

Notice To Members

National Association of Securities Dealers, Inc.

August 1989

Number 89 - 55**Suggested Routing:*** Senior Management Corporate Finance Government Securities Institutional Internal Audit Legal & Compliance Municipal Mutual Fund Operations Options Registration Research Syndicate Systems Trading Training

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

REQUEST FOR COMMENTS

Subject: Proposed Amendments to the NASD Uniform Practice Code Re: Clearly Erroneous Trades; and Proposed Amendments to Article IX of the NASD Code of Procedure Re: Non-NASDAQ Grievances; Last Date for Comments: September 1, 1989

EXECUTIVE SUMMARY

The NASD requests comments on proposed amendments to the NASD Uniform Practice Code regarding "clearly erroneous trades" and on an amendment to Article IX of the NASD Code of Procedure to include certain non-NASDAQ grievances. The proposed amendments to the NASD Uniform Practice Code would (1) enable the Association to declare clearly erroneous trades null and void and (2) establish procedures for such deter-

minations and appeals of such determinations. The proposed amendment to Article IX of the NASD Code of Procedure would expand its applicability from grievances involving only NASDAQ operations to grievances involving the operations of NASDAQ and of any other automated quotation, execution, or communication system owned or operated by the Corporation or one of its subsidiaries registered with the SEC.

BACKGROUND

NASD rules now are silent on the subject of clearly erroneous trades. In situations where a trade is obviously in error, the matter must be resolved by the members involved. The Association currently lacks the authority to declare such trades null and void, even though the erroneous quotation, execution, or report of such trade may be detrimental to the fair and orderly functioning of the market.

The proposed amendments reflect the NASD's observations that:

- The Association should have the capability, as do exchange floor governors, to resolve disputes involving obvious errors in an expeditious manner;
- Such capability would be beneficial to the membership in that it would provide an efficient mechanism for the disposition of disputes; and
- Any such capability should provide for Board of Governors review.

In its consideration of these issues, the NASD has also noted that the Code of Procedure does not provide procedures for the resolution of grievances arising out of systems other than NASDAQ operated by the Association.

PROPOSED AMENDMENTS

As a result of these observations, the Board of Governors, the Trading Committee and the Uniform Practice Committee have discussed possible amendments to the Uniform Practice Code to address these concerns. These discussions have resulted in a proposal to amend the Uniform Practice Code to add a new section, Section 70.

Proposed Section 70 of the Uniform Practice Code would initially provide the Association the authority to declare a transaction null and void on the grounds that one or more terms of the transaction is clearly erroneous in cases where it "deems it necessary to maintain a fair and orderly market, and to protect investors and the public interest." The authority would extend to any transactions arising out of the use or operation of any automated quotation, execution, or communication system owned or operated by the Corporation or its subsidiaries that is approved by the SEC. The section is therefore intended to apply to transactions occurring not only in NASDAQ but also involving other systems such as the Order Confirmation Transaction (OCT) system.

The amendments set forth the procedures for declaring a transaction void. These procedures have been formulated to make them as expeditious as possible. A member may initiate the procedure orally (with written confirmation) on the same business day the transaction occurs by contacting a designated officer of the Corporation and requesting that a transaction be declared null and void. The initiating member, as well as all other members involved in the transaction, would be obligated to provide the Association such information as may be requested.

Under the procedures, the designated officer may determine that the transaction is "clearly erroneous and detrimental to the maintenance of a fair and orderly market and the protection of investors and the public interest" and may declare the transaction null and void. The officer may also decline to act if he or she believes that action is unnecessary or inappropriate. That may occur, for example, if the error is such that, although obvious, it has no bearing on the functioning of the market or would otherwise appear more appropriately resolved by other channels such as arbitration.

The procedures would require a written determination, although in most cases it is anticipated that oral notice of the determination will be given.

The determination would then be appealable to the SOES Review Committee, provided the appeal was made within four market hours of notice of the determination. The SOES Review Committee, which was established by the Board in 1988, is proposed to be the appellate body in this instance because it is a committee that meets regularly and on short notice. The SOES Review Committee would be required to act within two business days of the determination. Under the procedures, it would consider the matter on the record or after a hearing, if it so ordered. Its determination would constitute final action by the Association and would be appealable to the Securities and Exchange Commission under the Securities Exchange Act of 1934.

