

# NASD NOTICE TO MEMBERS 96-83

**NASD Regulation Solicits Comment On Proposed Rule Relating To Prohibition On Members Receiving Any Payment To Publish A Quotation, Make A Market In An Issuer's Securities, Or Submit An Application In Connection Therewith; Comment Period Expires February 3, 1997**

## Suggested Routing

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

In the following document, NASD Regulation, Inc. (NASD Regulation) requests comment on a new proposed rule, NASD<sup>®</sup> Rule 2460 (Rule), that would prohibit any payment by an issuer or the issuer's affiliates and promoters, directly or indirectly, to a member for publishing a quotation, acting as a market maker, or submitting an application in connection therewith. This new proposed Rule is designed, among other things, to assure that members act in an independent capacity when publishing a quotation or making a market in an issuer's securities.

Questions concerning this Request For Comment should be directed to Suzanne E. Rothwell or David A. Spotts, Office of General Counsel, NASD Regulation, at (202) 728-8247 and (202) 728-8014, respectively.

## Request For Comment

The NASD encourages all members and other interested parties to comment on the new proposed Rule 2460. Comments can be mailed to:

Joan Conley  
Office of the Corporate Secretary  
NASD Regulation, Inc.  
1735 K Street, NW  
Washington, DC 20006-1500

or e-mailed to:  
*pubcom@nasd.com.*

Comments must be received by  
**February 3, 1997.**

Before becoming effective, any rule change developed as a result of the comments received must be adopted by the NASD Regulation Board of Directors, is subject to review by the NASD Board of Governors, and must be approved by the SEC.

© National Association of Securities Dealers, Inc. (NASD), December 1996. All rights reserved.

# NASD REGULATION REQUEST FOR COMMENT 96-83

## Executive Summary

NASD Regulation, Inc. (NASD Regulation) requests comment on a new proposed rule, NASD<sup>®</sup> Rule 2460 (Rule), that would prohibit any payment by an issuer or the issuer's affiliates and promoters, directly or indirectly, to a member for publishing a quotation, acting as a market maker, or submitting an application in connection therewith. This new proposed Rule is designed, among other things, to assure that members act in an independent capacity when publishing a quotation or making a market in an issuer's securities.

Questions concerning this Request For Comment should be directed to Suzanne E. Rothwell or David A. Spotts, Office of General Counsel, NASD Regulation, at (202) 728-8247 and (202) 728-8014, respectively.

## Background

It has been a longstanding policy and position of the NASD that a broker/dealer is prohibited from receiving compensation or other payments from an issuer for listing, quoting, or making a market in an issuer's securities or for covering the member's out-of-pocket expenses for making a market, or for submitting an application to make a market in an issuer's securities.<sup>1</sup> As stated in *Notice to Members 75-16*, such payments may be viewed as a conflict of interest since they may influence the member's decision as to whether to quote or make a market in a security and, thereafter, the prices that the member would quote.

In the past, certain broker/dealers have entered into arrangements with issuers to accept payments from an issuer, affiliate, or promoter of the issuer to make a market in the issuer's securities; or for covering out-of-pocket expenses of the member incurred in the course of market

making; or for submitting an application to act as a market maker. As stated above, the NASD believes that such conduct may be viewed as a conflict of interest. The NASD believes that a market maker should have considerable latitude and freedom to make or terminate market-making activities in an issuer's securities. The decision by a firm to make a market in a given security and the question of price generally are dependent on a number of factors, including, among others, supply and demand, the firm's expectations toward the market, its current inventory position, and exposure to risk and competition. This decision should not be influenced by payments from issuers or promoters to the member.

On October 27, 1994, the United States Court of Appeals, Tenth Circuit, reversed, in part, a Securities and Exchange Commission (SEC) decision in the matter of *General Bond & Share Co. (General Bond)*.<sup>2</sup> The NASD had held that General Bond had, among other things, violated Article III, Section 1 of the NASD Rules of Fair Practice (currently NASD Rule 2110) by accepting payments from issuers in return for listing itself as a market maker for the securities in the National Quotation Bureau, Inc. (NQB) Pink Sheets (Pink Sheets). The NASD position was based on NASD policy as articulated to the members in *Notice to Members 75-16*. The SEC, in affirming the NASD decision, agreed with the NASD that this conduct was inappropriate and in violation of NASD rules.

The Tenth Circuit decision held that the NASD rules at the time did not prohibit a member firm from accepting issuer-paid compensation for making a market in a security.<sup>3</sup> Although the NASD had previously stated that such specific conduct was

© National Association of Securities Dealers, Inc. (NASD), December 1996. All rights reserved.

prohibited, the Court held that the NASD was required by statute to submit a filing with the SEC amending NASD rules in this respect. The NASD is publishing this proposed Rule for comment to clarify the application of NASD rules to situations involving the acceptance of compensation for market-making activities.

