

SEPTEMBER 2006

# Notice to Members

## Notices

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## Disciplinary and Other NASD Actions

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# Notice to Members

SEPTEMBER 2006

## SUGGESTED ROUTING

Internal Audit  
Legal & Compliance  
Operations  
Registered Representatives  
Senior Management  
Systems  
Trading  
Training

## KEY TOPICS

Net Trading  
Rule 2441

## GUIDANCE

### Net Trading Requirements

SEC Approves New Rule 2441 Requiring Disclosure and Consent When Trading on a Net Basis with Customers;  
**Effective Date: October 2, 2006**

#### Executive Summary

On June 30, 2006, the Securities and Exchange Commission (SEC) approved new NASD Rule 2441, Net Transactions with Customers, which requires disclosure and consent when trading on a net basis with customers.<sup>1</sup> Rule 2441, as adopted, is set forth in Attachment A of this *Notice*. The rule becomes effective on October 2, 2006.

#### Questions/Further Information

Questions regarding this *Notice* may be directed to the Legal Section, Market Regulation, Regulatory Policy and Oversight (RPO) at (240) 386-5126; or the Office of General Counsel, RPO at (202) 728-8071.

#### Background and Discussion

On June 30, 2006, the SEC approved new NASD Rule 2441. Rule 2441 clarifies and codifies that a member is required to provide disclosure to, and obtain consent from, a customer prior to executing a transaction with a customer on a "net" basis. A "net" transaction means a principal transaction in which a market maker, after having received an order to buy (sell) an equity security, purchases (sells) the equity security at one price (from (to) another broker-dealer or another customer) and then sells to (buys from) the customer at a different price.<sup>2</sup>

The disclosure and consent requirements under the new rule differ depending on whether the member is trading with an institutional or non-institutional customer.<sup>3</sup>

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- ▶ For non-institutional customers, a member must obtain the customer's written consent on an order-by-order basis prior to executing a transaction for or with the customer on a net basis, and such consent must evidence the customer's understanding of the terms and conditions of the order.
  - ▶ For institutional customers, a member must obtain the customer's consent prior to executing a transaction for or with the customer on a net basis. Consent may be obtained on an order-by-order basis or by use of a negative consent letter.
    - ▶ If using a negative consent letter, such letter must clearly disclose in writing the terms and conditions for handling the customer orders and provide the institutional customer with a meaningful opportunity to object to the execution of transactions on a net basis. If the customer does not object, then the member may reasonably conclude that the institutional customer has consented to the member trading on a net basis with the customer and the member may rely on such letter for all or a portion of the customer's orders (as instructed by the customer).
    - ▶ A member also may obtain consent from institutional customers orally or in writing on an order-by-order basis. A member that chooses to obtain consent orally on an order-by-order basis also must clearly explain to the institutional customer, prior to each transaction, the terms and conditions for handling the order and provide the institutional customer with a meaningful opportunity to object to the execution of the transaction on a net basis. The member also must document, on an order-by-order basis, the customer's understanding of the terms and conditions of the order and the customer's consent.

If a customer has granted trading discretion to a fiduciary (e.g., an investment adviser), a member is permitted to obtain the consent required under Rule 2441 from the fiduciary. Further, if the fiduciary meets the definition of "institutional customer" in Rule 2441(e), the member may comply with the disclosure and consent requirements under Rule 2441 in the same manner permitted for institutional customers, notwithstanding the status of the ultimate customer.

New Rule 2441 becomes effective October 2, 2006.

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## Questions and Answers Relating to New Rule 2441

To assist members in understanding the application of new Rule 2441, NASD is publishing the following questions and answers.

**Q1 What is a net transaction?**

A1 As defined in Rule 2441, a “net” transaction means a principal transaction in which a market maker, after having received an order to buy (sell) an equity security, purchases (sells) the equity security at one price (from (to) another broker-dealer or another customer) and then sells to (buys from) the customer at a different price.

**Q2 Do the Rule 2441 consent and disclosure requirements apply to orders received from members and other registered broker-dealers?**

A2 No. Rule 2441 does not apply to orders received from member firms and other registered broker-dealers.

**Q3 What are the ways in which consent can be obtained from institutional customers under the rule?**

A3 As described in detail in Rule 2441(c), there are three methods for obtaining an institutional customer’s consent. The member may obtain the institutional customer’s consent prior to executing the customer’s transaction on a net basis: (1) through the use of a negative consent letter; (2) orally, on an order-by-order basis; or (3) in writing on an order-by-order basis.

**Q4 What is an institutional customer?**

A4 An institutional customer is a customer whose account qualifies as an “institutional account” under NASD Rule 3110(c)(4). Any customer whose account does not qualify as an institutional account under Rule 3110(c)(4) would be deemed a non-institutional customer.

**Q5 If I obtained a negative consent letter from my institutional customer, does that apply to all of the orders from that customer?**

A5 Depending on the institutional customer’s instructions to the firm, the negative consent may apply to all or only a portion of the customer’s orders.

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**Q6 Is negative consent permissible for non-institutional customers?**

A6 No, use of a negative consent letter is not a permissible method to obtain consent to trade on a net basis with a non-institutional customer. For non-institutional customers, a member must obtain the customer's written consent on an order-by-order basis prior to executing a transaction for or with the customer on a "net" basis and such consent must evidence the customer's understanding of the terms and conditions of the order.

**Q7 How does the rule apply if the customer has granted trading discretion to a fiduciary?**

A7 Absent any instructions to the contrary, a member may look to the institutional or non-institutional status of the fiduciary, rather than the underlying account, when determining the Rule 2441 disclosure and consent requirements.

**Q8 When do the requirements in Rule 2441 go into effect?**

A8 The disclosure and consent requirements set forth in Rule 2441 become effective on October 2, 2006.

## Endnotes

1 See Securities Exchange Act Release No. 54088 (June 30, 2006), 71 FR 38950 (July 10, 2006) (File No. SR-NASD-2004-135).

2 See Rule 2441(e).

3 An "institutional customer" is a customer whose account qualifies as an "institutional account" under Rule 3110(c)(4). Any customer whose account does not qualify as an institutional account under Rule 3110(c)(4) would be deemed a non-institutional customer.

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## ATTACHMENT A

New language is underlined.

### 2441. Net Transactions with Customers

(a) Prior to executing a transaction for or with a customer on a "net" basis as defined in paragraph (e) below, a member must provide disclosure to and obtain consent from the customer as provided in this Rule.

(b) With respect to non-institutional customers, the member must obtain the customer's written consent on an order-by-order basis prior to executing a transaction for or with the customer on a "net" basis and such consent must evidence the customer's understanding of the terms and conditions of the order.

(c) With respect to institutional customers, a member must obtain the customer's consent prior to executing a transaction for or with the customer on a "net" basis in accordance with one of the following methods:

(1) a negative consent letter that clearly discloses to the institutional customer in writing the terms and conditions for handling the customer order(s) and provides the institutional customer with a meaningful opportunity to object to the execution of transactions on a net basis. If the customer does not object, then the member may reasonably conclude that the institutional customer has consented to the member trading on a "net" basis with the customer and the member may rely on such letter for all or a portion of the customer's orders (as instructed by the customer) pursuant to this Rule;

(2) oral disclosure to and consent from the customer on an order-by-order basis. Such oral disclosure and consent must clearly explain the terms and conditions for handling the customer order and provide the institutional customer with a meaningful opportunity to object to the execution of the transaction on a net basis. The member also must document, on an order-by-order basis, the customer's understanding of the terms and conditions of the order and the customer's consent; or

(3) written consent on an order-by-order basis prior to executing a transaction for or with the customer on a "net" basis and such consent must evidence the customer's understanding of the terms and conditions of the order.

(d) For those customers that have granted trading discretion to a fiduciary (e.g. an investment adviser), a member is permitted to obtain the consent required under this Rule from the fiduciary. If the fiduciary meets the definition of "institutional customer" in paragraph (e), the member may meet the disclosure and consent requirements under this Rule in the same manner permitted for institutional customers.

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(e) For purposes of this Rule, (1) "institutional customer" shall mean a customer whose account qualifies as an "institutional account" under Rule 3110(c)(4); and (2) "net" transaction shall mean a principal transaction in which a market maker, after having received an order to buy (sell) an equity security, purchases (sells) the equity security at one price (from (to) another broker-dealer or another customer) and then sells to (buys from) the customer at a different price.

(f) Members must retain and preserve all documentation relating to consent obtained pursuant to this Rule in accordance with Rule 3110(a).

# Notice to Members

SEPTEMBER 2006

## SUGGESTED ROUTING

Advertising  
Executive Representatives  
Investment Companies  
Legal & Compliance  
Mutual Funds  
Registered Representatives  
Senior Management

## KEY TOPICS

Mutual Fund Performance Advertising  
Fees and Expenses  
Rule 2210  
Rule 2211

## GUIDANCE

### Mutual Fund Performance Sales Material

SEC Approves Amendments to NASD Rules 2210 and 2211 to Require Disclosure of Fees and Expenses in Mutual Fund Performance Sales Material;

**Effective Date: April 1, 2007**

#### Executive Summary

On July 5, 2006, the Securities and Exchange Commission (SEC) approved amendments to NASD Rules 2210 and 2211 that impose certain disclosure and presentation requirements on member communications with the public, other than institutional sales material and public appearances, that present non-money market mutual fund performance data (performance sales material).<sup>1</sup> Such communications must disclose: (1) the standardized performance information mandated by Rule 482 under the Securities Act of 1933 (Rule 482) and Rule 34b-1 under the Investment Company Act of 1940 (Rule 34b-1); and (2) to the extent applicable, the fund's maximum front-end or back-end sales charge and annual operating expense ratio. The rule requires that all of this information be presented prominently and, in any print advertisement, in a prominent text box.

The effective date of this rule change is April 1, 2007. Included with this *Notice* is Attachment A (text of rule amendments).

#### Questions/Further Information

Questions or comments concerning this *Notice* may be directed to Joseph P. Savage, Associate Vice President, Investment Companies Regulation, Regulatory Policy and Oversight (RPO), at (240) 386-4534; or Philip A. Shaikun, Associate Vice President and Associate General Counsel, Office of General Counsel, RPO, at (202) 728-8451.

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Questions about individual performance sales material should be directed to the NASD Advertising Regulation Department analyst assigned to review the member's sales material.

## Background and Discussion

### Current Performance Advertising Standards

The content of mutual fund performance advertising is governed primarily by NASD Rules 2210 and 2211, Rule 482 under the Securities Act of 1933 and Rule 34b-1 under the Investment Company Act of 1940 (1940 Act). These rules help ensure that these communications are fair, balanced and not misleading.

Rule 2210 governs member communications with the public, including performance advertising. Rule 2210(d) provides that all member communications with the public must be based on principles of fair dealing and good faith, and should provide a sound basis for evaluating the facts in regard to any particular security or type of security, industry or service. The rule further provides that "no member may omit any material fact or qualification" if the omission would cause the communication to be misleading. Rule 2210(e) provides in part that any member violation of an SEC rule applicable to member communications will be deemed a violation of Rule 2210.

Rule 2211 sets forth separate standards for institutional sales material and correspondence. Rule 2211(d)(1) provides that all institutional sales material and correspondence are subject to the content standards of Rule 2210(d)(1) and the applicable Interpretive Materials under Rule 2210.

Rule 482 and Rule 34b-1 permit the inclusion of performance information in investment company sales material. If performance information is included, Rule 482 requires disclosure of the fund's maximum sales charges and its average annual total return for the most recent one-, five- and 10-year periods, as of the most recent calendar quarter.<sup>2</sup> The total return must be calculated according to standards set by the SEC, taking into account sales charges and expenses.<sup>3</sup> These returns are generally referred to as standardized performance. These rules also require that the standardized performance figures be presented at least as prominently as any non-standardized performance information included in the sales material.<sup>4</sup> Rule 482 does not require a mutual fund performance advertisement to disclose the fund's expense ratio.

Prior to this rule change, NASD had not interpreted Rule 2210 or Rule 2211 to require performance advertising to include a fund's expense ratio. However, NASD believes that such information is just as important in evaluating whether to invest in a fund as the fund's maximum sales charge, since a fund's total annual operating expenses will impact its performance for as long as an investor holds shares in the fund.

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### **New Performance Advertising Standards**

On July 5, 2006, the SEC approved amendments to Rules 2210 and 2211 to impose certain disclosures and presentation requirements on performance sales material.<sup>5</sup> Specifically, Rule 2210(d)(3)(A) requires that such performance sales material disclose the standardized performance mandated by SEC Rule 482 and Rule 34b-1, and to the extent applicable, the maximum sales charge imposed on purchases or the maximum deferred sales charge, and the expense ratio, gross of any fee waivers or expense reimbursements. Both the sales charges and the expense ratio should reflect the amounts stated in the investment company's prospectus fee table, current as of the date of submission of an advertisement for publication, or as of the date of distribution of other communications with the public. And if performance sales material appears in a print advertisement, the required information must be presented in a prominent text box.

These rule changes become effective on April 1, 2007. Accordingly, all member performance sales material that is used on or after April 1, 2007 must comply with the new requirements of Rule 2210(d)(3).

During the comment process for this rule, four principal issues arose. First, a number of commenters had questions about the rule's prominence requirements. Second, members inquired as to the application of the text box requirement to member advertisements. Third, commenters had questions concerning the expense ratio that must be disclosed in performance sales material. Fourth, questions have arisen regarding the use of previously filed performance sales material that is revised to meet the requirements of Rule 2210(d)(3) on or after April 1, 2007. We address and give guidance on each of these issues below.