Finally, in connection with its consideration of issues involving clearly erroneous trades, the Board noted that Article IX of the Code of Procedure is limited to grievances involving the NASDAQ System and its operations. The Code does not provide separate procedures for grievances involving other systems whose implementation has postdated the adoption of Article IX. The Board is proposing that Article IX be amended to expand its scope to cover redress for grievances arising out of the operation of "any automated quotation, execution, or communication system owned or operated by the Corporation or subsidiary thereof registered with the SEC," the grievances of which are not otherwise addressed by the Code of Procedure.

The Board of Governors believes that the proposed amendments to the Uniform Practice Code will enhance the integrity of the market and be beneficial to members and that the amendment to the Code of Procedure is necessary to provide a mechanism for redress of grievances that arise from systems other than NASDAQ.

The NASD encourages all members and interested persons to comment on the proposed amendments. Comments should be directed to Mr. Lynn Nellius, Secretary, National Association of Securities Dealers, Inc., 1735 K Street, NW, Washington, DC 20006.

Questions concerning this notice can be directed to Ms. Therese M. Haberle, Special Counsel, at (202) 728-8287.

Comments must be received no later than **September 1, 1989**. Changes to the Uniform Practice

Code and Code of Procedure must be approved by the Board of Governors and filed with, and approved by, the SEC before becoming effective.

PROPOSED AMENDMENT TO THE UNIFORM PRACTICE CODE

(Note: New text is underlined.)

UNIFORM PRACTICE CODE

Clearly Erroneous Trades

Sec. 70.

Authority to Declare Transaction Void

(a) (1) In circumstances in which the Association deems it necessary to maintain a fair and orderly market, and to protect investors and the public interest, the Association may, pursuant to the procedures set forth in paragraph (b), declare any transaction arising out of the use or operation of any automated quotation, execution, or communication system owned or operated by the Corporation or any subsidiary thereof approved by the Securities and Exchange Commission, null and void on the grounds that one or more of the terms of the transaction are clearly erroneous.

(2) For the purposes of this section, the terms of a transaction are clearly erroneous when there is an obvious error in any term, such as price, number of shares or other unit of trading, or identification of the security.

Procedures for Declaring a Transaction Void

(b) (1) Any member or person associated with a member that seeks to have a transaction declared null and void pursuant to paragraph (a) shall notify an officer of the Corporation designated by the President of the transaction during NASDAQ operating hours on the same business day the transaction occurs, and shall provide such official all facts and information necessary for a determination under paragraph (a). Information communicated orally shall be confirmed promptly in writing. Each member and/or person associated with a member involved in the transaction shall provide the Association with any information requested by the Association in order to resolve the matter on a timely basis.

(2) An officer of the Corporation designated by the President shall review the information submitted and determine whether the transaction in dispute is clearly erroneous and detrimental to the

maintenance of a fair and orderly market and the protection of investors and the public interest and may declare that the transaction be null and void. The official may decline to act upon a disputed transaction if he or she believes that action is unnecessary or inappropriate. The Association shall issue a written determination of the matter, setting forth the actions taken and the reasons therefore.

(3) A member or person associated with a member may appeal the determination under subparagraph (2) to the Board SOES Review Committee provided such appeal is made within four market hours of notification of such determination. For the purposes of this section, "market" hours shall mean those hours the NASDAQ market is open in the United States, Eastern Time. Upon consideration of the record, and after such hearings as it may order, the SOES Review Committee shall affirm, modify, reverse, dismiss, or remand the determination under subparagraph (2). The SOES Review Committee shall set forth specific grounds upon which its determination is based. The determination of the SOES Review Committee shall be issued within two business days of the determination under subparagraph (2). In any case where a person feels aggrieved by any decision of the SOES Review Committee taken pursuant to subparagraph (3), the person may make application for review to the Securities and Exchange Commission in accordance with the Securities Exchange Act of 1934, as amended.

(4) The decision of the SOES Review Committee shall be final and binding upon any member or person associated with a member and shall constitute final Association action on the matter in issue.

PROPOSED AMENDMENT TO THE CODE OF PROCEDURE

(Note: New text is underlined, deleted text is in brackets.]

