

NASD NOTICE TO MEMBERS 96-60

Clarification Of Members' Suitability Responsibilities Under NASD Rules With Special Emphasis On Member Activities In Speculative And Low-Priced Securities

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

Executive Summary

In *Notice to Members 96-32*, NASD Regulation, Inc. (NASD Regulation) informed the membership of its concerns over unusual and increased trading in speculative or low-priced securities. The Notice was intended, among other things, to remind members of their fair dealing and suitability responsibilities to customers under NASD® rules. NASD Regulation is publishing this Notice to supplement *Notice to Members 96-32* and to clarify certain issues addressed in that Notice.

Questions regarding this Notice may be directed to Daniel M. Sibears, Member Regulation, NASD Regulation, at (202) 728-6911; or David Spotts, Office of General Counsel, NASD Regulation, at (202) 728-8014.

Discussion

Notice to Members 96-32, published May 9, 1996, urged members to focus particular attention on certain rules, regulations, and best practices when dealing with customers in speculative or low-priced securities. It focused on NASD Regulation's concern for potential abusive conduct in connection with the sale of such securities, including market manipulation, misrepresentations, high pressure sales tactics, and fraudulent markups. In particular, NASD Regulation emphasized suitability, disclosure, valuations, supervision, and cold calling as areas in which members must take special care in discharging obligations to customers, especially when dealing in speculative or low-priced securities.

The purpose of this Notice is to supplement *Notice to Members 96-32*, and to clarify members' suitability obligations to customers under NASD rules.

Suitability Obligation

NASD Rule 2310 (formerly Article III, Section 2 of the NASD Rules of Fair Practice) provides that in recommending to a customer the purchase, sale, or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of facts available, including other security holdings, financial situation, and needs.

The suitability rule was amended in 1990 to require that, for all accounts opened and recommendations made after January 1, 1991, members make reasonable efforts to obtain certain information from each non-institutional customer before executing a recommended transaction (excluding transactions in money market mutual funds) including the customer's financial status, tax status, investment objectives, and other information considered to be reasonable in making recommendations to customers.

In discussing suitability determinations, *Notice to Members 96-32* included a statement that the NASD Rules of Fair Practice "requires a careful review of the appropriateness of transactions in low-priced, speculative securities, whether solicited or unsolicited." It is the reference to unsolicited transactions that NASD Regulation wishes to clarify.

A member's suitability obligation under Rule 2310 applies only to securities that have been recommended by the member. It would not apply, therefore, to situations in which a member acts solely as an order-taker for persons who, on their own initiative, effect transactions without a recommendation from the member (*See* SEC Release No. 34-27160, August 22, 1989). However,

a broad range of circumstances may cause a transaction to be considered recommended, and this determination does not depend on the classification of the transaction by a particular member as “solicited” or “unsolicit-

ed.” In particular, a transaction **will** be considered to be recommended when the member or its associated person brings a specific security to the attention of the customer through any means, including, but not limited to,

direct telephone communication, the delivery of promotional material through the mail, or the transmission of electronic messages.