#### ***Prominence Requirements***

Rule 2210(d)(3)(B) provides that all of the information required by paragraph (A) must be set forth "prominently." NASD will apply the same prominence and proximity standards for disclosure of the expense ratio as those used for standardized performance and sales charges under the SEC rules.

For example, the quotations of the standardized average annual total returns for one-, five- and 10-year periods must be set forth with equal prominence, and any quotations of non-standardized performance may not be set forth in greater prominence than the standardized performance.<sup>6</sup> Similarly, the disclosures of a fund's maximum sales load and expense ratio generally would have to be presented in print advertisements "in a type size at least as large as and of style different from, but at least as prominent as, that used in the major portion of the advertisement ..."<sup>7</sup> When fund performance data is presented on a Web site, members may present standardized performance through the use of a hyperlink, provided that the standardized performance is presented prominently and is consistent with the standards of SEC Rule 482.

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### ***Text Box Requirement***

Rule 2210(b)(3)(B) also provides that, in any print advertisement, the information required by paragraph (A) must be set forth in a prominent text box that contains only the required information and, at the member's option, comparative performance and fee data and other disclosures that are required to be in the advertisement under Rule 482 and Rule 34b-1. Thus, for example, a text box may include the prospectus disclosure language required by Rule 482, the performance of a relevant benchmark index, or a comparison of the fund's expense ratio to the average expense ratio of similar funds.

The text box requirement applies only to advertisements that appear in print advertisements, such as a print newspaper, magazine or other periodical. The text box requirement does not apply to printed sales literature, such as fund fact sheets, brochures or form letters, nor does it apply to Web sites, television or radio commercials, or any other electronic communication.

### ***Annual Fund Operating Expense Ratio***

Rule 2210(d)(3)(A)(ii)(b) requires performance sales material to disclose a fund's total annual operating expense ratio, *gross* of any fee waivers or expense reimbursements (the unsubsidized expense ratio), as stated in the fee table of the fund's prospectus. This requirement to disclose the unsubsidized expense ratio applies even if a fund's prospectus also discloses its expense ratio net of fee waivers or reimbursements (the subsidized expense ratio). NASD requires the disclosure of the unsubsidized expense ratio because fund advertisements, like prospectuses, are directed to prospective investors. The required expense ratio disclosure does not reflect fee waivers or reimbursements because they may not be available to fund shareholders in the future, and thus may mislead an investor without further explanation.

The rule does not preclude performance sales material from also presenting a fund's subsidized expense ratio, as long as the member presents both expense ratios in a fair and balanced manner in accordance with the standards of NASD Rule 2210. In this regard, NASD expects a member that also presents a subsidized expense ratio to disclose in the sales material whether the fee waivers or expense reimbursements were voluntary or mandated by contract, and the time period during which the fee waiver or expense reimbursement obligation, if any, remains in effect. In print advertisements, a member may show the subsidized expense ratio in the text box with the unsubsidized expense ratio as long as they are presented in a fair and balanced manner.

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### ***Use of Performance Sales Material on or after April 1, 2007***

Performance sales material used on or after April 1, 2007 will be required to meet the disclosure standards of Rule 2210(d)(3). At a minimum, members will be required to disclose the unsubsidized total annual fund operating expense ratio unless the sales material already discloses this ratio in a manner that meets the prominence requirements of Rule 2210(d)(3). Members will not be required to re-file with the Advertising Regulation Department (the Department) previously filed sales material if the only revision is the addition of the expense ratio.

All performance print advertisements also will be required to include a prominent text box and must be re-filed with the Department. The addition of the text box to previously filed advertisements alters the content and presentation of the performance information, requiring that the advertisement be re-filed with the Department.

Members that have questions about whether they must re-file previously filed performance sales material that has been revised to comply with Rule 2210(d)(3) should contact the Department staff.

### **Endnotes**

- 1 SEC Rel. No. 34-54103 (July 5, 2006), 71 Fed. Reg. 39379 (July 12, 2006) (File No. SR-NASD-2004-043).
- 2 SEC Rules 482(b)(3)(ii) and 482(d)(3).
- 3 SEC Rule 482(d)(3)(i).
- 4 SEC Rule 482(d)(5)(iv).
- 5 The rule does not apply to member sales material that includes only mutual fund rankings and does not include performance data, since sales material containing fund rankings is governed by IM-2210-3.
- 6 See SEC Rules 482(d)(3)(iii) and 482 (d)(5)(iv).
- 7 See SEC Rule 482(b)(5). Rule 482(b)(5) also provides that when performance data is presented in a print advertisement in a type size smaller than that of the major portion of the advertisement, the maximum sales load may appear in a type size no smaller than that of the performance data.

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## ATTACHMENT A

### Text of Rule Change

New text is underlined; deletions are in brackets.

\* \* \* \*

#### 2210. Communications With the Public

(a) through (c) No change.

(d) Content Standards

(1) through (2) No change.

##### (3) Disclosure of Fees, Expenses and Standardized Performance

(A) Communications with the public, other than institutional sales material and public appearances, that present non-money market fund open-end management investment company performance data as permitted by Rule 482 under the Securities Act of 1933 and Rule 34b-1 under the Investment Company Act of 1940 must disclose:

(i) the standardized performance information mandated by Rule 482 and Rule 34b-1; and

(ii) to the extent applicable:

(a) the maximum sales charge imposed on purchases or the maximum deferred sales charge, as stated in the investment company's prospectus current as of the date of submission of an advertisement for publication, or as of the date of distribution of other communications with the public; and

(b) the total annual fund operating expense ratio, gross of any fee waivers or expense reimbursements, as stated in the fee table of the investment company's prospectus described in paragraph (a).

(B) All of the information required by paragraph (A) must be set forth prominently, and in any print advertisement, in a prominent text box that contains only the required information and, at the member's option, comparative performance and fee data and disclosures required by Rule 482 and Rule 34b-1.

(e) No change.

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## 2211. Institutional Sales Material and Correspondence

(a) through (c) No change.

### (d) Content Standards Applicable to Institutional Sales Material and Correspondence

(1) All institutional sales material and correspondence are subject to the content standards of Rule 2210(d)(1) and the applicable Interpretive Materials under Rule 2210, and all correspondence is subject to the content standards of Rule 2210(d)(3).

(2) through (3) No change.

# Notice to Members

SEPTEMBER 2006

## SUGGESTED ROUTING

Executive Representatives  
Legal & Compliance

## KEY TOPICS

Arbitration  
Dispute Resolution Regional Offices  
Mediation

INFORMATIONAL

## Dispute Resolution

NASD to Close Mid-Atlantic Dispute Resolution Office  
October 6, 2006

### Executive Summary

Effective October 6, 2006, NASD will close its Mid-Atlantic Dispute Resolution Office. All arbitration cases currently assigned to the Mid-Atlantic Region will continue to be administered by that office until parties are notified in writing that the case has been reassigned. On June 12, 2006, NASD realigned the regional office assignments for several of its 68 hearing locations. All new cases filed on or after June 12, 2006 have been assigned according to the new hearing location assignment plan. A map and complete listing of the new hearing location assignments can be found at [www.nasd.com/arbitration\\_mediation/hearing\\_locations](http://www.nasd.com/arbitration_mediation/hearing_locations).

NASD will continue to offer 68 hearing venues, including one in each state of the United States, Puerto Rico and London, UK. We will not be closing any of our remaining four regional offices.

### Questions/Further Information

Questions regarding this *Notice* may be directed to Shari L. Sturm, Associate Vice President and Director of the Mid-Atlantic Region, at (202) 728-8828.

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## Discussion

As of June 12, 2006, all new arbitration cases that would have been assigned to the Mid-Atlantic Region in the past were assigned to the Southeast, Midwest and Northeast regional offices. In addition, existing cases are being shifted to the other regional offices in phases. Hearing locations have been allocated as follows:

- ◆ Southeast Region will administer cases with venues in:  
Baltimore, MD; Charlotte, NC; Columbia, SC; Memphis, TN; Nashville, TN;  
Norfolk, VA; Raleigh, NC; Richmond, VA; Washington, DC; and Wilmington, DE.
- ◆ Midwest Region will administer cases with venues in:  
Charleston, WV and Pittsburgh, PA.
- ◆ Northeast Region will administer cases with a venue in: Philadelphia, PA.

NASD looks forward to continuing to provide quality dispute resolution services to the investing public, members, arbitrators and mediators.

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# Notice to Members

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## SUGGESTED ROUTING

Advertising  
Internal Audit  
Legal & Compliance  
Operations  
Registered Representatives  
Senior Management  
Systems  
Trading  
Training

## KEY TOPICS

Communications with the Public  
Manipulative and Deceptive  
Quotations  
Publication of Transactions and  
Quotations  
Rule 2120  
Rule 2210  
Rule 3310  
Trading Interest  
Trading Volume  
Use of Manipulative, Deceptive or  
Other Fraudulent Devices

## GUIDANCE

### Trading Volume and Interest

NASD Reminds Members of Their Obligation to Provide Accurate Information to Services that Disseminate Trading Volume and Trading Interest

#### Executive Summary

NASD is publishing this *Notice* to remind members of their obligation to communicate accurate information when using services to communicate trading volume and trading interest to the marketplace.

#### Questions

Questions concerning this *Notice* should be directed to Peter Santori, Chief Counsel, Market Regulation, at 240-386-5098; David Chapman, Deputy Director, Market Regulation, at 240-386-4995; or the Office of General Counsel, at 202-728-8071.

#### Background and Discussion

Members have the ability to communicate or advertise their trading activity or interest to the marketplace through several service providers that disseminate this information to subscribers and/or the marketplace. For example, some of these services allow members to publicize their current trading interest, as well as their historical trading volume, in a particular security. A member may choose to advertise such activity in order to inform other market participants that it is active in a particular security or market sector, with a view toward attracting order flow, underwriting activity or other business to its firm. While there is no prohibition on the use of such services for this or other proper, lawful purposes, members are reminded that, to the extent that they use such services to communicate or advertise trading activity or interest, such information must be truthful, accurate and not misleading.

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The communication of untruthful, inaccurate or misleading information would be considered conduct inconsistent with high standards of commercial honor and just and equitable principles of trade.<sup>1</sup> In addition, depending on the nature and content of the communication, such communications may also violate NASD Rule 3310 (Publication of Transactions and Quotations) and IM-3310 (Manipulative and Deceptive Quotations), as well as Rule 2120 (Use of Manipulative, Deceptive or Other Fraudulent Devices), Rule 2210 (Communications with the Public) and the anti-fraud provisions of the federal securities laws.

NASD also is reminding members that use such services that they must establish, maintain and enforce written supervisory procedures and supervisory systems that are reasonably designed to ensure, among other things, that the information communicated or advertised by the member or its associated persons is truthful, accurate and not misleading.

## Endnote

1 See Rule 2110.

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# Notice to Members

SEPTEMBER 2006

## SUGGESTED ROUTING

Legal and Compliance  
Institutional  
Senior Management  
Operations  
Trading  
Options

## KEY TOPICS

Contrary Exercise Advice  
Exercise-by-Exception  
Exercise Procedures  
Options  
Rule 2860  
Rule 11850

## GUIDANCE

### Options

Amendments to Option Exercise Procedures in Rule 2860;  
**Effective Date: October 12, 2006**

#### Executive Summary

On August 10, 2006, NASD filed with the Securities and Exchange Commission (SEC) for immediate effectiveness a rule change to amend Rule 2860(b)(23) (Tendering Procedures for Exercise of Options) to: (1) simplify the manner in which a Contrary Exercise Advice (CEA) is submitted; (2) extend by one hour the cut-off time by which members must submit CEA notices; (3) add procedures for exercising a standardized equity option when a modified close of trading is announced; and (4) consolidate all provisions pertaining to the exercise of standardized options contracts into Rule 2860(b)(23) instead of having additional and overlapping provisions in Rule 11850 (Tendering Procedures for Exercise of Options).<sup>1</sup>

Rule 2860 and Rule 11850, as amended, are set forth in Attachment A of this *Notice*. The implementation date of the amendments is October 12, 2006.

#### Questions/Further Information

Questions regarding this *Notice* may be directed to Gary L. Goldsholle, Vice President and Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight (RPO), at (202) 728-8104, or Kathryn M. Moore, Assistant General Counsel, Office of General Counsel, RPO, at (202) 974-2974.

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## Background and Discussion

Rule 2860(b)(23) and Rule 11850 set forth the procedures to exercise options, including procedures that address The Options Clearing Corporation's (OCC) exercise-by-exception procedure (Ex-by-Ex) for standardized options. The Ex-by-Ex procedure in OCC Rule 805 provides for the automatic exercise of certain options that are in-the-money by a specified amount. Under the Ex-by-Ex procedure, option holders with an option contract that is in-the-money by the requisite amount and who wish to have their contracts automatically exercised need to take no further action. However, under OCC Rule 805, option holders who do not want their options automatically exercised, or who want their options to be exercised under different parameters than that of the Ex-by-Ex procedure, must file a CEA and instruct OCC of their "contrary intention." The option exercise procedures and CEA delivery requirements contained in the analogous rules of the Options Exchanges<sup>2</sup> have recently been amended<sup>3</sup> and NASD has made the conforming changes to its rules.

The amendments to Rule 2860(b)(23) modify CEA delivery requirements, add exercise procedures for standardized equity options in the event of a modified close of trading and consolidate all provisions pertaining to the exercise of standardized options contracts into Rule 2860(b)(23) from Rule 11850.