NASD Code of Procedure

Article IX

Procedures on Grievances Concerning [the NASDAQ] Automated Systems

Purpose

Sec. 1. The purpose of this Article is to provide, where justified, redress for persons aggrieved

by the [operations of the NASDAQ system] operation of any automated quotation, execution, or communication system owned or operated by the Corporation, or any subsidiary thereof registered

with the Securities and Exchange Commission, not otherwise provided for by this Code, and to provide procedures for the handling of qualification matters pursuant to NASDAQ rules.

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August 1989

Number 89 - 56**Suggested Routing:*** Senior Management Corporate Finance Government Securities Institutional Internal Audit Legal & Compliance Municipal Mutual Fund Operations Options Registration Research Syndicate Systems Trading Training

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REQUEST FOR COMMENTS

Subject: Proposed Amendments to NASD Uniform Practice Code Re: Mandatory Buy-In for Short Sales; Last Date for Comments: September 1, 1989

EXECUTIVE SUMMARY

The NASD requests comments on proposed amendments to Section 59 of the NASD Uniform Practice Code regarding buying in. The proposed amendments would impose a mandatory buy-in for guaranteed delivery 10 days after normal settlement date in connection with a short sale in certain NASDAQ securities. The rule would apply to short sales for the accounts of customers and

the proprietary accounts of registered broker-dealers in securities that have a clearing short position of 10,000 shares or more that is equal to at least one half of one percent of the total shares outstanding. Short sales as a result of bona fide market-making activity and short sales in which the resulting position is fully hedged or arbitrated would be exempt from the rule.

BACKGROUND

A mandatory buy-in rule was first suggested in the 1986 *Report on Short Sale Regulation of NASDAQ Securities*. The report included the following recommendation:

A mandatory buy-in requirement for guaranteed delivery should be adopted. The fail-to-deliver/fail-to-receive problem has the potential for causing serious difficulties in a lengthy bear market. While the evidence does not suggest that delivery problems exist in many securities, the fact that there is no automatic mechanism preventing the substan-

tial buildup of short positions at the clearing corporation and of fails to receive in brokerage firms carries the potential for serious problems, particularly in the event of crisis market conditions, such as existed in the late 1960s. A mandatory buy-in requirement would force short sellers to borrow and deliver or cover; and a requirement for guaranteed delivery would prevent short sellers from again selling short to the brokers executing the buy-in.

The NASD Board of Governors deferred action on this recommendation until it had an oppor-

tunity to assess the effect that other recommendations — set forth in the report and implemented by the Association — had on abusive short-selling practices. In July 1988, the Quality of Markets Committee submitted its final report to the NASD Board. That Committee also examined short selling in NASDAQ and again recommended that ". . . the NASD formulate the necessary rules to require a mandatory buy-in for the account of the short-selling party if it fails to deliver after a short period of time." The Trading Committee took this recommendation under consideration and formed, along with the Uniform Practice Committee, a mandatory buy-in subcommittee to study the issue further. The subcommittee's efforts culminated in the Board's determination to request comment on the proposed rule amendment.

PROPOSED AMENDMENTS

The mandatory buy-in requirement is aimed primarily at curbing "naked" or abusive short selling in NASDAQ securities. The mandatory buy-in rule is designed to specifically address "problem situations," e.g., where shorts to clearing equal a significant percentage of a company's total shares outstanding. The rule has been drafted so as to identify securities whose short positions at the clearing corporation represent a significant percentage of the issues' total shares outstanding. These securities could be placed on a "restricted list," meaning that any subsequent short sale would be subject to a mandatory buy-in after a specified period of time.

The mandatory buy-in rule would apply to NASDAQ securities only. As proposed, the rule would impose a mandatory buy-in for guaranteed delivery in connection with short sales if a fail-to-deliver exists 10 days after the normal settlement date. The rule would apply to short sales in securities that have a clearing short position of 10,000 shares or more that is equal to at least one half of one percent of the total shares outstanding. According to NASD staff research, application of this parameter as of March 7, 1989, would have resulted in a total of 91 NASDAQ securities being covered by the rule.