The proposed Rule is intended to apply a fair practice standard to a particular course of conduct of a member as described below. In addition, however, the action of a member in charging an issuer a fee for making a market, or accepting an unsolicited payment from an issuer where the member makes a market in the issuer's securities, could also subject the member to violations of the antifraud provisions of federal securities laws and NASD Rule 2120 (formerly Article III, Section 18 of the NASD Rules of Fair Practice). Further, the payment by an issuer to a market maker to facilitate market-making activities also may cause the member to contribute to violations of Section 5 of the Securities Act of 1933.<sup>4</sup>

### Description Of Proposed Rule

The proposed Rule would prohibit receipt by a broker/dealer of "any payment or other consideration" from a prohibited party and is intended to cover any form of payment in cash, non-cash items, or securities. The concept of "consideration" would include, for example, the granting of options in the securities in which a member makes a market, where the options are exercisable at a price that is discounted from the prevailing market price. The Rule also would cover the purchase of securities by a member from a prohibited party at a discount from the prevailing market. Such payments are intended to be prohibited because they may, as discussed in *Notice to*

*Members 75-16*, create a conflict of interest that would influence the member to enter a quotation or make a market in a security.

The proposed Rule prohibits payments that are made "for publishing a quotation, acting as a market maker in a security, or submitting an application in connection therewith." This language would apply the prohibitions of the Rule to the entry of a quotation in a security, making a market in a security, and the entry of a quotation or the quotation of a security at a particular price.<sup>5</sup> The definition of "quotation" is drawn from SEC Rule 15c2-11 and includes indications of interest. The proposed Rule also specifies that a member may not impose a fee or accept a payment for submitting an application to enter quotations or make a market in an issuer's securities, e.g., an NASD Form 211 application to enter a quotation in the OTC Bulletin Board<sup>®</sup> or NQB Pink Sheets.

The proposed Rule would apply to payments by an issuer, an affiliate of the issuer, or a promoter, whether received directly or indirectly through another party. Whether a person is considered an affiliate would be determined under the provisions of NASD Rule 2720 (formerly Schedule E to the NASD By-Laws) that relate to the existence of a control relationship between an issuer and a member. The concept of "promoter" is broadly defined to encompass all persons other than the issuer and its affiliates who would have an interest in influencing a member to make a market in a security. Thus, the definition includes not only the organizer of the issuer's business, but also any director, employee, consultant, accountant, or attorney of the issuer. In addition, certain categories of securityholders are also within the definition, since these persons are considered to have an interest greater than that of the average securityhold-

er in ensuring the existence of an active market. The categories in the definition, however, are intended to be illustrative only, and the proposed Rule would prohibit payments by any similar person with an interest in promoting the entry of quotations or market making in the issuer's securities.

The proposed Rule also is intended to prohibit indirect payments by the issuers, affiliates, or promoters through other members. The proposed Rule language does not prohibit payments by other members, unless they would otherwise qualify as affiliates or promoters of the issuer. The NASD specifically solicits comment on whether payments by other members should be specifically prohibited, and what impact such a prohibition would have on existing payment arrangements between broker/dealers.

In addition, the proposed Rule contains a general exception that permits payments to a member by prohibited persons for "other bona fide services." Other bona fide services are intended to include, but not be limited to, investment banking services, including traditional underwriting compensation and fees. The proposed Rule contains a further exemption for reimbursement of fees imposed by the SEC and states, and listing fees imposed by self-regulatory organizations. Such fees have been generally considered costs of the issuer, even when paid by the broker/dealer.

A third exception is intended to encourage members to conduct an initial SEC Rule 15c2-11 review of the issuer and the security by permitting reimbursement of the member's reasonable out-of-pocket expenses related to this review.<sup>6</sup> This exception is limited to the member's initial review required under that Rule and is not intended to apply to expenses incurred in the course of making a market in an issuer's securities. Fur-

ther, this exception would not relieve a member of its obligation to comply with other provisions of the federal and state securities laws that may apply when a member is reimbursed for certain expenses from an issuer and the member publishes a quotation for the issuer's securities in an interdealer quotation medium (e.g., Section 17(b) of the Securities Act of 1933).<sup>7</sup>

The third exception requires that out-of-pocket expenses paid to the member must be handled on an accountable basis, i.e., the member must provide a detailed bill for reimbursement (thereby permitting review by NASD Regulation<sup>SM</sup> examination staff), and retain such documentation as a record of the broker/dealer.<sup>8</sup> A member must be prepared to provide this information to a customer if requested.<sup>9</sup> Moreover, such out-of-pocket expenses cannot include the member's overhead, which is defined to include salaries, rent, utilities, insurance, depreciation, supplies, or similar expenses the member incurred in the normal conduct of business. The provision requires that the amount of the member's expenses must be "reasonable." This exception would not, however, permit a member to charge an issuer or receive a payment in connection with the preparation of a Form 211 or other similar application for the listing or quotation of a security. Furthermore, the proposed Rule would not permit an arrangement with an issuer for reimbursement of expenses that is conditioned on the agreement of the member to act as a market maker or publish a quotation for the issuer's securities.