Rule 2860(b)(23)(A)(i) was amended to mirror the provisions of Rule 11850(a)(1) and provides that members may establish fixed procedures as to the latest time they will accept exercise instructions from customers for tender to OCC.

Rule 2860(b)(23)(A)(ii) was amended to integrate the provisions of Rule 11850(b)(1)(A) regarding the cut-off time to submit final exercise decisions. In order to conform to similar amendments to the rules of the Options Exchanges, NASD has extended the cut-off time for members to submit CEAs to the appropriate venue from 5:30 pm ET to 6:30 pm ET. Please note, however, that option holders continue to be required to submit exercise decisions to members no later than 5:30 pm ET. This one-hour extension applies only to members submitting CEAs for customer accounts and non-customer accounts where the member employs an electronic procedure with time stamp recording for the submission of exercise instructions by options holders. Members must establish fixed procedures to ensure secure time stamps in connection with the utilization of the electronic stamp provision for their non-customer accounts. If a member does not employ an electronic time stamp and appropriate procedures to ensure secure time stamps, the member will have to submit CEAs for non-customer accounts by 5:30 pm ET.

Rule 2860(b)(23)(A)(iii) was amended to incorporate the provisions of Rule 11850(b)(1)(A) and contains the particulars of the Ex-by-Ex procedure, including when and where exercise notices and CEAs must be filed, together with conforming language and definitional changes to harmonize the rule with the rules of the Options Exchanges.

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A new subparagraph (iv) was added to Rule 2860(b)(23)(A), which includes provisions parallel to the provisions of Rule 11850(b)(1)(B) and details the procedures to be followed in the event the Ex-by-Ex procedure has been waived. New subparagraph (iv) also tracks the amended rules of the Options Exchanges that provide that when the Ex-by-Ex procedure has been waived, no CEA is required to be filed if the option holder does not wish to exercise the expiring standardized equity option.

Rule 2860(b)(23)(A)(v) provides (as previously provided in Rule 11850(b)(1)(C)) that members that maintain proprietary or public customer positions in expiring standardized equity options must take necessary steps to ensure that final exercise decisions are properly indicated to the relevant national options exchange with respect to such positions. In addition, members that have accepted the responsibility to indicate final exercise decisions on behalf of another member also must take necessary steps to ensure that such decisions are properly indicated to the relevant national options exchange.

Rule 2860(b)(23)(A)(vi) retains the provision (as previously provided in Rule 2860(b)(23)(A)(ii) and Rule 11850(b)(2)) that allows members to make final exercise decisions after the exercise cut-off time, but before expiration of the standardized equity option, subject to the same exceptions as Rule 11850 previously provided, which are also consistent with the rules of the Options Exchanges. Specifically, exercise decisions may be effected after the exercise cut-off time: (1) in order to remedy mistakes or errors made in good faith; (2) to take appropriate action as the result of a failure to reconcile unmatched option transactions; or (3) where extraordinary circumstances restricted a customer's or member's ability to inform the respective member of such decisions (or a member's ability to receive such decisions) by the cut-off time. Rule 2860(b)(23)(B) also retains the requirements for reporting and record keeping obligations when a member relies on these exceptions and incorporates provisions from Rule 11850(b)(3) that require members to submit to NASD a copy of the memorandum describing the circumstances that gave rise to any exception.

NASD also added to Rule 2860, in subparagraph (vii), a similar provision as found in the rules of the Options Exchanges that addresses when a national options exchange or OCC establishes a different time for the close of trading.<sup>4</sup> Under such circumstances, the deadline for making a final decision to exercise or not to exercise will be one hour and 28 minutes following the time announced for the close of trading. With respect to the submission of a CEA by members, the cut-off time will be two hours and 28 minutes after the close of trading for customer accounts and non-customer accounts where the member firm employs an electronic procedure with time stamp for the submission of exercise instructions. Members that do not employ an electronic submission procedure for exercise instructions will be required to submit a CEA within one hour and 28 minutes after the close of trading for non-customer accounts.

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New subparagraphs (viii), (ix) and (x) of Rule 2860(b)(23)(A), wholly incorporate the provisions previously contained in Rule 11850(b)(4), (5) and (6), respectively. Specifically, subparagraph (viii) provides that the filing of a final exercise decision, exercise instruction, exercise advice, CEA or Advice Cancel does not serve as a substitute to the effective notice required to be submitted to OCC for the exercise or non-exercise of expiring standardized equity options. Subparagraph (ix) provides that submitting or preparing an exercise instruction after the exercise cut-off time in any expiring standardized equity option on the basis of material information released after the exercise cut-off time is activity inconsistent with just and equitable principles of trade. Subparagraph (x) provides that the exercise cut-off requirements do not apply to any currency option or standardized index option products listed on a national options exchange.

Finally, paragraphs (C) and (D) of Rule 2860(b)(23) govern the allocation of exercise assignment notices and delivery and payment, respectively, which are the same as the corresponding provisions in Rule 11850(c) and (d). Accordingly, these provisions are deleted from Rule 11850.

The implementation date of the amendment is October 12, 2006.

## Endnotes

- 1 See Exchange Act Release No. 54313 (August 14, 2006), 71 FR 47850 (August 18, 2006) (Notice of Filing and Immediate Effectiveness of SR-NASD-2006-099). Under Section 19(b) of the Securities Exchange Act of 1934, the SEC has the authority to summarily abrogate this type of rule change within 60 days of filing.
- 2 See Rule 980 of the AMEX; Rule 1042 of the PHLX; Rule 6.24 of the NYSE Arca (formerly the PCX); Rule 11.1 and related Regulatory Circulars RG03-41 and RG 03-54 of the CBOE; Rule 1100 of the ISE; and Chapter VII Section 1 of the BOX (collectively referred to as the Options Exchanges).
- 3 See Exchange Act Release No. 47885 (May 16, 2003), 68 FR 28309 (May 23, 2003) (Approval Order of SR-AMEX-2001-92); Exchange Act Release No. 48639 (October 16, 2003), 68 FR 60764 (October 23, 2003) (Notice of Filing and Immediate Effectiveness of SR-PHLX-2003-65); Exchange Act Release No. 48640 (October 16, 2003), 68 FR 60757 (October 23, 2003) (Notice of Filing and Immediate Effectiveness of SR-PCX-2003-47); Exchange Act Release No. 49275 (February 18, 2004), 69 FR 8713 (February 25, 2004) (Notice of Filing and Immediate Effectiveness of SR-CBOE-2003-47); Exchange Act Release No. 48505 (September 17, 2003), 68 FR 55680 (September 26, 2003) (Notice of Filing and Immediate Effectiveness of SR-ISE-2003-20) and Exchange Act Release No. 49191 (February 4, 2004), 69 FR 7055 (February 12, 2004) (Notice of Filing and Immediate Effectiveness of SR-BSE-2004-04).
- 4 See *id.*

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## ATTACHMENT A

New language is underlined; deletions are in brackets.

### 2860. Options

(a) No Change.

#### (b) Requirements

(1) through (22) No Change.

#### (23) Tendering Procedures for Exercise of Options

##### (A) Exercise of Options Contracts

(i) Subject to the restrictions established pursuant to paragraph (b)(4) and (b)(8) hereof and such other restrictions that may be imposed by [the Association]NASD, The Options Clearing Corporation or an options exchange pursuant to appropriate rules, an outstanding option contract issued by The Options Clearing Corporation may be exercised during the time period specified in the rules of The Options Clearing Corporation by the tender to The Options Clearing Corporation of an exercise notice in accordance with rules of The Options Clearing Corporation. An exercise notice may be tendered to The Options Clearing Corporation only by the clearing member in whose account the option contract is carried. [Exercise instructions of their customers relating to exchange listed option contracts shall not be accepted by members after 5:30 p.m. (Eastern Time) on the business day immediately prior to the expiration date of any option contract. Exercise instructions in respect of such option contracts carried in any proprietary account of a member shall similarly not be accepted by any other member with which such member maintains an account after 5:30 p.m. (Eastern Time) on the business day immediately prior to the expiration date of any option contract.]Members may establish fixed procedures as to the latest time they will accept exercise instructions from customers.

[(ii) Notwithstanding the provisions of subparagraph (A)(i) hereof, members may receive and act on exercise instructions after the cut-off time for the acceptance of exercise instructions but prior to 5:00 p.m. (Eastern Time) on the expiration date of an option contract:]

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[a. in the case of option contracts carried in an account maintained for another member in which only positions of customers of such other member are carried;]

[b. in order to remedy mistakes or errors made in good faith;]

[c. to take appropriate action as the result of a failure to reconcile unmatched option transactions; or]

[d. where extraordinary circumstances relating to a public customer's ability to communicate exercise instructions to the member (or the member's ability to receive exercise instructions) prior to such cut-off time warrant such action.]

[(iii) This subparagraph (A) is intended as a means of providing for relatively uniform procedures in respect of exercise instructions and not to alter or affect in any way the expiration times for an option which are fixed in accordance with the rules of The Options Clearing Corporation or any other provisions of an options contract, and the exercise prior to expiration of an option contract in contravention of this subparagraph (A) shall neither affect the validity of such exercise nor modify or otherwise affect any right or obligation of any holder or writer of any option contract of such series of options.]

(ii) Final exercise decisions of options holders to either exercise or not to exercise an expiring standardized equity option must be indicated to an options exchange that is a national securities exchange (national options exchange) that lists and trades the option, either directly to such national options exchange or via a member of such national options exchange if it is not a member of such exchange, by the respective member no later than 5:30 p.m. Eastern time ("ET") on the business day immediately prior to the expiration date. For customer accounts, members may not accept exercise instructions after 5:30 p.m. ET but have until 6:30 p.m. ET to submit a Contrary Exercise Advice (as defined below). For non-customer accounts, members may not accept exercise instructions after 5:30 p.m. ET but have until 6:30 p.m. ET to submit a Contrary Exercise Advice if such member employs an electronic submission procedure with time stamp for the submission of exercise instructions by option holders. Members are required to submit a Contrary Exercise Advice by 5:30 p.m. ET for non-customer accounts if such members do not employ an electronic submission procedure with time stamp for the submission of exercise instructions by option holders. Each member shall establish fixed procedures to ensure secure time stamps in connection with their electronic systems employed for the recording of submissions to

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exercise or not exercise expiring options. For purposes of this Rule 2860(b)(23)(A), the terms “customer account’ and non-customer account” shall have the meanings as defined in The Options Clearing Corporation By-laws.

(iii) Special procedures apply to the exercise of standardized equity options on the last business day before their expiration (“expiring options”). Unless waived by The Options Clearing Corporation, expiring standardized equity options are subject to the Exercise-by-Exception (“Ex-by-Ex”) procedure under The Options Clearing Corporation Rule 805. This rule provides that, unless contrary instructions are given, standardized equity option contracts that are in-the-money by specified amounts shall be automatically exercised. In addition to The Options Clearing Corporation rules, the following NASD requirements apply with respect to expiring standardized equity options. Option holders desiring to exercise or not exercise expiring standardized equity options must either:

a. take no action and allow exercise determinations to be made in accordance with The Options Clearing Corporation’s Ex-by-Ex procedure where applicable; or

b. submit a “Contrary Exercise Advice” by the deadline specified in paragraph (ii) above. A Contrary Exercise Advice is a form approved by the national options exchanges, NASD or The Options Clearing Corporation for use by a member to submit a final exercise decision committing an options holder to either: (1) not exercise an option position which would automatically be exercised pursuant to The Options Clearing Corporation’s Ex-by-Ex procedure; or (2) to exercise a standardized equity option position which would not automatically be exercised pursuant to The Options Clearing Corporation’s Ex-by-Ex procedure. A Contrary Exercise Advice may be canceled by filing an “Advice Cancel” or resubmitted at any time up to the submission cut-off times specified in paragraph (ii) above. Contrary Exercise Advices and/or Advice Cancels may be submitted by any member to:

1. a place designated for that purpose by any national options exchange of which it is a member and where the standardized equity option is listed;

2. a place designated for that purpose by any national options exchange that lists and trades the standardized equity option via a member of such exchange if the member is not a member of such exchange;

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3. any national options exchange of which it is a member and where the standardized equity option is listed via The Options Clearing Corporation in a form prescribed by The Options Clearing Corporation; or

4. any national options exchange where the standardized equity option is listed via The Options Clearing Corporation in a form prescribed by The Options Clearing Corporation, provided the member is a member of The Options Clearing Corporation.

(iv) In those instances when The Options Clearing Corporation has waived the Ex-by-Ex procedure for an options class, members must either:

a. submit to any of the places listed in paragraphs (iii)b.1. through 4. above, a Contrary Exercise Advice, within the time limits specified in paragraph (ii) above if the holder intends to exercise the standardized equity option, or

b. take no action and allow the standardized equity option to expire without being exercised.

The applicable underlying security price in such instances will be as described in The Options Clearing Corporation Rule 805(1), which is normally the last sale price in the primary market for the underlying security. In cases where the Ex-by-Ex procedure has been waived for an options class, The Options Clearing Corporation rules require that members wanting to exercise such options must submit an affirmative Exercise Notice to The Options Clearing Corporation, whether or not a Contrary Exercise Advice has been filed.

(v) Members that maintain proprietary or public customer positions in expiring standardized equity options shall take necessary steps to ensure that final exercise decisions are properly indicated to the relevant national options exchange with respect to such positions. Members that have accepted the responsibility to indicate final exercise decisions on behalf of another member also shall take necessary steps to ensure that such decisions are properly indicated to the relevant national options exchange. Members may establish a processing cut-off time prior to NASD's exercise cut-off time at which they will no longer accept final exercise decisions in expiring standardized equity options from customers.