The buy-in requirement would be applicable to short sales for the accounts of customers and the proprietary accounts of registered broker-dealers. Short sales as a result of bona fide market-making

activity and short sales in which the resulting position is fully hedged or arbitrated would be exempt from the rule.

The buy-in requirement will be triggered 10 business days after normal settlement date. This is consistent with the approach taken in SEC Rule 15c3-3, which requires a broker-dealer to close a transaction with a customer by purchasing securities of like kind and quantity when a fail-to-deliver exists 10 business days after settlement date in a customer long sale.

As drafted, the mandatory buy-in requirement would be added to Section 59 of the Code as a new subsection. The new subsection (o) would be mandatory and would incorporate by reference the provisions of Section 59 otherwise available on a discretionary basis.

The NASD encourages all members and interested persons to comment on the proposed amendments. Comments should be directed to Mr. Lynn Nellius, Secretary, National Association of Securities Dealers, Inc., 1735 K Street, NW, Washington, DC 20006.

Questions concerning this notice can be directed to Ms. Therese M. Haberle, Special Counsel, at (202) 728-8287.

Comments must be received no later than **September 1, 1989**. Changes to the Uniform Practice Code must be approved by the Board of Governors and filed with, and approved by, the SEC before becoming effective.

PROPOSED AMENDMENT TO THE UNIFORM PRACTICE CODE

(Note: New text is underlined.)

UNIFORM PRACTICE CODE

Sec. 59. Close-Out Procedure; Buying-in
((a) through (n) are unchanged.)

Mandatory Buy-in for Short Sales

(o)(i) A contract involving a short sale in NASDAQ securities described below, for the account of a customer or for a member's own account, which has not resulted in delivery by the seller within 10 business days of the normal settlement date, must be closed by the buyer for guaranteed delivery in accordance with the procedures set forth in this Section.

(o)(ii) This requirement shall apply to NASDAQ securities, as published from time to time by the Association, which have clearing short positions of 10,000 shares or more that are equal to at least one-half (1/2) of one percent

of the issue's total shares outstanding.

(o)(iii) This mandatory buy-in requirement shall not apply to bona fide market making transactions that result in fully hedged or arbitrated positions.

Notice To Members

National Association of Securities Dealers, Inc.

August 1989

Number 89 - 57

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 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 |

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Subject: SEC Approval of By-Law and Rule of Fair Practice Amendments on Providing Terminated Employees With Form U-5 and Obtaining Prior Form U-5 for Potential Employees — Effective September 1, 1989

EXECUTIVE SUMMARY

The Securities and Exchange Commission recently approved amendments to Article IV, Section 3, of the NASD By-Laws and Article III, Section 27, of the Rules of Fair Practice. These amendments require NASD members to provide a copy of the Form U-5 to persons who terminate or are terminated by the member. Members will be required to provide the Form U-5 concurrently with the filing of the Form U-5 with the NASD. In addition, each NASD member will be required to use its best efforts to obtain the most recent Form U-5 from any person seeking employment in a registered capacity.

BACKGROUND AND SUMMARY

The amendment to Article IV, Section 3, of the By-Laws will require that a member submitting to the NASD a Uniform Termination Notice of Securities Industry Registration (Form U-5), pursuant to Article IV, Section 3, of the NASD By-Laws, should also provide a copy to the employee who has been terminated. As in the past, the member is required to exercise good faith and to dis-

close the circumstances of the termination in a manner reasonably designed to inform the NASD and future employers of these circumstances. The NASD believes that the policy of providing broader access to the information on the Form U-5 requires that terminated persons be given the Form U-5 so they can verify the accuracy and completeness of the representations in the form. The terminated individual then can express any disagreement with the Form U-5 to his or her subsequent NASD member employer. In addition, the amendments codify the requirement that an amendment to the Form U-5 be filed if later-discovered information causes any statements in the form to be inaccurate or incomplete.

The amendment to Article III, Section 27, of the Rules of Fair Practice will require NASD members that employ persons previously registered with another NASD member to obtain a copy of the Form U-5 (and any amendments thereto) filed by the person's most recent employer. Article III, Section 27(e), requires that "each member shall have the responsibility and duty to ascertain by investigation the good character, business repute, qualifications and experience of any person prior to making such a certification in the application of such person for registration with this Association." The NASD believes that, by making the Form U-5

available in this manner, members will be better able to meet their obligation under this section of the Rules of Fair Practice to adequately investigate the background of potential employees.