Comment is specifically requested on the merits of the third exception described above.

### Request For Comment

The NASD encourages all members and other interested parties to com-

ment on the new proposed Rule 2460. Comments can be mailed to:

Joan Conley  
Office of the Corporate Secretary  
NASD Regulation, Inc.  
1735 K Street, NW  
Washington, DC 20006-1500

or e-mailed to:  
[pubcom@nasd.com](mailto:pubcom@nasd.com).

Comments must be received by **February 3, 1997**.

Before becoming effective, any rule change developed as a result of the comments received must be adopted by the NASD Regulation Board of Directors, is subject to review by the NASD Board of Governors, and must be approved by the SEC.

### Text Of New Proposed Rule

(All rule language is new.)

#### Rule 2460. Payments for Publishing Quotations

(a) No member or person associated with a member shall accept any payment or other consideration, directly or indirectly, from an issuer of a security, or any affiliate or promoter thereof, for publishing a quotation, acting as market maker in a security, or submitting an application in connection therewith.

(b) The provisions of paragraph (a) shall not preclude a member from accepting:

(1) payment for other bona fide services, including, but not limited to, investment banking services (including underwriting compensation and fees);

(2) reimbursement of any payment for registration imposed by the Securities and Exchange Commission and/or state regulatory authorities

and for listing of an issue of securities imposed by a self-regulatory organization; and

(3) reimbursement of reasonable out-of-pocket expenses on an accountable basis, not including the member's overhead, in connection with the member's initial review process in determining whether to agree to publish a quotation or to act as a market maker in a particular security.

(c) For purposes of this rule, the following terms shall have the stated meanings:

(1) "affiliate" shall have the same definition as used in Rule 2720 of the Business Conduct Rules of the Association;

(2) "overhead" shall mean payment for rent, utilities, insurance, salaries, supplies, depreciation, and similar expenses of the member incurred in the normal conduct of business;

(3) "promoter" means any person who founded or organized the business or enterprise of the issuer, is a director or employee of the issuer, acts or has acted as a consultant, advisor, accountant or attorney to the issuer, is the beneficial owner of any of the issuer's securities that are considered "restricted securities" under Rule 144, or is the beneficial owner of five percent (5%) or more of the public float of any class of the issuer's securities, and any other person with a similar interest in promoting the entry of quotations or market making in the issuer's securities; and

(4) "quotation" shall mean any bid or offer at a specified price with respect to a security, or any indication of interest by a member in receiving bids or offers from others for a security, or an indication by a member that he wishes to advertise his general interest in buying or selling a particular security.

## Endnotes

<sup>1</sup> See, *Notices to Members 75-16 and 92-50*.

<sup>2</sup> *General Bond & Share Co. v. Securities and Exchange Commission*, 39 F. 3d 1451 (10th Cir.).

<sup>3</sup> The court reversed the SEC's finding of violation that related to the firm's acceptance of issuer-paid compensation, but sustained all of the SEC's other findings of violation by General Bond.

<sup>4</sup> The insertion of quotations for a security in an interdealer quotation system in exchange for a payment by an issuer may result in a violation of Section 5 of the Securities Act of 1933 based on the issuer's interest in facilitat-

ing the subsequent sale. This "second sale" theory was articulated by the SEC and upheld by the court in *SEC v. Harwyn Industries, Inc.*, 326 F. Supp. 943 (S.D.N.Y. 1971). See Monroe Securities, Inc. No-Action Letter, May 4, 1973.

<sup>5</sup> *Notice to Members 75-16* states that questionable payments to a market maker have the potential to influence the member's "... decision to make a market and thereafter, perhaps, the prices it would quote."

<sup>6</sup> Rule 15c2-11 imposes an "affirmative review" obligation on a broker/dealer to form a reasonable belief that the information submitted in connection with an application to

enter a quotation is accurate in all material respects and that the sources of the information are reliable. See SEC Rel. No. 34-29094 (April 17, 1991).

<sup>7</sup> Section 17(b) of the Securities Act of 1933 explicitly makes it unlawful for any person receiving consideration, directly or indirectly from an issuer, to publish or circulate any material which describes such issuer's securities without fully disclosing the receipt of such consideration, whether past or prospective, and the amount thereof.

<sup>8</sup> See SEC Rule 15c2-11(b)(1) and (c).

<sup>9</sup> See SEC Rule 15c2-11(a)(xvi).