(vi) Members may effect or amend exercise decisions for standardized equity options after the exercise cut-off time (but prior to expiration) under the following circumstances:

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- a. in order to remedy mistakes or errors made in good faith;
  - b. to take appropriate action as the result of a failure to reconcile unmatched option transactions; or
  - c. where extraordinary circumstances restricted a customer's or member's ability to inform the respective member of such decisions (or a member's ability to receive such decisions) by the cut-off time.

The burden of establishing an exception for a proprietary or customer account of a member rests solely on the member seeking to rely on such exception.

(vii) In the event a national options exchange or The Options Clearing Corporation provides advance notice on or before 5:30 p.m. ET on the business day immediately prior to the last business day before the expiration date indicating that a modified time for the close of trading in standardized equity options on such last business day before expiration will occur, then the deadline to make a final decision to exercise or not exercise an expiring option shall be 1 hour 28 minutes following the time announced for the close of trading on that day instead of the 5:30 p.m. ET deadline found in paragraph (ii) above. However, members may deliver a Contrary Exercise Advice or Advice Cancel to the places specified in paragraphs (iii)b.1. through 4. above within 2 hours 28 minutes following the time announced for the close of trading in standardized equity options on that day instead of the 6:30 p.m. ET deadline found in paragraph (ii) above for customer accounts and non-customer accounts where such member firm employs an electronic submission procedure with time stamp for the submission of exercise instructions. For non-customer accounts, members that do not employ an electronic procedure with time stamp for the submission of exercise instructions are required to deliver a Contrary Exercise Advice or Advice Cancel within 1 hour and 28 minutes following the time announced for the close of trading on that day instead of the 5:30 p.m. ET deadline found in paragraph (ii) above.

(viii) The filing of a final exercise decision, exercise instruction, exercise advice, Contrary Exercise Advice or Advice Cancel required by paragraph (A) hereof does not serve as a substitute to the effective notice required to be submitted to The Options Clearing Corporation for the exercise or non-exercise of expiring standardized equity options.

(ix) Submitting or preparing an exercise instruction after the exercise cut-off time in any expiring standardized equity option on the basis of material information released after the exercise cut-off time is activity inconsistent with just and equitable principles of trade.

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(x) The exercise cut-off requirements contained in this paragraph (A) do not apply to any currency option or standardized index option products listed on a national options exchange.

(B) [Each member shall prepare a memorandum of every exercise instruction received from a customer showing the time such instruction was received. Such memoranda shall be subject to the requirements of SEC Rules 17a-3(a)(6) and 17a-4(b) under the Act.] In the event a member receives and acts on an exercise instruction (for its own proprietary account or on behalf of a customer's account) pursuant to an exception set forth in subparagraphs a, b., or c. of subparagraph (A)~~(ii)~~(vi) hereof, the member shall maintain a memorandum setting forth the circumstances giving rise to such exception and shall file a copy of the memorandum with the Market Regulation Department of the national options exchange trading the option, if it is a member of such exchange, or NASD's Market Regulation Department if it is not a member of such exchange, no later than 12:00 p.m., ET on the business day following that expiration. Such memorandum must additionally include the time when such final exercise decision was made or, in the case of a customer, received, and shall be subject to the requirements of SEC Rules 17a-3(a)(6) and 17a-4(b). [If the member is relying on subparagraph b. or subparagraph d. as the basis for an exception, it shall promptly file a copy of the memorandum with the Association.]

(C) through (D) No Change.

(24) No Change.

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## [11850. Tendering Procedures for Exercise of Options]

### [(a) Exercise of Option Contracts]

[(1) Subject to the restrictions established pursuant to Rule 2860 of the Association's Rules, and such other restrictions which may be imposed by the Association, the Options Clearing Corporation (OCC) or an options exchange pursuant to appropriate rules, an outstanding exchange listed option contract may be exercised during the time period specified in the OCC rules by the tender to OCC of an exercise notice in accordance with OCC rules. An exercise notice may be tendered to OCC only by the clearing member in whose account the option contract is carried. Members may establish fixed procedures as to the latest time at which they will accept exercise notices from their customers.]

### [(b) Exercise Cut-Off for Expiring Equity Options ]

[(1)(A) Final exercise decisions of options holders to either exercise or not to exercise an expiring equity option must be indicated to an options exchange that is a national securities exchange (national options exchange) that lists and trades the option, either directly to such national options exchange or via a member of such national options exchange if it is not a member of such exchange, by the respective member no later than 5:30 p.m., Eastern Time on the business day immediately prior to the expiration date ("the exercise cut-off time") in either of the following manners:]

[(i) take no action and allow exercise determinations to be made in accordance with OCC's Rule 805 exercise-by-exception procedure where applicable; or]

[(ii) submit a Contrary Exercise Advice. A Contrary Exercise Advice is a form approved by the national options exchanges and the Association for use by a member to submit a final exercise decision committing an options holder to not exercise an option position which would automatically be exercised pursuant to OCC's exercise-by-exception procedure, or to exercise an equity option position which would not automatically be exercised pursuant to OCC's exercise-by-exception procedure. Contrary Exercise Advices may be submitted by any member:]

[a. to a place designated for that purpose by any national options exchange of which they are a member and where the equity option is listed;]

[b. to a place designated for that purpose by any national options exchange that lists and trades the equity option via a member of the such exchange if the member is not a member of such exchange;]

[c. to any national options exchange of which they are a member and where the equity option is listed via OCC in a form prescribed by OCC; or]

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[d. to any national options exchange where the equity option is listed via OCC in a form prescribed by OCC, provided the member is a member of OCC.]

[(B) In those instances when OCC has waived the exercise-by-exception procedure, a Contrary Exercise Advice is still required to be submitted by members wanting to exercise an option that would not have been automatically exercised, or not to exercise an option that would have been automatically exercised, had the exercise-by-exception procedure been in effect. The applicable underlying security price in such instances will be as described in OCC Rule 805(1), which is normally the last sale price in the primary market for the underlying security. In cases where the exercise-by-exception procedure has been waived for an options class, OCC rules require that OCC members and member organizations wanting to exercise such options must submit an affirmative Exercise Notice to OCC, whether or not a Contrary Exercise Advice has been filed.]

[(C) Members that maintain proprietary or public customer positions in expiring options shall take necessary steps to ensure that final exercise decisions are properly indicated to the relevant national options exchange with respect to such positions. Members who have accepted the responsibility to indicate final exercise decisions on behalf of another member also shall take necessary steps to ensure that such decisions are properly indicated to the relevant national options exchange. Members may establish a processing cut-off time prior to the Association's exercise cut-off time at which they will no longer accept final exercise decisions in expiring options from customers.]

[(2) Members may effect or amend exercise decisions for standardized equity options after the exercise cut-off time (but prior to expiration) under the following circumstances:]

[(A) in order to remedy mistakes or errors made in good faith;]

[(B) to take appropriate action as the result of a failure to reconcile unmatched option transactions; or]

[(C) where extraordinary circumstances restricted a customer's or member's ability to inform the respective member of such decisions (or a member's ability to receive such decisions) by the cut-off time.]

[The burden of establishing an exception for a proprietary or customer account of a member rests solely on the member seeking to rely on such exception.]

[(3) In the event a member makes a final exercise decision (for its own proprietary account or on behalf of a customer's account) after the exercise cut-off time pursuant to an exception set forth in clauses (A), (B), or (C) of paragraph (b)(2) hereof, the member shall maintain a

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memorandum setting forth the circumstances regarding such exception and shall file a copy of the memorandum with the Market Regulation Department of the national options exchange trading the option, if it is a member of such exchange, or the Association's Market Regulation Department if it is not a member of such exchange, no later than 12:00 p.m., Eastern Time on the business day following that expiration. Such memorandum must additionally include the time when such final exercise decision was made or, in the case of a customer, received, and shall be subject to the requirements of SEC Rules 17a-3(a)(6) and 17a-4(b).]

[4] The filing of a final exercise decision required by paragraph (b)(1) hereof does not serve as a substitute to the effective notice required to be submitted to OCC for the exercise or non-exercise of expiring options.]

[5] Submitting or preparing an exercise instruction after the exercise cut-off time in any expiring option on the basis of material information released after the exercise cut-off time is activity inconsistent with just and equitable principles of trade.]

[6] The exercise cut-off requirements contained in this paragraph (b) do not apply to any currency option or standardized index option products listed on a national options exchange.]

**[(c) Allocation of Exercise Assignment Notices]**

[1] Each member shall establish fixed procedures for the allocation to customers of exercise notices assigned in respect of a short position in option contracts in such member's customer accounts. Such allocation shall be on a "first in - first out" or automated random selection basis that has been approved by the Association or on a manual random selection basis that has been specified by the Association. Each member shall inform its customers in writing of the method it uses to allocate exercise notices to its customer's accounts, explaining its manner of operation and the consequences of that system.]

[2] Each member shall report its proposed method of allocation to the Association and obtain the Association's prior approval thereof, and no member shall change its method of allocation unless the change has been reported to and been approved by the Association. The requirements of this paragraph shall not be applicable to allocation procedures submitted to and approved by another self-regulatory organization having comparable standards pertaining to methods of allocation.]

[3] Each member shall preserve for a three-year period sufficient workpapers and other documentary materials relating to the allocation of exercise assignment notices to establish the manner in which allocation of such exercise assignment notices is in fact being accomplished.]

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**[(d) Delivery and Payment]**

[Delivery of the shares of an underlying security upon the exercise of an option contract and payment of the aggregate exercise price in respect thereto, shall be effected in accordance with the rules of the Options Clearing Corporation. As promptly as practicable after the exercise of an option contract by a customer, the member shall require the customer to make full cash payment of the aggregate exercise price in the case of a call option contract or to deposit the underlying stock in the case of a put option contract, or, in either case, to make the required margin deposit in respect thereto if such transaction is effected in a margin account, in accordance with the applicable regulations of the Federal Reserve Board and Rule 2520 of the Association's Conduct Rules. As promptly as practicable after the assignment to a customer of an exercise notice, the member shall require the customer to deposit the underlying stock in the case of a call option contract if the shares of the underlying security are not carried in the customer's account, or to make full cash payment of the aggregate exercise price in the case of a put option contract, or, in either case, to make the required margin deposit in respect thereof, if such transaction is effected in a margin account, in accordance with Rule 2520 and the applicable regulations of the *Federal Reserve Board*.]

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# Notice to Members

SEPTEMBER 2006

## SUGGESTED ROUTING

Corporate Financing  
Legal & Compliance  
Senior Management  
Trading & Market Making

## KEY TOPICS

Affiliate  
Conflicts of Interest  
Equity & Debt Offerings  
Investment Banking  
Qualified Independent Underwriter  
Rule 2710  
Rule 2720  
Underwriting Compensation

## REQUEST FOR COMMENT

### Proposed Amendments to Rule 2720

NASD Requests Comment on Proposed Amendments to Rules Governing Conflicts of Interest in Public Offerings of Securities; **Comment Period Expires October 30, 2006**

#### Executive Summary

NASD is issuing this *Notice to Members* to solicit comments from members and other interested parties on a proposal to modernize and simplify Rule 2720 (Distributions of Securities of Members and Affiliates – Conflicts of Interest). Rule 2720 governs public offerings of securities issued by participating members or their affiliates, public offerings in which a member or any of its associated persons or affiliates has a conflict of interest, and public offerings that result in a member becoming a public company. The more significant amendments that are proposed in this *Notice* would:

- ▶ exempt from the filing requirements and the qualified independent underwriter (QIU) requirements of Rule 2720 public offerings with a book-running lead manager or dealer-manager that does not have a conflict of interest and that can meet the disciplinary history requirements for a QIU and public offerings of investment-grade rated debt and securities that have a bona fide public market;
- ▶ change the definition of “conflict of interest” so that the Rule covers public offerings in which at least five percent of the offering proceeds are directed to a participating member or its affiliates and eliminates ownership of subordinated debt as a basis for a conflict of interest;
- ▶ modify the Rule’s disclosure requirements so that more information relating to conflicts of interest is prominently disclosed in offering documents;
- ▶ amend the Rule’s provisions regarding the use of a QIU to focus on the QIU’s due diligence responsibilities and eliminate the requirement that the QIU render a pricing opinion;

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- ▶ amend the QIU qualification requirements to focus on the experience of the firm rather than its board of directors, prohibit a member that would receive more than five percent of the proceeds of an offering from acting as a QIU, and lengthen from five to ten years the amount of time that a person involved in due diligence in a supervisory capacity must have a clean disciplinary history;
  - ▶ eliminate provisions in the Rule that do not apply to public offerings and instead address an issuer's corporate governance responsibilities; and
  - ▶ eliminate a provision that applies certain disclosure requirements to intrastate offerings.

### Action Requested

NASD requests comment on the proposed amendments. Comments must be received by October 30, 2006. Members and interested persons can submit their comments using the following methods:

- ▶ E-mailing written comments to [pubcom@nasd.com](mailto:pubcom@nasd.com)
- ▶ Submitting written comments online at the NASD Web Site ([www.nasd.com](http://www.nasd.com))
- ▶ Mailing hardcopy written comments to:

Barbara Z. Sweeney  
NASD  
Office of the Corporate Secretary  
1735 K Street, NW  
Washington, D.C. 20006-1506

**Important Notes:** The only comments that will be considered are those submitted in writing via one of the methods set forth above. All comments received in response to this *Notice* will be made available to the public on the NASD Web site. Generally, comments will be posted on the NASD Web site one week after the end of the comment period.<sup>1</sup>

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

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## Questions/Further Information

As noted, written comment should be submitted to Barbara Z. Sweeney. Questions concerning this *Notice* should be directed to Thomas M. Selman, Senior Vice President, Corporate Financing/Investment Companies, Regulatory Policy and Oversight (RPO), at (240) 386-4623; Joseph E. Price, Vice President, Corporate Financing Department, RPO, at (240) 386-4623; Gary L. Goldsholle, Vice President and Associate General Counsel, Office of the General Counsel (OGC), RPO, at (202) 728-8104; or Lisa C. Horrigan, Assistant General Counsel, OGC, RPO, at (202) 728-8190.

