination of Material News By Issuers

The Securities and Exchange Commission recently approved the NASD's proposal to impose trading halts in NASDAQ securities and listed issues traded over-the-counter pending the dissemination of material news.

The new rule prohibits members and associated persons from directly or indirectly effecting any transaction in a security subject to a trading halt.

The SEC also approved a companion amendment to Schedule D of the By-Laws setting forth the authority and the procedures for the NASD to initiate trading halts.

Before the Change

Prior to the SEC's action, the NASD could only halt quotations in an issue pending the release of material news that might reasonably be expected to affect the value of an issuer's securities or influence investors. As a practical matter, trading halts did not bring about a complete halt in trading in NASDAQ securities, including NASDAQ National Market System securities, raising questions about the protections afforded investors during the critical disclosure process.

New Rule's Value

The new rule remedies that problem as well as any actual or perceived advantage of professional investors with direct access to the markets. The value of the new rule is that during trading halts, individual and institutional investors will have an equal opportunity to evaluate material information and consider it in making investment decisions.

A related proposal, which has also been approved by the SEC, will require NASDAQ issuers to notify the NASD Market Surveillance Section of the release of any material news no later than simultaneously with the release of such information to the press with a recommendation that the notification be given at least 10 minutes in advance of the release. If after consulting with the issuer, the NASD deems a trading halt appropriate, notice of the halt will appear in the NASDAQ "NEWS" frame at which point all members must cease trading in the halted security.

Resumption of Trading

Normally, trading will resume as soon as there has been adequate time (usually 30 minutes after the news crosses the wires) to disseminate the news and upon notice via NASDAQ that the halt has ended. The NASD will distribute a Notice to Members detailing these trading halt procedures shortly.

Market Surveillance Committee Disciplines Member, Trader For Improper Use of the Small Order Execution System

The NASD's Market Surveillance Committee recently took disciplinary actions against Morgan Stanley & Co. Incorporated, and one of its traders for misusing the NASD's Small Order Execution System (SOES).

As sanctions, the committee censured Morgan Stanley, fined the firm $50,000, and suspended it for 30 days from acting as a SOES market maker or SOES order-entry firm. The trader, Samuel Wegbreit, was censured and fined $10,000. Morgan Stanley and Wegbreit also were assessed costs of the disciplinary proceeding, jointly and severally, of $1,799.05. SOES is an automated system designed to facilitate the execution of agency orders for public customers at the best-available price. Its rules prohibit broker-dealers from using SOES to execute trades for their own proprietary accounts.

In addition, customer orders may not exceed certain size limits of the system. The limit for NASDAQ/NMS securities is 1,000 shares; for other NASDAQ securities, it is 500 shares. Orders in excess of those limits may not be divided into small parts to meet the SOES size requirements, a practice known as "order splitting."

In this case, the Market Surveillance Committee found that between June and September of 1986, Wegbreit, a Morgan Stanley equity trader in the firm's index and equity program trading department, acting through two junior clerks, used SOES improperly to execute the over-the-counter portion of the equity side of program trades for Morgan Stanley's proprietary account. This happened in 193 transactions in 14 securities.

In addition, Wegbreit, acting through the same two clerks, split orders for customers engaged in program trading on 18 occasions in six securities during the same time period. The NASD found that by using SOES to execute trades for Morgan Stanley's proprietary account and by splitting orders, Wegbreit violated Article II, Section 1 of the NASD Rules of Fair Practice.

The committee also found that Morgan Stanley failed to establish, maintain, and enforce written supervisory procedures during the June to September 1986 time period. The NASD concluded that Morgan Stanley violated Article III, Sections 1 and 27 of the NASD Rules of Fair Practice.

The Market Surveillance Committee is responsible for maintaining the integrity of the NASDAQ market and with disciplining persons who violate market rules.

Pink Sheet

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NASD has imposed fines, expulsions, and bars on members and associated persons who were found to have violated securities laws and NASD rules when dealing in these non-NASDAQ securities.