The NASD believes that the circumstances of a termination, as disclosed on the Form U-5, may well be relevant to the hiring decision and that this information should be readily available to any NASD member for that purpose. This information is particularly pertinent in the situation where the person was terminated for cause or where affirmative answers have been provided to Items 13-15 of the Form U-5 regarding possible rule violations during the period of employment. As part of the hiring process, members should be allowed to compare the Form U-5 with any statements made by the potential employee regarding the termination. The amendments will establish the requirement to obtain the Form U-5, set forth timeliness standards for compliance, and provide for obtaining the Form U-5 through the NASD Firm Access Query System (FAQS) for FAQS subscribers or from the prospective employee for firms that do not subscribe to FAQS.

Questions concerning this notice may be directed to Craig L. Landauer, Senior Attorney, NASD Office of General Counsel, at (202) 728-8291.

AMENDMENT TO ARTICLE IV, SECTION 3, OF THE NASD BY-LAWS

(Note: New language is underlined.)

Registered Representatives and Associated Persons
Notification by Member to Corporation and
Associated Person of Termination; Amendments to
Notification.

Sec. 3(a). Following the termination of the association with a member of a person who is registered with it, such member shall promptly, but in no event later than thirty (30) calendar days after such termination, give written notice to the Association on a form designated by the Board of Governors of the termination of such association, and concurrently shall provide to the person whose association has been terminated a copy of said notice as filed with the Association. A member who does not submit such notification in writing, and provide a copy thereof to the person whose association has been terminated, within the time

period prescribed shall be assessed a late filing fee as specified by the Board of Governors. Termination of registration of such person associated with a member shall not take effect so long as any complaint or action is pending against a member and to which complaint or action such person associated with a member is also a respondent, or so long as any complaint or action is pending against such person individually or so long as any examination of the member of person associated with such member is in process. The Corporation, however, may in its discretion declare the termination effective at any time.

(b) The member shall notify the Association in writing by means of an amendment to the notice filed pursuant to paragraph (a) above in the event that the member learns of facts or circumstances causing any information set forth in said notice to become inaccurate or incomplete. Such amendment shall be filed with the Association and provided to the person whose association with the member has been terminated not later than thirty (30) calendar days after the member learns of the facts or circumstances giving rise to the amendment.

AMENDMENT TO ARTICLE III, SECTION 27, OF THE RULES OF FAIR PRACTICE

(Note: New language is underlined.)

Supervision

Qualifications investigated. (e) Each member shall have the responsibility and duty to ascertain by investigation the good character, business repute, qualifications and experience of any person prior to making such a certification in the application of such person for registration with this Association. Where an applicant for registration has previously been registered with the Association, the member shall obtain from the Firm Access Query System (FAQS) or from the applicant a copy of the Uniform Termination Notice of Securities Industry Registration ("Form U-5") filed with the Association by such person's most recent previous NASD member employer, together with any amendments thereto that may have been filed pursuant to Article IV, Section 3 of the Association's By-Laws. The member shall obtain the Form U-5 as required by this section no later than sixty (60) days following the filing of the ap-

plication for registration or demonstrate to the Association that it has made reasonable efforts to comply with the requirement. A member receiving a Form U-5 pursuant to this section shall review the Form U-5 and any amendments thereto and shall take such action as may be deemed appropriate.

Applicant's Responsibility. (f) Any applicant for registration who receives a request for a copy of his or her Form U-5 from a member pursuant to this section shall provide such copy to the member

within two (2) business days of the request if the Form U-5 has been provided to such person by his or her former employer. If a former employer has failed to provide the Form U-5 to the applicant for registration, such person shall promptly request the Form U-5, and shall provide it to the requesting member within two (2) business days of receipt thereof. The applicant shall promptly provide any subsequent amendments to a Form U-5 he or she receives to the requesting member.

(Current subsection (f) is renumbered as (g).)

Notice To Members

National Association of Securities Dealers, Inc.