## Background

### A. Rule 2720

Rule 2720 generally requires members to file public offerings for NASD review and imposes certain substantive requirements when members participate in offerings: (i) of their own or their affiliates' securities; (ii) in which they or their affiliates have a "conflict of interest"; or (iii) that result in a member becoming a public company. The Rule defines "affiliate" to include companies under common control or that control one another.

One of the principal substantive requirements in Rule 2720 is the requirement that the underwriting syndicate retain a QIU in certain circumstances. This requirement is discussed in greater detail below.

### B. Rule 2710

Rule 2710 generally requires members to file public offerings for NASD review of proposed underwriting terms and arrangements. The underwriting terms and arrangements must comply with the substantive requirements in Rule 2710, including limits on the compensation that can be charged for performing underwriting services.

Rule 2710 contains certain exemptions to its filing requirements, including exemptions for public offerings of the securities of seasoned issuers and offerings of investment-grade debt.<sup>2</sup> These exemptions, however, are inapplicable to offerings that fall within the scope of Rule 2720 because Rule 2720(m) specifically directs that such offerings must be filed with NASD, notwithstanding any express exemption in Rule 2710. Thus, for example, while a public offering of the securities of a seasoned issuer is exempt from filing under Rule 2710, it must nevertheless be filed and comply with Rule 2710 if a member participating in the offering has a conflict of interest, as defined in Rule 2720, with the seasoned issuer.

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## Discussion

### A. Offerings Governed by Rule 2720 and Rule 2710

Under existing Rule 2720, a “conflict of interest” is presumed to exist if the member or any of its associated persons or affiliates owns ten percent or more of the common or preferred stock or subordinated debt of the issuer, or participates in ten percent of the profits or losses of the issuer. The proposed amendments would eliminate ownership of subordinated debt as a basis for a conflict of interest.

In addition, the proposed amendments would expand the definition of “conflict of interest” to include a member’s participation in an offering in which at least five percent of the proceeds are intended to be directed to the member, its affiliates or its associated persons. Rule 2710(h) requires that public offerings in which ten percent or more of the offering proceeds (not including the underwriting discount) will be paid to participating members must comply with Rule 2720’s QIU requirements. The proposed amendments would eliminate Rule 2710(h). The new five percent threshold for proceeds directed to a member in Rule 2720 would apply to each participating member individually (including the member’s affiliates and its associated persons), not on an aggregate basis for all participating members, as is currently the case. Thus, for example, a conflict of interest would exist if a member received five percent of the proceeds, but not if two unaffiliated members each received three percent of the proceeds.

The proposed amendments would also amend the definition of “conflict of interest” to expressly include instances in which the issuer is controlled by or under common control with the member or any of its affiliates or associated persons. Control under the current Rule is presumed at ten percent beneficial ownership of voting securities, ten percent interest in a partnership’s profits or losses, or the power to direct management or policies of the entity. The proposed amendments would expand the definition of “control” to include not only voting shares beneficially owned by a participating member, but also the right to receive voting securities within 60 days of the effective date of the public offering. Accordingly, warrants or rights for voting securities that are exercisable within 60 days of the effective date of the public offering would be included in the calculation of voting securities when determining whether a member, company or natural person will be presumed to control an entity.

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## B. Scope of Rule 2720

Rule 2720 requires that all public offerings within the scope of the Rule comply with its provisions and the provisions of Rule 2710, including the Rule 2710 filing requirement. Under the current Rule, public offerings of investment-grade rated securities and offerings of equity securities for which there is a “bona fide independent market”<sup>3</sup> are exempt from the Rule’s QIU requirement, but subject to all other requirements.

The proposed amendments would establish an exemption from the QIU and filing requirements of Rule 2720 for two types of offerings: (1) an offering with a book-running lead manager or dealer-manager that does not have a conflict of interest, is not an affiliate of any member that does have a conflict of interest, and can meet the disciplinary history requirements for a QIU; or (2) an offering of investment-grade rated securities or equity securities for which there is a “bona fide public market.”<sup>4</sup> While these two types of offerings would be exempt from the filing requirements, they would be subject to Rule 2720’s disclosure requirements and, if applicable, the Rule’s escrow and discretionary account requirements.<sup>5</sup>

If an offering does not meet either of these two exemptions, a QIU must participate in the preparation of the offering documents and perform due diligence, and the offering must meet Rule 2720’s disclosure requirements and, if applicable, the Rule’s escrow and discretionary account requirements.

## C. Disclosure Requirement

Rule 2720(d) requires disclosure in the registration statement or offering circular regarding the date the offering will be completed and the terms upon which proceeds will be released from the escrow account. The Rule requires the following disclosure in the underwriting section of the registration statement or offering circular:

- ◆ The fact that the offering is being made pursuant to Rule 2720;
- ◆ The member’s status in the offering; and
- ◆ Disclosure about the QIU, if one is required.

In lieu of these disclosure requirements, the proposed amendments would require prominent disclosure of the nature of the conflict of interest in offerings in which a participating member has a conflict of interest, but the Rule does not require a QIU (*i.e.*, offerings falling into either of the two QIU and filing exemptions discussed above).

For offerings that require a QIU, the proposed amendments would require prominent disclosure of the following:

- ◆ The nature of the conflict of interest;
- ◆ The name of the member acting as QIU; and
- ◆ The fact that the QIU will assume due diligence responsibilities.

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#### **D. QIU Requirement**

Rule 2720 requires that a QIU provide an opinion that the price at which equity securities are offered to the public is no higher, or the yield for debt securities is no lower, than that recommended by the QIU. The Rule also requires the QIU to participate in the preparation of the registration statement, prospectus or offering circular and perform due diligence. A QIU is not required under the existing Rule if there is a bona fide independent market for the equity or the securities are rated investment grade.

The proposed amendments would eliminate the requirement that the QIU provide a pricing opinion. In an offering in which a participating member has a conflict of interest, but the book-running lead manager or dealer-manager does not have a conflict of interest, a QIU would not be required because the book-running lead manager or dealer-manager could be expected to perform the necessary due diligence.<sup>6</sup> The proposed amendments would retain the current exemption from the QIU requirement for offerings of securities with an investment grade rating or for which there is a bona fide public market.<sup>7</sup> For offerings in which a QIU is required, the QIU must participate in the preparation of the registration statement, prospectus and offering circular and perform due diligence.

#### **E. QIU Qualifications**

Rule 2720 contains lengthy requirements for a member firm to qualify to act as a QIU. The Rule currently permits a member to serve as a QIU only if (i) the member is "actively engaged" in the investment banking or securities business and has been so engaged for at least five years immediately preceding the filing of the registration statement and (ii) a majority of its board of directors or general partners has been similarly engaged in the investment banking or securities business. The proposed amendments would eliminate the requirement regarding board or partner experience, since NASD staff believes that the experience of the firm is more relevant.

The Rule also currently requires that a QIU must have acted as a managing underwriter for offerings of a similar size and type for at least five years. The proposed amendments would shorten this period from five years to three years but impose the additional requirement that a QIU must have acted as a managing underwriter in at least three similar offerings during that time.

The Rule currently prohibits an associated person's involvement in the due diligence process in a supervisory capacity if that person has been subject to certain criminal and disciplinary actions pertaining to the offering of securities within five years prior to the filing of the registration statement. The proposed amendments would lengthen this period from five to ten years.

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The Rule currently prohibits a member from acting as a QIU if it is an affiliate of the issuer or if it beneficially owns at least five percent of the equity, subordinated debt or partnership interest of the issuer. The proposed amendments would delete the provision that makes ownership of subordinated debt a basis for disqualification of a QIU. NASD specifically requests comment on whether the five percent ownership threshold should apply to securities held not only by the QIU, but also by its affiliates and natural control persons. If so, should the determination of beneficial ownership incorporate the principles of Securities Exchange Act Section 13(d)?<sup>8</sup>

Finally, the Rule currently does not disqualify or prohibit a QIU from receiving proceeds from an offering. The proposed amendments would prohibit a QIU from receiving more than five percent of the offering proceeds. The receipt of such proceeds would disqualify a member from acting as a QIU because it would fall within the proposed expansion of the definition of "conflict of interest," which is discussed above.

#### **F. Corporate Governance and Periodic Reporting**

Rule 2720 currently includes certain provisions that do not apply to the public offering itself and instead require the issuer to adopt corporate governance policies relating to an audit committee and public directors and to issue periodic reports to shareholders.

The proposed amendments would delete these requirements. Congress recently passed corporate governance legislation and the Securities and Exchange Commission recently passed comprehensive new rules that govern reporting requirements.<sup>9</sup> The Sarbanes-Oxley Act addresses the role of public directors and audit committees for U.S. companies, and the Securities Offering Reform rules address periodic reporting requirements for United States issuers. Accordingly, NASD believes that separate Rule 2720 requirements for corporate governance and periodic reporting are unnecessary.

#### **G. Intrastate Offerings**

Rule 2720 currently requires any member offering its securities pursuant to the intrastate offering exemption under the Securities Act to include in the offering documents information required in a release that the SEC published in 1972. The proposed amendments would delete this requirement from Rule 2720. NASD requests comment on whether NASD should propose a new rule that would govern disclosure requirements in offering documents used in intrastate offerings.

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## Endnotes

- 1 See *Notice to Members 03-73* (Nov. 2003) (NASD Announces Online Availability of Comments). Personal identifying information, such as names or email addresses, will not be edited from submissions. Persons commenting on this proposal should submit only information that they wish to make publicly available.
- 2 A "seasoned issuer" is eligible for an exemption from filing under Rule 2710(b)(7) if it has a three-year reporting history and either \$150 million float or \$100 million float plus annual trading volume of three million shares.
- 3 A "bona fide independent market" is currently defined as a market in a security that is listed on a national securities exchange or NASDAQ with a market price of \$5 per share, aggregate trading volume of 500,000 shares over 90 days and a public float of 5 million shares. The proposed amendments would eliminate the definition of "bona fide independent market" and replace it with a new definition of "bona fide public market."
- 4 The proposed amendments would define "bona fide public market" as a market for a security issued by a company that has been reporting under the Securities Exchange Act for at least 90 days, is current in its reporting requirements, and whose securities are listed on a national securities exchange with an average daily trading volume of at least \$1 million, provided that the issuer's common equity securities have a public float value of at least \$150 million. These numerical standards are derived from Regulation M under the Securities Exchange Act of 1934. NASD requests comment on whether the proposed bona fide public market definition's listing requirement should include OTC-traded equity securities of foreign issuers listed on a foreign exchange deemed comparable to a national securities exchange and, if so, what criteria should be used to determine the eligible foreign exchanges.
- 5 The proposed amendments would provide that offerings of investment-grade rated securities include securities that have not received an individual rating but are of the same class or series and are considered "pari passu" with other investment-grade rated securities issued by the same company.
- 6 All syndicate members have due diligence responsibility, but typically the book-runner hires outside counsel to help all syndicate members meet their due diligence obligations.
- 7 The bona fide independent market standards would be replaced with new standards in the definition of "bona fide public market."
- 8 SEC Rule 13d-3 provides the basis for determining "beneficial ownership" under Securities Exchange Act Section 13(d), which includes voting power, investment power and the power to divest or prevent the vesting of beneficial ownership as part of a plan to evade the reporting requirements of Section 13(d).
- 9 Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (2002); Securities Offering Reform, Securities Act Release No. 8591 (July 19, 2005), 70 FR 44722 (August 3, 2005).

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## ATTACHMENT A

### 2710. Corporate Financing Rule – Underwriting Terms and Arrangements

Rule 2710 is proposed to be amended by deleting paragraph (h) and renumbering the remaining paragraphs.

### 2720. Public Offering of Securities With Conflicts of Interest

#### (a) Requirements for Participation in Certain Public Offerings

No member that has a conflict of interest may participate in a public offering unless the offering complies with paragraphs (1) or (2).

(1) The registration statement, prospectus, offering circular or similar document for the public offering prominently discloses the nature of the conflict of interest and either:

(A) the book-running lead-manager or dealer manager does not have a conflict of interest, is not an affiliate of any member that does have a conflict of interest, and meets the requirement of paragraph (f)(8)(E);

(B) the securities offered have a bona fide public market; or

(C) the securities offered are debt or preferred securities that have been rated investment grade (Baa or better by Moody's rating service or BBB or better by Standard & Poor's rating service or rated in a comparable category by another rating service acceptable to NASD) or debt or preferred securities that rank *pari passu* with such rated securities.

(2) (A) A qualified independent underwriter has participated in the preparation of the registration statement and the prospectus, offering circular, or similar document and has exercised the usual standards of "due diligence" in respect thereto; and

(B) the registration statement, prospectus, offering circular or similar document for the offering prominently discloses:

(i) the nature of the conflict of interest;

(ii) the name of the member acting as qualified independent underwriter; and

(iii) the fact that the qualified independent underwriter is assuming the responsibilities of a qualified independent underwriter in conducting due diligence.