For example, on May 2, 1988, the NASD announced a disciplinary action in which it suspended Blinder, Robinson & Co., Inc., as an NASD member for five business days and also suspended Meyer Blinder, the firm's president, and four other employees from association with any NASD members in any capacity for a period of 90 days. The NASD also imposed a fine of $250,000 upon the respondents, jointly and severally, and all were censured.

Unfair and Excessive Markups

The NASD found that respondents charged unfair and excessive markups in the sale of Telephone Express Corporation, a non-NASDAQ OTC security. The markups ranged from 11 to 150 percent above the prevailing market price in 1,328 aftermarket sales to public customers.

The NASD found that Blinder, Robinson underwrote the initial public offering of the stock, placing it exclusively with Blinder's retail customers.

Given the virtual absence of inter-dealer transactions in secondary market activity and Blinder's ability to manage the retail trade through its registered representatives, the NASD determined that Blinder effectively dominated and controlled the aftermarket for the securities.

Because the NASD's rules prohibit members from exploiting customers' lack of knowledge of current market conditions to make unreasonable profits, the NASD concluded that, considering all relevant circumstances, the markups charged by the respondents were excessive and fraudulent.

Aftermarket Manipulation

In another case, the NASD found a New Jersey firm, Patten Securities Corporation, guilty of manipulating the price of Horizon Capital Corporation units.

As a result, the NASD expelled the firm, barred its founder and president, John Patten, from association with any NASD member in any capacity, imposed a $50,000 fine jointly and severally for the firm and Patten, and made the firm and Patten disgorge $167,000 in illegal profits.

Patten Securities underwrote a units offering of Horizon Capital Corporation, a blind pool company with no operating history, revenues, or income. Horizon's total assets at the time of the units offering were only $6,000.

Horizon Principals

The two principals of Horizon were school teachers with no relevant business experience who intended to devote only 10 percent of their time to Horizon's affairs. Patten sold the offering of 5,750,000 units at 3 cents each. Out of the total proceeds of approximately $172,500, Horizon Capital Corporation received about $100,000.

Aftermarket Trading

In the initial aftermarket, trading in the Horizon units was flat. After several days, Patten Securities purchased 2,485,000 units at admittedly arbitrary prices above the firm's own bid price thereby gaining direct control of a substantial percentage of the outstanding Horizon units.

This and subsequent aftermarket activity by Patten put respondents in a position where they dominated and controlled the market, accounting for nearly all of the purchase and sale volume for the Horizon units.

The respondents' manipulative activity caused the aftermarket price to rise 316 percent above the public offering price and resulted in a $167,000 profit to the respondents.

New Program Expands Surveillance Of New Issue Offerings by NASD Staff

With the introduction of its Best Efforts Distribution Reporting Program, the NASD has expanded its surveillance of non-NASDAQ new issue public offerings. The NASD can now monitor the distribution process for all best-efforts offerings of non-NASDAQ issues by reviewing monthly reports obtained from managing underwriters reflecting daily sales volume during the distribution period. Using these data, the NASD tracks several compliance areas, such as contingencies under SEC Rule 15c2-4, while the issue is still in distribution.

This program complements the Free-Riding and Withholding Program and the computerized New Issue Market Manipulation System which monitors member distribution practices and aftermarket activity. For new issues on NASDAQ, the Surveillance staff obtains information on the immediate aftermarket from the NASDAQ System; for non-NASDAQ issues, it obtains the information directly from underwriters and market makers.

Thus far, these programs have uncovered cases of alleged market manipulation involving pink sheet stocks, marking the close, fraud, and sales of hot issues to restricted accounts.

"This expanded surveillance in the distribution phase of new issues of non-NASDAQ stocks is an important step in monitoring member firms' best-efforts underwriting activities by closely reviewing these activities for possible manipulation or other serious sales practice abuses," says John E. Pinto, Jr., Senior Vice President, NASD Compliance. "It has proven to be very effective in broadening the NASD's regulation of the over-the-counter market."