August 1989

Number 89 - 58

Suggested Routing:*

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| <input checked="" 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 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 |

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Subject: Amendment Re: Predispute Arbitration Clauses in Customer Agreements

EXECUTIVE SUMMARY

In conjunction with its approval of various amendments to the NASD Code of Arbitration Procedure, the Securities and Exchange Commission recently approved an amendment to Article III, Section 21, of the NASD Rules of Fair Practice. The amendment will require each member using a predispute arbitration clause in a customer agreement after September 7, 1989, to highlight that clause and to include similarly highlighted disclosures concerning the nature of arbitration

and the waiver of the customer's right to litigate disputes arising under the agreement.

The amendment also prohibits the use in any agreement of any language that limits or contradicts the arbitration rules of any self-regulatory organization, limits the ability of a party to file a claim in arbitration, or limits the ability of the arbitrators to make an award under the arbitration rules of a self-regulatory organization and applicable law. The text of the proposed amendment follows this notice.

BACKGROUND AND ANALYSIS

In keeping with its support for the continued improvement of securities industry arbitration as a fair, expeditious, and economical means for the resolution of disputes, the NASD, responding to suggestions of the Securities and Exchange Commission and others seeking more explicit disclosure of the existence and meaning of predispute arbitration clauses in customer agreements, filed with the SEC following approval by membership vote an amendment to Article III, Section 21, of the NASD Rules of Fair Practice.

On May 10, 1989, the SEC approved the NASD's proposed amendment to Article III, Sec-

tion 21, set forth in *NASD Notice to Members 89-21* (March 1989). The amendment applies to any member using a predispute arbitration clause in new agreements signed by an existing or new customer after September 7, 1989, the effective date of the amendment. The amendment will require each member using a predispute arbitration clause in a customer agreement to highlight that clause and to include similarly highlighted disclosures concerning the nature of arbitration and the waiver of the customer's right to litigate disputes arising under the agreement. The amendment also will prohibit the use in any agreement of any language that limits or contradicts the arbitration

rules of any self-regulatory organization, limits the ability of a party to file a claim in arbitration, or limits the ability of arbitrators to make an award under the arbitration rules of a self-regulatory organization and applicable law.

Questions concerning this notice may be directed to Norman Sue Jr., Assistant General Counsel, NASD Office of General Counsel, at (202) 728-8117.

**PROPOSED AMENDMENT
TO ARTICLE III, SECTION 21, OF
THE NASD RULES OF FAIR PRACTICE**

(Note: New language is underlined.)

Books and Records

**Sec. 21. Requirements When Using
Predispute Arbitration Agreements With Customers**

(f)(1) Any predispute arbitration clause shall be highlighted and shall be immediately preceded by the following disclosure language (printed in outline form as set forth herein) which shall also be highlighted:

(i) Arbitration is final and binding on the parties.

(ii) The parties are waiving their right to seek remedies in court, including the right to jury trial.

(iii) Pre-arbitration discovery is gene-

rally more limited than and different from court proceedings.

(iv) The arbitrators' award is not required to include factual findings or legal reasoning and any party's right to appeal or to seek modification of rulings by the arbitrators is strictly limited.

(v) The panel of arbitrators will typically include a minority of arbitrators who were or are affiliated with the securities industry.

(2) Immediately preceding the signature line, there shall be a statement which shall be highlighted that the agreement contains a predispute arbitration clause. The statement shall also indicate at what page and paragraph the arbitration clause is located.

(3) A copy of the agreement containing any such clause shall be given to the customer who shall acknowledge receipt thereof on the agreement or on a separate document.

(4) No agreement shall include any condition which limits or contradicts the rules of any self-regulatory organization or limits the ability of a party to file any claim in arbitration or limits the ability of the arbitrators to make any award.

(5) The requirements of this subsection (f) shall apply only to new agreements signed by an existing or new customer of a member after September 7, 1989.

Notice To Members

National Association of Securities Dealers, Inc.