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**(b) Escrow of Proceeds; Net Capital Computation**

(1) All proceeds from an offering by a member of its securities shall be placed in a duly established escrow account and shall not be released therefrom or used by a member in any manner until the member has complied with subparagraph (2) hereof.

(2) Any member offering its securities pursuant to this Rule shall immediately notify NASD when the offering has been terminated and settlement effected and it shall file with NASD a computation of its net capital computed pursuant to the provisions of SEC Rule 15c3-1 under the Act (the net capital rule) as of the settlement date. If at such time its net capital ratio as so computed is more than 10:1 or, net capital fails to equal 120 percent of the minimum dollar amount required by Rule 15c3-1 or, in the event the provisions of Rule 15c3-1(f) are utilized in making such computation, the net capital is less than seven percent of aggregate debit items as computed in accordance with Rule 15c3-3a, all monies received from sales of securities of the offering must be returned in full to the purchasers thereof and the offering withdrawn, unless the member has obtained from the Commission a specific exemption from the net capital rule. Proceeds from the sales of securities in the offering may be taken into consideration in computing net capital ratio for purposes of this paragraph.

**(c) Discretionary Accounts**

Notwithstanding Rule 2510, no member that has a conflict of interest may sell any security to a discretionary account unless the member has received specific written approval of the transaction from the account holder and retains documentation of the approval in its records.

**(d) Application of Rule 2710**

Any offering subject to paragraph (a)(2) is subject to Rule 2710, whether or not the offering would be otherwise exempted from the filing or other requirements of that rule.

**(e) Requests for Exemption from Rule 2720**

Pursuant to the Rule 9600 Series, NASD may in exceptional and unusual circumstances, taking into consideration all relevant factors, exempt a member unconditionally or on specified terms from any or all of the provisions of this rule that it deems appropriate.

**(f) Definitions**

For purposes of this Rule, the following words shall have the stated meanings:

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**(1) Affiliate**

An entity that controls, is controlled by or is under common control with another entity or member.

**(2) Beneficial Ownership**

The right to the economic benefits of a security.

**(3) Bona Fide Public Market**

A market for a security issued by a company that has been reporting under the Exchange Act for at least 90 days, is current in its reporting requirements, and whose securities are traded on a national securities exchange with an ADTV (as provided by Regulation M under the Securities Exchange Act of 1934) of at least \$1 million, provided that the issuer's common equity securities have a public float value of at least \$150 million.

**(4) Conflicts of Interest**

A member's participation in a public offering of securities if any of the following applies:

(A) the securities are to be issued by the member or its affiliate;

(B) the issuer controls, is controlled by or is under common control with the member, its affiliates or the member's associated persons;

(C) at least five percent of the offering proceeds are intended, as of the effective date of the registration statement, to be:

(i) used to reduce or retire the balance of a loan or credit facility extended by the member, its affiliates and its associated persons, in the aggregate; or

(ii) otherwise directed to the member, its affiliates and associated persons, in the aggregate; or

(D) as a result of the public offering and any transactions contemplated at the time of the public offering:

(i) the member will be an affiliate of the issuer;

(ii) the member will become publicly owned; or

(iii) the issuer will become a member or form a broker-dealer subsidiary.

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**(5) Control**

(A) A member, entity, or associated person controls another member or entity if the member, entity or associated person:

(i) beneficially owns 10 percent or more of the outstanding voting securities of an entity that is a corporation, including any right to receive such securities within 60 days;

(ii) beneficially owns 10 percent or more of the distributable profits or losses of an entity that is a partnership or similar vehicle, including any right to receive within 60 days any interests in such distributable profits or losses; or

(iii) has the power to direct or cause the direction of the management or policies of the member or entity.

(B) A member, and entity are under common control if the same natural person or entity controls both of them.

**(6) Entity**

For purposes of the definitions of affiliate and control under this Rule, an entity:

(A) includes a company, corporation, partnership, trust, association or organized group of persons; and

(B) excludes the following:

(i) an investment company registered under the Investment Company Act of 1940;

(ii) a "separate account" as defined in Section 2(a)(37) of the Investment Company Act of 1940;

(iii) a "real estate investment trust" as defined in Section 856 of the Internal Revenue Code

(iv) a "direct participation program" as defined in Rule 2810; or

(v) a corporation, trust, partnership or other entity issuing financing instrument-backed securities which are rated by a nationally recognized statistical rating organization in one of its four highest generic rating categories.

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## **(7) Public Offering**

Any primary or secondary offering of securities made pursuant to a registration statement or offering circular including exchange offers, rights offerings, offerings made pursuant to a merger or acquisition, and all other securities offerings of any kind whatsoever, except any offering made pursuant to:

- (A) an exemption from registration under Sections 4(1), 4(2), or 4(6) of the Securities Act of 1933;
- (B) SEC Rule 504, if the securities are “restricted securities” under SEC Rule 144(a)(3), SEC Rules 505 or 506; or
- (C) SEC Regulation S.

## **(8) Qualified Independent Underwriter**

The term “qualified independent underwriter” means a member:

- (A) that does not have a conflict of interest and is not an affiliate of any member that does have a conflict of interest;
- (B) that does not beneficially own as of the date of filing of the registration statement and the effective date of the offering, more than 5% of the class of securities that would give rise to a conflict of interest, including any right to receive any such securities exercisable within 60 days; and
- (C) that has agreed in acting as a qualified independent underwriter to undertake the legal responsibilities and liabilities of an underwriter under the Securities Act of 1933, specifically including those inherent in Section 11 thereof.
- (D) that has served as underwriter in at least three public offerings of a similar size and type during the three-year period immediately preceding the filing of the registration statement. This requirement will be deemed satisfied if, during the past three years, the member:
  - (i) with respect to a proposed debt offering, has acted as sole underwriter or book-running lead- or co-manager of at least three public offerings of debt securities each with gross proceeds of not less than 25% of the anticipated gross proceeds of the proposed offering; and

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(ii) with respect to a proposed equity offering, has acted as sole underwriter or book-running lead- or co-manager of at least three public offerings of equity securities (or of securities convertible into equity securities), each with gross proceeds of not less than 50% of the anticipated gross proceeds of the proposed offering.

(E) none of whose associated persons in a supervisory capacity who are responsible for organizing, structuring or performing due diligence with respect to corporate public offerings of securities:

(i) has been convicted within ten years prior to the filing of the registration statement of a violation of the anti-fraud provisions of the federal or state securities laws, or any rules or regulations promulgated thereunder, in connection with a registered or unregistered offering of securities;

(ii) is subject to any order, judgment, or decree of any court of competent jurisdiction entered within ten years prior to the filing of the registration statement permanently enjoining or restraining such person from engaging in or continuing any conduct or practice in violation of the anti-fraud provisions of the federal or state securities laws, or any rules or regulations promulgated thereunder in connection with a registered or unregistered offering of securities; or

(iii) has been suspended or barred from association with any member by an order or decision of the Commission, any state, NASD or any other self-regulatory organization within ten years prior to the filing of the registration statement for any conduct or practice in violation of the anti-fraud provisions of the federal or state securities laws, or any rules, or regulations promulgated thereunder, or the anti-fraud rules of any self-regulatory organization in connection with a registered or unregistered offering of securities.

# Notice to Members

SEPTEMBER 2006

## SUGGESTED ROUTING

Internal Audit  
Legal & Compliance  
Operations  
Senior Management  
Trading

## KEY TOPICS

Bona Fide Market Making  
Short Sales  
Rule 5100  
IM-5100

## GUIDANCE

### Short Sales

Guidance on the Requirements for Availability of Bona Fide Market Making Activity Exception to NASD Rule 5100

#### Executive Summary

Rule 5100 generally prohibits a member from effecting short sales in NASDAQ Global Market (NGM) securities<sup>1</sup> otherwise than on an exchange for a customer account, or the member's own account, at or below the current national best (inside) bid, when the current national best (inside) bid is below the preceding national best (inside) bid (the bid test).<sup>2</sup> Rule 5100(c)(1) provides an exception to the bid test for short sales by a market maker registered in the security in connection with bona fide market making activity. NASD is issuing this *Notice* to remind member firms of the requirements to qualify for the bona fide market making activity exception to NASD's short sale rule contained in Rule 5100.

#### Questions/Further Information

Questions regarding this *Notice* may be directed to the Legal Section, Market Regulation, at (240) 386-5126 or the Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8071.

#### Discussion

Rule 5100 generally prohibits a member from effecting short sales<sup>3</sup> in NGM securities otherwise than on an exchange for a customer account, or the member's own account, at or below the current national best (inside) bid, when the current national best (inside) bid is below the preceding national best (inside) bid. All short sales in NGM securities must comply with Rule 5100 or qualify for an exception to, or exemption from, the rule. Among others, Rule 5100 provides an exception to the bid test for certain bona fide market making activity.

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NASD is issuing this *Notice* to remind member firms of the circumstances under which the bona fide market making exception is available. To qualify for the exception, Rule 5100(c)(1) requires that the broker-dealer be a market maker registered in the security and that the short sale activity constitutes bona fide market making activity. The rule also specifically provides that bona fide market making activity does not include transactions unrelated to normal market making activity, such as index arbitrage and risk arbitrage that are independent from a member's market making functions. Although such activity may be part of the firm's overall hedging or risk management strategy, they do not warrant an exception from Rule 5100.

IM-5100(a) provides further guidance as to what constitutes bona fide market making, noting that the bona fide market making exception was established to recognize those short sale transactions engaged in to maintain continuous, liquid markets in NGM securities. IM-5100 further provides that bona fide market making activity would not include activity related to the speculative selling strategies of the member or investment decisions of the firm that is disproportionate to the usual market making patterns or practices of the member in that security.

#### **Market Making Exception to Regulation SHO "Locate" Requirements**

The uniform "locate" requirements in Regulation SHO provide a similar exception for short sales effected by a market maker in connection with bona fide market making activities.<sup>4</sup> Although the Regulation SHO bona fide market making exception applies to the locate requirements, NASD believes the standards set forth are equally applicable to the bona fide market making exception to NASD Rule 5100. Accordingly, NASD applies and interprets the bona fide market making exception to Rule 5100 consistent with the SEC's application and interpretation of the exception to the Regulation SHO locate requirements.

In this regard, the SEC staff has indicated that while the determination of whether activity would qualify for the bona fide market making exception will depend on the facts and circumstances of the particular activity, there are clear examples of what types of activities would not be deemed bona fide market making activities.<sup>5</sup> Specifically, in its Regulation SHO Adopting Release, the SEC indicated that bona fide market making does not include activity that is related to speculative selling strategies or investment purposes of the broker-dealer and is disproportionate to the usual market making patterns or practices of the broker-dealer in that security.<sup>6</sup> Likewise, where a market maker posts continually at or near the best offer, but does not also post at or near the best bid, the market maker's activities would not generally qualify as bona fide market making for purposes of the exception.<sup>7</sup> Moreover, a market maker that continually executes short sales away from its posted quotes would generally not be able to rely on the bona fide market making exception.<sup>8</sup>

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Further, the SEC stated that bona fide market making does not include transactions whereby a market maker enters into an arrangement with another broker-dealer or customer in an attempt to use the market maker's exception for the purpose of avoiding compliance with the locate requirement by the other broker-dealer or customer.<sup>9</sup> For example, to the extent that a member engages in short selling activity under the pretext of market maker status to establish short positions at the direction of customers who would otherwise not be able to comply with the locate requirements, such activity would not constitute bona fide market making activity and, thus, not be exempt from the locate requirements of Regulation SHO.<sup>10</sup> Accordingly, members are reminded that short sale positions taken to facilitate a short sale position of a customer that do not comply with Regulation SHO generally will not be deemed to fall within the bona fide market making exception.

### **Surveillance and Examination of the Rule 5100 Requirements**

NASD closely monitors member activity for violations of Rule 5100, including use of the market making exception and schemes that attempt to avoid application of the rule. Rule 3010 requires members to establish and maintain a supervisory system that is designed to ensure compliance with NASD rules and federal securities laws. Members' supervisory systems should include reviews designed to ensure that reliance upon the bona fide market making exception is justified.

Further, NASD is reminding members that intend to rely on the bona fide market making exception to Rule 5100 that they will be expected to be able to demonstrate, upon request, how the short sale transaction meets the bona fide market making exception. Thus, members availing themselves of this exception must have a reasonable basis to believe that each short sale transaction satisfies the terms of the exception and must be able to provide documentation in support of such position.

### **Endnotes**

- 1 Note: NASDAQ National Market securities were renamed NASDAQ Global Market securities. See Securities Exchange Act Release No. 54071 (June 29, 2006), 71 FR 38922 (July 10, 2006) (File No. SR-NASD-2006-068).
- 2 On June 30, 2006, the SEC approved SR-NASD-2005-087, which amends certain NASD rules to reflect the separation of NASDAQ from NASD upon the operation of the NASDAQ Exchange as a national securities exchange. See Securities Exchange Act Release No. 54084 (June 30, 2006), 71 FR 38935 (July 10, 2006). Among other amendments, NASD's rule change amended Rule 3350 to renumber it as Rule 5100 and apply it uniformly to short sales of over-the-counter (OTC) transactions reported to the Alternative Display Facility (ADF) or the Trade Reporting Facility (TRF). SR-NASD-2005-087 became effective on August 1, 2006, the date upon which NASDAQ began operation as an exchange for NASDAQ-listed securities.
- 3 The term "short sale" has the meaning contained in Rule 200 of Regulation SHO.

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- 4 Rule 203(b)(1) of Regulation SHO requires that broker-dealers, prior to effecting short sales in all equity securities, locate securities available for borrowing. To comply with the Regulation SHO locate requirements, a broker-dealer must borrow the security, enter into an arrangement to borrow the security or have reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due. See Securities Exchange Act Release No. 50103 (July 28, 2004), 69 FR 48008 (August 6, 2004) (“Regulation SHO Adopting Release”).
  - 5 See Division of Market Regulation: Responses to Frequently Asked Questions Concerning Regulation SHO (Question 4.8). For purposes of Regulation SHO, the term “market maker” is defined in Section 3(a)(38) of the Exchange Act as “any specialist permitted to act as a dealer, any dealer acting in the capacity of a block positioner, and any dealer who, with respect to a security, holds itself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for its own account on a regular or continuous basis.” Moreover, the SEC has previously stated that “a bona fide market maker is a broker-dealer that deals on a regular basis with other broker-dealers, actively buying and selling the subject security as well as regularly and continuously placing quotations in a quotation medium on both the bid and ask side of the market.” See Securities Exchange Act Release No. 32632 (July 14, 1993), 58 FR 39072, 39074 (July 21, 1993). It is important to note, however, that NASD Rule 5100(c)(1) also requires that the market maker be registered in the security to be eligible for the bona fide market making exception.
  - 6 See Regulation SHO Adopting Release at 48015.
  - 7 *Id.*
  - 8 See Regulation SHO Adopting Release at footnote 68.
  - 9 See Regulation SHO Adopting Release at 48015.
  - 10 NASD expelled a member firm and barred its principal for creating and maintaining short positions in OTC equity securities on behalf of the firm’s clients who were unable to sell the stocks short themselves because they could not satisfy the locate requirements under former NASD Rule 3370. See Department of Market Reg. v. Ryan & Co., LLP, Discip. Proceeding No. CLG050062.

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# Notice to Members

SEPTEMBER 2006

## SUGGESTED ROUTING

Legal and Compliance  
Options  
Institutional  
Senior Management  
Trading

## KEY TOPICS

Disclosure Documents Delivery  
Characteristics and Risks of  
Standardized Options  
Special Statement for Uncovered  
Option Writers  
Options  
Rule 2860

## GUIDANCE

### Option Disclosure Documents

Amendments to Option Disclosure Documents Delivery Requirements in Rule 2860; **Implementation Date: October 26, 2006**

#### Executive Summary

On August 17, 2006, NASD filed with the Securities and Exchange Commission (SEC) for immediate effectiveness a rule change to Rule 2860 (Options) to (1) require that a copy of each amendment to the options disclosure document, Characteristics and Risks of Standardized Options, be distributed to each customer not later than the time of the delivery of a confirmation of a transaction in the category of options issued by The Options Clearing Corporation (OCC) to which the amendment pertains, and (2) clarify that revisions to the Special Statement for Uncovered Option Writers be distributed to each customer approved for writing uncovered short options not later than the time of the delivery of a confirmation of a transaction in options issued by the OCC.<sup>1</sup> Rule 2860, as amended, is set forth in Attachment A of this *Notice*. The amendments will be implemented on October 26, 2006.

#### Questions/Further Information

Questions regarding this *Notice* may be directed to Gary Goldsholle, Vice President and Associate General Counsel, Office of General Counsel (OGC), Regulatory Policy and Oversight (RPO), at (202) 728-8104; or Kathryn M. Moore, Assistant General Counsel, OGC, RPO, at (202) 974-2974.

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## Background and Discussion

NASD has amended the requirement to deliver amendments and/or revisions to the options disclosure documents in Rule 2860 to conform to similar rules of other self-regulatory organizations.<sup>2</sup> Specifically, NASD has amended the rule to more clearly delineate the particular delivery requirements applicable to the Characteristics and Risks of Standardized Options (commonly known as the ODD) and the Special Statement for Uncovered Option Writers (the Special Written Statement).

Rule 2860(b)(11)(A) previously required that amendments and revisions to both disclosure documents be distributed to each customer not later than the time a confirmation of a transaction is delivered to each customer who enters into a transaction in options issued by the OCC. As amended, the delivery of an amendment to the ODD is triggered by a customer transaction in an options contract to which such amendment pertains. The rule change harmonizes NASD's rule for amendments to the ODD with the corresponding rules of the Options Exchanges.

In addition, through a new subparagraph (2), NASD clarified that revisions to the Special Written Statement must be distributed to each customer having an account approved for writing uncovered short options not later than the time a confirmation of a transaction is delivered to each customer who enters into a transaction in options issued by the OCC.

The amendments to Rule 2860 will be implemented on October 26, 2006.

## Endnotes

- 1 See Exchange Act Release No. 54463 (September 15, 2006), 71 FR 55814 (September 25, 2006) (Notice of Filing and Immediate Effectiveness of File No. SR-NASD-2006-100). Under Section 19(b) of the Securities Exchange Act of 1934 (Act), the SEC has the authority to summarily abrogate this type of rule change within 60 days of filing.
- 2 See Rule 9.15 of the CBOE; Rule 616 of the ISE; Rule 1029 of the PHLX; Rule 926 of the AMEX; Rule 726 of the NYSE; and Chapter XI, Section 17 of the BOX (collectively referred to as the Options Exchanges).

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## ATTACHMENT A

New language is underlined; deletions are in brackets.

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### 2860. Options

(a) No Change.

(b) Requirements

(1) through (10) No Change.

(11) Delivery of Current Disclosure Documents[(s)]

(A) (1) Characteristics and Risks of Standardized Options (the "ODD"). Every member shall deliver the [appropriate] current ODD [disclosure document(s)] to each customer at or prior to the time such customer's account is approved for trading [in the category of] options issued by The Options Clearing Corporation [to which such disclosure document relates]. Thereafter, a copy of each amendment to the ODD shall be distributed to each customer to whom the member previously delivered the ODD not later than the time a confirmation of a transaction in the category of options to which the amendment pertains is delivered to such customer.

(2) Special Statement for Uncovered Option Writers ("Special Written Statement"). In the case of customers approved for writing uncovered short options transactions, the Special Written Statement [disclosure document] required by paragraph (b)(16) shall be in a format prescribed by [the Association]NASD and delivered to customers in accordance with paragraph (b)(16). [Thereafter,] A copy of each new or revised Special Written Statement [current disclosure document(s)] shall be distributed to [every]each customer having an account approved for writing uncovered short options [such trading or in the alternative, shall be distributed] not later than the time a confirmation of a transaction is delivered to each customer who enters into a transaction in options issued by The Options Clearing Corporation.

(3) [The Association] NASD will advise members when a new or revised current disclosure document meeting the requirements of SEC Rule 9b-1 of the Act is available.

(B) and (C) No Change.

(12) through (24) No Change.

# Notice to Members

SEPTEMBER 2006

## SUGGESTED ROUTING

Executive Representatives  
Legal & Compliance  
Operations  
Senior Management  
Systems

## KEY TOPICS

NASD Sanction Guidelines

## GUIDANCE

### NASD Sanction Guidelines

NASD Revises *Sanction Guidelines* to Further Address Consideration of a Firm's Size

#### Executive Summary

This *Notice* advises NASD member firms of modifications to the NASD *Sanction Guidelines* (Guidelines). NASD has amended the General Principles Applicable to All Sanction Determinations (General Principles) to clarify that adjudicators should consider a firm's size and available resources when imposing monetary sanctions. In particular, as revised, the Guidelines state that, in determining sanctions for violations that are not egregious and do not involve fraud, adjudicators should take into account a firm's revenues, as well as other factors indicative of firm size. The revisions also state that, as a result of adjudicators' consideration of size and available resources, a fine that is below the minimum level otherwise recommended in the Guidelines may be imposed. The revisions to the General Principles are effective immediately and are available on NASD's Web site at [www.nasd.com/sanctionguidelines](http://www.nasd.com/sanctionguidelines).

#### Questions/Further Information

Questions concerning this *Notice* may be directed to Carla Carloni, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8019.

#### Discussion

NASD's Guidelines are designed to address a wide variety of potential violations of NASD's rules and provide fact-specific guidance for crafting appropriately remedial sanctions. NASD's adjudicators rely on the Guidelines to determine appropriately remedial sanctions, and NASD's Departments of Enforcement and Market Regulation, as well as the defense bar, rely on the Guidelines in negotiating settlements in disciplinary matters.

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With these revisions to the General Principles, NASD reiterates and reinforces its dedication to ensuring that the sanctions imposed in litigated and settled matters are proportionately remedial and are not punitive. The revisions remind users of the Guidelines that it is appropriate in certain cases to consider a respondent member firm's size when determining monetary sanctions.

With these revisions, NASD expands on the concept in General Principle No. 1 that adjudicators factor a firm's size into monetary sanction considerations. Prior to these revisions, the Guidelines pointed to the following facts to consider, among others, in determining firm size: the number of individuals associated with the firm; the level of trading activity at the firm; and other entities under common control with the firm. As revised, the Guidelines specifically include firm revenues as a factor to consider in assessing sanctions. The Guidelines now state that, in assessing whether to reduce sanctions based on firm size, adjudicators can consider, among other factors:

the amount of the firm's revenues; the financial resources of the firm; the nature of the firm's business; the number of individuals associated with the firm; the level of sales and trading activity at the firm; other entities that the firm controls, is controlled by, or is under common control with; the firm's contractual relationships; and prior disciplinary actions against the firm (see General Principle No. 2 regarding recidivists).

The revised Guidelines also state that, in imposing a sanction that is proportionately scaled to the firm's size, adjudicators may reduce the level of the sanction below the minimum level otherwise recommended in the Guidelines. Adjudicators' consideration of a firm's size is limited to violations that are neither egregious nor involve fraud.

NASD also amended General Principle No. 3 to reinforce for adjudicators, in connection with the determination of appropriately remedial sanctions, that it is appropriate to consider a firm's size and available resources. As revised, the Guidelines emphasize that, when considering reduction of a monetary sanction for a firm, adjudicators should aim to achieve a remedial sanction that is proportionately scaled to the firm's size and that may result in a reduction of the sanction below the minimum level that is otherwise indicated in the Guidelines.

The amendments to the Sanction Guidelines are effective immediately.

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## Disciplinary and Other NASD Actions

### REPORTED FOR SEPTEMBER

NASD® has taken disciplinary actions against the following firms and individuals for violations of NASD rules; federal securities laws, rules, and regulations; and the rules of the Municipal Securities Rulemaking Board (MSRB). The information relating to matters contained in this Notice is current as of the end of August 2006.

### Firms Fined, Individuals Sanctioned

**Davrey Financial Services, Inc. (CRD #38914, Tacoma, Washington) and Pravin Roy Davrey (CRD #2243197, Registered Principal, Tacoma, Washington).** The firm was censured and fined \$35,000, and the firm and Davrey are required to submit all of the firm's proposed advertising to NASD's Advertising Regulation Department for pre-use approval for two years. Pravin Davrey was suspended from association with any NASD member in a financial and operations principal (FINOP), general securities and registered representative capacities for two years, and must requalify by exam as a FINOP and general securities principal. The suspensions shall run concurrently. The United States Securities and Exchange Commission (SEC) sustained the National Adjudicatory Council's (NAC) decision following an appeal. The sanctions were based on findings that the firm, acting through Davrey, failed to maintain accurate books and records, and engaged in a securities business when the firm did not meet its minimum net capital requirement. The findings stated that the firm, acting through Davrey, made exaggerated, unwarranted and misleading statements in its television advertisement and failed to submit a script, outline, list of questions or other material used in the preparation of the TV advertisement, or any portion thereof, to the NASD Advertising Regulation Department for approval at least 10 days prior to its use. The findings also stated that the firm, acting through Davrey, did not include a warning in the TV advertisement to the effect that options are not suitable for all investors, portions of statement of risks were not reflected, failed to state the name and address of a person from whom a current options disclosure document might be obtained, and used a projected performance figure in portions of the TV options advertisement.

The suspensions are in effect from February 6, 2006 through February 5, 2008. (NASD Case #C3B20020015)

**Great American Investors, Inc. (CRD #28489, Overland Park, Kansas) and David Kennedy Richards (CRD #375518, Registered Principal, Shawnee Mission, Kansas)** submitted a Letter of

Acceptance, Waiver and Consent in which they were fined \$12,500, jointly and severally, and Richards was suspended from association with any NASD member in any supervisory capacity for 30 days. Without admitting or denying the findings, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Richards, failed to adequately supervise a registered representative by allowing him to trade excessively in a public customer's account when Richards knew, or should have known, that these transactions were unsuitable for the customer. The findings stated that the firm, acting through Richards, failed to make and maintain a memorandum of each transaction in the form that the SEC and NASD required.

The suspension in any supervisory capacity is in effect from August 21, 2006 through September 19, 2006. (NASD Case #E0420030367-02)

**Peyton, Chandler & Sullivan, Inc. (CRD #113517, Roseville, California) and Richard Scott From (CRD #703869, Registered Principal, Rocklin, California)** submitted a Letter of Acceptance, Waiver and Consent in which they were censured and fined \$10,000, jointly and severally. From was suspended from association with any NASD member in a principal capacity for 10 business days. Without admitting or denying the findings, the firm and From consented to the described sanctions and to the entry of findings that the firm, acting through From, conducted a securities business while failing to maintain the required minimum net capital.