August 1989

Number 89 - 59

Suggested Routing:*

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| <input checked="" type="checkbox"/> Corporate Finance | <input type="checkbox"/> Legal & Compliance | <input type="checkbox"/> Options | <input checked="" type="checkbox"/> Systems |
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Subject: Report on Group of Thirty Recommendations Regarding Clearance and Settlement and Request for Comments

EXECUTIVE SUMMARY

In a report titled "Clearance and Settlement Systems in the World's Securities Markets," a private-sector group published nine recommendations proposing standards for clearance and settlement of corporate securities to reduce risk and maximize efficiency. Targeted for implementation by 1990 or 1992, the report's nine recommendations address both risk and efficiency. Briefly, the authors suggest containing risk by shortening the time between trade date and settlement, promoting trade guarantees, and assuring the simultaneous exchange of payment and securities. To promote efficiency, they recommend eliminating the physical movement of

certificates, encouraging the use of netting systems where appropriate, and standardizing communications methods and settlement schedules.

At a recent meeting of the heads of the various U.S. securities and options markets, the Group of Thirty recommendations were a major agenda item. In light of differing views on the merits of the Group's recommendations, particularly as they relate to individual investors, a determination was made that the proposals should be circulated to members for comment. Since virtually all firms that do a public business are NASD members, the NASD was asked to undertake this task.

BACKGROUND

The Group of Thirty includes high-level international businesspeople, bankers, and others concerned with the workings of the international financial system. The Group met in London to discuss the state of clearance and settlement practices in the principal securities markets of the world as well as the plans of countries for making those practices more compatible. Their conclusion was

that while the development of a single global clearing facility was not practical, agreement on a set of practices and standards that could be embraced by the markets that, in essence, constitute the world's securities system was highly desirable. The group found the need for such an agreement especially compelling because present standards of clearance and settlement are not acceptable. They are inefficient and generate undue costs,

overt and hidden, and undue risks for participants.

According to the report, the risk and inefficiency associated with the system are apparent in the following areas:

- The current process lacks compatible trade-comparison systems for both domestic and international trades.

- Different settlement periods exist for different markets and range from same-day settlement to several weeks.

- The lack of delivery versus payment (DVP) leaves one party to a transaction unduly exposed.

- Standardized trade guarantees are not available.

- Many markets have not developed book-entry processing for settlement of securities transactions.

Listed below are the specific recommendations. Most of the recommendations would not affect the U.S. since effective clearance and settlement systems exist. However, Recommendations 6 and 7, relating to payment in same-day funds and shrinking the settlement cycle to T+3, would have a significant impact on U.S. broker-dealers. In addition, Recommendation 9 would require introduction of a new numbering standard.

SPECIFIC RECOMMENDATIONS

Recommendation 1: By 1990, all comparisons of trades between direct market participants (i.e., brokers, broker-dealers, and other exchange members) should be accomplished by T+1.

The lack of timely, efficient, and disciplined matching systems creates significant risk for participants in the securities processing cycle. The report recommends that comparison (or trade matching) should occur no later than trade date plus 1 (T+1) and that all markets should accomplish this T+1 matching goal by 1990.

This T+1 standard gives both sides to a trade a chance to correct any discrepancies or conflicts while reducing risk in the settlement system and helping to ensure timely settlement. To achieve this standard will require an automated system that can report trade detail to counterparties, match trades, resolve trade errors, and "lock in" matching trades.

Present plans are for both the NASD and the NYSE to share systems in operation that meet this goal.

Recommendation 2: Indirect market participants (such as institutional investors or any trading counterparties that are not broker-dealers) should, by 1992, be members of a trade comparison system that achieves positive affirmation of trade details.

Affirmation systems exist for institutional investors that are unwilling or unable to participate in a risk-sharing arrangement, such as that found in a two-sided comparison system. In the former system, the institution (and its agent bank) receives a list of trades to which it is a counterparty. The institution then must affirm or question the trades within a preset time frame.

These systems link indirect members to a central clearing system or securities depository. The most efficient systems are highly automated and provide participants with on-line, real-time access to information, such as clearing and settlement data (to manage positions) and accounts (to manage cash).

The identification system operated by the Depository Trust Company (DTC) provides U.S. conformance with this goal.

Recommendation 3: Each country should have an effective and fully developed central securities depository organized and managed to encourage the broadest possible industry participation (directly and indirectly) in place by 1992.

A central securities depository's (CSD) main function is to immobilize stock certificates to facilitate "book entry" processing of securities transactions. With the book-entry method in place, securities can be transferred from one account to another by a simple debit or credit on the books of the CSD. The CSD can include the capability for trade clearance, safe custody, and settlement/postsettlement processing of securities and information, such as corporate actions and dividend/interest processing. In addition, it may include a payments system that could credit or debit the cash account of the member financial institution at the same time it processes the securities side of the transaction. The DTC fulfills this function for the United States.

Recommendation 4: Each country should study its market volumes and participation to determine whether a trade netting system would be

beneficial in terms of reducing risk and promoting efficiency. If a netting system would be appropriate, it should be implemented by 1992.

Trade-netting systems work best in high-volume markets. Three basic options exist for netting transactions. These are bilateral netting with all trades in the same security between the same counterparties netting to one final delivery versus payment; multilateral netting with all trades in the same security netting to a final long or short position for each participant; and continuous net settlement with all trades in a particular security plus failed trades continuously netting to a final long or short position and the clearing corporation standing in as the counterparty to the trade.

The National Securities Clearing Corporation (NSCC) currently operates a continuous net settlement system that meets this objective.

Recommendation 5: Delivery versus payment (DVP) should be employed as the method for settling all securities transactions. A DVP system should be in place by 1992.

Simultaneous exchange of value is important to eliminate the risks of price change and failure to perform according to contract. DVP effectively removes any exposure resulting from delivery delay by a counterparty. Although CSDs are useful, DVP can be accomplished through linkage to a final payment system, a system of bank guarantees, or a clearance or depository agency's financial guarantees. The NSCC and DTC do provide DVP settlement.

Recommendation 6: Payments associated with the settlement of securities transactions and the servicing of securities portfolios should be made consistent across all instruments and markets by adopting the "same day" funds convention.

Same-day funds refers to the availability of funds on the same day as they are deposited. Adoption of this convention should help increase the efficiency of the accounting and payment systems. As noted above, this is not the current practice in the United States.

Recommendation 7: A "rolling settlement" system should be adopted by all markets. Final settlement should occur on T+3 by 1992. As an interim target, final settlement should occur on T+5 by 1990 at the latest, except where it

hinders the achievement of T+3 by 1992.

In a rolling settlement environment, trades settle on all business days of the week. This process limits the number of outstanding trades, thereby reducing market exposure. The primary objective of this proposal is to reduce the delay between trade date and settlement date. The secondary objective is to standardize settlement time frames throughout international markets.

T+3 settlement would require that the NSCC change its settlement cycle from T+5.

Recommendation 8: Securities lending and borrowing should be encouraged as a method of expediting the settlement of securities transactions. Existing regulatory and taxation barriers that inhibit the practice of lending securities should be removed by 1990.

In many countries, restrictions and taxation apply that make it impossible or excessively expensive for market participants to lend or borrow securities to achieve timely settlement of transactions. These impediments to the lending and borrowing of securities should be removed in order to allow the maximum possible number of transactions to settle in the recommended time frame.

Securities lending and borrowing is common practice in this country.

Recommendation 9: Each country should adopt the standard for securities messages developed by the International Organization of Standardization [ISO Standard 7775]. In particular, countries should adopt the ISIN numbering system for securities issues as defined in the ISO Standard 6166, at least for cross-border transactions. These standards should be universally applied by 1992.

No worldwide securities numbering system exists. Many countries with highly developed securities businesses identify issues by code numbers, but these numbers have little significance outside the country concerned. Securities of the same issue are identified by different numbers in different countries where they may be physically held and/or booked. As a result, the national numbers are not satisfactory for cross-border transactions. The rapid expansion of the international securities business has created an urgent need for a universally applicable international securities identification number (ISIN).

Various standards for numbering securities exist today, including CUSIP, SEDOL, and others. For trade information to be communicated in a consistent format and handled by computers, a single numbering standard and message system would be ideal. Such a system is provided by the international ISO Standards 6166 and 7775. The ISIN consists of a country code, a security's domestic code number, and a check digit to validate the code.

This would require some change but should be feasible if applied only to cross-

border transactions.

REQUEST FOR COMMENTS

Member comments on the Group of Thirty recommendations are earnestly solicited to guide us in our discussions on these recommendations. They should be directed to Mr. Lynn Nellius, Secretary, National Association of Securities Dealers, Inc., 1735 K Street, NW, Washington, DC 20006. All comments received will be shared with other interested U.S. markets.