The suspension in a principal capacity is in effect from September 5, 2006 through September 18, 2006. (NASD Case #20050011549-01)

**Sands Brothers & Co., Ltd. (CRD# 26816, New York, New York) and Steven Brett Sands (CRD #730742, Registered Principal, Locust Valley, New York)** submitted an Offer of Settlement in which the firm was censured and fined \$150,000, \$100,000 of which was assessed jointly and severally with Sands. Sands was also suspended from association with any NASD member in a principal capacity for 60 days. Without admitting or denying the allegations, the respondents consented to the described sanctions and to the entry of findings that the firm, acting through Sands, failed to file a continuing membership application with NASD seeking approval for the transfer of customer accounts and

registered representatives to another firm Sands had founded. The findings stated that the firm, acting through Sands, permitted an individual to engage in the firm's investment banking and securities business without the benefit of registration. The findings also stated that Sands failed to disclose a material fact on his Uniform Application for Securities Industry Registration or Transfer (Form U4).

The suspension in a principal capacity is in effect from August 21, 2006 through October 19, 2006. (NASD Case # E102004106801)

## Firms and Individuals Fined

**Cambridge Legacy Securities, LLC (CRD #103722, Dallas, Texas) and Oran Ben Carroll (CRD #1295071, Registered Principal, Granbury, Texas)** submitted a Letter of Acceptance, Waiver and Consent in which they were censured and fined \$10,000, jointly and severally. Without admitting or denying the findings, the firm and Carroll consented to the described sanctions and to the entry of findings that the firm, acting through Carroll, commenced a best efforts, "minimum-maximum" offering an affiliated company conducted, and failed to deposit the checks the first two public customers sent into a bank escrow account, and held the funds for a period of time before transferring them to an escrow account. The findings stated that the firm, acting through Carroll, held customers' funds by virtue of its failing to place the funds raised in the offering into a *bona fide* escrow account and instead, deposited the funds into an account on which Carroll had signature authority. The findings also stated that the firm, acting through Carroll, conducted a securities business while failing to maintain its required minimum net capital. (NASD Case #E062005004001)

**GFI Securities LLC (CRD #19982, New York, New York) and Donald Patrick Fewer (CRD #1415123, Registered Principal, Staten Island, New York)** submitted a Letter of Acceptance, Waiver and Consent in which they were censured and fined \$30,000, jointly and severally, and the firm was fined an additional \$7,500. Without admitting or denying the findings, the firm and Fewer consented to the described sanctions and to the entry of findings that the firm failed to report required yield information for corporate bond transactions eligible for Trade Reporting and Compliance

Engine (TRACE) reporting. The findings stated that the firm, acting through Fewer, permitted an individual to act in a capacity requiring registration with NASD when the individual was not registered in any capacity. (NASD Case #E102005015602)

**The Dratel Group, Inc. (CRD #8049, East Hampton, New York) and William Marshall Dratel (CRD #843025, Registered Principal, East Hampton, New York)** submitted a Letter of Acceptance, Waiver and Consent in which the firm and Dratel were censured and fined \$15,000, jointly and severally. Without admitting or denying the findings, the firm and Dratel consented to the described sanctions and to the entry of findings that the firm, acting through Dratel, failed to timely report statistical and summary information regarding a settlement with a public customer to NASD. The findings stated that the firm failed to timely amend Dratel's Form U4 to disclose a material fact. The findings also stated that the firm, acting through Dratel, failed to timely obtain an opinion of counsel concerning a lawsuit asserting a claim that could have had a material impact on the firm's net capital, failed to include the claim in the calculation of aggregate indebtedness and failed to timely notify the SEC or NASD of the deficiencies. (NASD Case #2005001123301)

## Firms Fined

**A.C.R. Securities, Inc. (CRD #43645, Cedarhurst, New York)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured, fined \$10,000 and required to certify to NASD that the firm has reviewed its procedures regarding email retention and has established systems and procedures reasonably designed to achieve compliance with the laws, regulations and rules concerning the retention of electronic mail communications. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that the firm did not have a system to retain electronic communications the firm or its registered representative sent or received, and failed to preserve copies of electronic communications relating to its business sent or received by the firm or its registered representative. (NASD Case #2006003890001)

**A.G. Edwards & Sons, Inc. (CRD #4 St. Louis, Missouri)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured, fined \$125,000 and ordered to pay \$17,017.50, plus interest, in restitution to public customers. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to use reasonable diligence to ascertain the best inter-dealer market and failed to buy or sell in such market so that the resultant price to its customers was as favorable as possible under prevailing market conditions. The findings stated that the firm failed to establish, maintain and enforce written procedures for its fixed income department and supervise its associated persons' activities that were reasonably designed to achieve compliance with applicable securities laws, regulations and NASD rules concerning best execution of debt securities. The findings also stated that the firm failed to register individuals as the firm's principals when each was actively engaged in the management of its securities business as supervisors. (NASD Case #20050001631-02)

**Aegis Capital Corp. (CRD #15007, New York, New York)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured, fined \$50,000 and required to revise its supervisory procedures regarding registration and qualifications, limit order display, limit order protection, best execution, SEC Rules 11Ac1-5 and 11Ac1-6, anti-intimidation/coordination, trade reporting, affirmative determination, bid test compliance, firm quote compliance, the Order Audit Trail System<sup>SM</sup> (OATS<sup>SM</sup>), books and records, order handling and execution, sale transactions, other trading rules and rules relating to Chinese walls. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to immediately display customer limit orders in NASDAQ securities in its public quotation when each order was at a price that would have improved its bid or offer in each security, or when the order was priced equal to the firm's bid or offer in each security; or when the order was priced equal to the firm's bid or offer and the national best bid or offer for each security and the size of the order represented more than a *de minimis* change in relation to the size associated with the firm's bid or offer in each security. The findings stated that the firm failed to report the correct symbol indicating

whether the firm executed transactions in eligible securities in a principal or agency capacity to the Automated Confirmation Transaction Service<sup>SM</sup> (ACT<sup>SM</sup>) (now known as the NASDAQ Market Center). The findings also stated that the firm failed to report the correct symbol indicating whether the transaction was a "buy," "sell," "sell short," "sell short exempt" or "cross" in last sale reports of transactions and the correct number of shares in last sale reports in OTC Equity transactions through ACT; and incorrectly reported the first and second legs of "riskless" principal transactions in Over-the-Counter (OTC) Equity securities to ACT and the NASDAQ Market Center, because the firm incorrectly designated the capacity of the transactions as principal or agent. The findings also included that the firm failed to submit required order information to OATS, and transmitted a report to OATS that failed to match a NASDAQ Market Center trade report.

NASD found that the firm failed to provide written notification disclosing to its customers that transactions were executed at an average price. NASD also found that the firm made a report on its routing of non-directed orders in covered securities publicly available that included incorrect information as to the identity of the venues to which non-directed orders for NASDAQ securities were routed for execution and the percentages of total non-directed orders for NASDAQ securities routed to the venues. In addition, NASD determined that the firm failed to show the terms and conditions, the entry time and the correct execution time (or any execution time) on brokerage order memoranda; failed to make and keep a copy of the confirmation of the sale of securities for a customer's account; and failed to show the contra side executing broker on brokerage order memoranda. Moreover, NASD found that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with applicable securities laws, regulations and NASD rules concerning registration and qualifications, limit order display, limit order protection, best execution, SEC Rules 11Ac1-5 and 11Ac1-6, anti-intimidation/coordination, trade reporting, affirmative determination, bid test compliance, firm quote compliance, OATS, books and records, order handling and execution, best execution, sale transactions, other trading rules and rules relating to Chinese walls. (NASD Case #20042000170-01)

**Archipelago Securities L.L.C. (CRD #102500, Chicago, Illinois)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined \$10,000. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it transmitted reports to OATS that contained inaccurate, incomplete or improperly formatted data, in that the reports failed to match the related order reports submitted to SuperMontage or SelectNet. (NASD Case #20050000137-01)

**B-Trade Services, LLC (CRD #41262, New York, New York)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured, fined \$20,000 and required to revise its written supervisory procedures regarding firm quote compliance. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to execute orders to buy or sell securities for the purpose of SEC Rule 11Ac1-1 presented to it by another broker or dealer at a price at least as favorable to the buyer or seller as the firm's published bid or offer in any amount up to its published quotation size. The findings stated that the firm failed to execute transactions for at least a normal unit trading at its displayed quotation as disseminated in the NASDAQ Stock Market at the time of receipt of any such offer. The findings also stated that the firm made offers to buy or sell a security at a stated price without purchasing or selling at the price and under the conditions as stated at the time of the offer to buy or sell. The findings also included that the firm's conduct was the result of its failure to properly enable a broker-dealer's acronym for access to the firm through the NASDAQ Stock Market's SuperMontage system. NASD found that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with applicable securities laws, regulations and NASD rules concerning firm quote compliance. (NASD Case #20050016956-01)

**Bear, Stearns & Co., Inc. (CRD #79, New York, New York)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined \$42,000. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to report to the NASDAQ Market Center the correct symbol indicating whether it executed transactions in eligible securities in a principal, riskless principal or agency capacity. The

findings stated that the firm failed to report to the NASDAQ Market Center the correct symbol indicating whether the transaction was a "buy," "sell," "sell short," "sell short exempt" or "cross" for a transaction in eligible securities, and failed to report the contra side executing broker in transactions in eligible securities. The findings also stated that the firm failed to report the correct number of shares through the NASDAQ Market Center in a last sale report of a transaction in an eligible security and executed proprietary short sales in listed securities at a price that was below the security's last sale price. The findings also included that the firm failed, within 90 seconds after execution, to transmit last sale reports of transactions in OTC Equity securities to the NASDAQ Market Center and failed to designate such last sale reports as late. NASD found that the firm incorrectly designated last sale reports of transactions in OTC equity securities executed during normal market hours as ".T" through the NASDAQ Market Center, and failed, within 90 seconds after execution, to transmit last sale reports of transactions in CQS securities through NASDAQ Market Center. (NASD Case #20042000210-01)

**Bishop, Rosen & Co., Inc. (CRD #1248, New York, New York)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured, fined \$12,000 and required to revise its written supervisory procedures concerning trade reporting. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to accept or decline transactions in eligible securities in the NASDAQ Market Center within 20 minutes after execution. The findings stated that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with respect to the applicable securities laws, regulations and NASD rules concerning trade reporting. (NASD Case #20050002661-01)

**Citigroup Global Markets Inc. (CRD #7059, New York, New York)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured, fined \$350,000 and required to undertake a comprehensive review of its disclosure in its technical and quantitative (tech/quant) research reports. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to include in its tech/quant research reports whether the firm or the analyst had an ownership

interest in the company, had a material conflict of interest, received income from investment banking transactions with the company, whether the analyst or a member of his household held a position as officer or director or whether the firm acted as a market maker for the stock. The findings also stated that none of the firm's tech/quant research reports included a description of the ratings used, a distribution of the ratings or a price chart illustrating closing prices for particular stocks. NASD found that the firm failed to establish and maintain a supervisory system reasonably designed to detect and prevent the firm's violations of Rule 2711(h) and failed to implement the Rule in a timely manner. (NASD Case #2005000792101)

**Commerce One Financial Inc. (CRD #100340, Westbury, New York)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined \$19,250. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to timely file Uniform Termination Notices for Securities Industry Registration (Forms U5). The findings stated that the firm failed to timely report statistical and summary information relating to customer complaints to NASD. The findings also stated that equity transactions the firm executed revealed that order tickets did not reflect the order entry time, were not maintained by the firm and did not reflect the order execution time. (NASD Case #ELI2005000401)

**Credit Suisse Securities (USA) LLC (CRD #816, New York, New York)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured, fined \$225,000, and required to review a meaningful sample of its research reports, and describe the methodology used to review this sample of reports and certify in writing to NASD that the firm is in compliance with NASD Rules 2711(h)(7) and 2711(h)(10) with respect to such sample, including the requirement that price target valuation methods and risks that might impede achievement of the price target be disclosed in a clear, comprehensive and prominent manner. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it published research reports that failed to clearly and prominently disclose the valuation methods used to determine price target valuation methods and the risks that might impede achievement of the price target. The findings stated that the firm's disclosures concerning

risks that might impede achievement of the price target were comparably deficient. The findings also stated that the firm failed to establish, maintain and enforce its written supervisory procedures reasonably designed to ensure compliance with NASD rules concerning price target disclosures. (NASD Case #EAF0401490001)

**Feltl & Company (CRD #6905, Minneapolis, Minnesota)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined \$10,000. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to adopt and implement written supervisory procedures reasonably designed to achieve compliance concerning research reports. The findings stated that the firm published research reports that contained misleading statements. (NASD Case #E0420050042-02)

**Financial America Securities, Inc. (CRD #5100, Cleveland, Ohio)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured, fined \$10,000 and required to revise its written supervisory procedures concerning trade reporting. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed, within 90 seconds after execution, to transmit last sale reports of transactions in OTC equity securities through the NASDAQ Market Center. The findings stated that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with respect to the applicable securities laws, regulations and NASD rules concerning trade reporting. (NASD Case #20050026999-01)

**First Republic Group, LLC (CRD #39781, New York, New York)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined \$85,000. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to timely report TRACE-eligible customer transactions to TRACE. The findings stated that the firm inaccurately reported the execution time and incorrectly reported the yield to TRACE. The findings also stated that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with respect to TRACE reporting. The findings also included that the firm failed to preserve copies of all electronic mail

communications relating to its business for three years and/or maintain electronic mail in an accessible place for the first two years. NASD found that the firm did not have adequate systems or procedures in place that were reasonably designed to retain and/or make accessible electronic communications to achieve compliance with SEC and NASD rules. (NASD Case #E102004016101)

**Goldman, Sachs & Co. (CRD# 361, New York, New York)** submitted a Letter of Acceptance, Waiver and consent in which the firm was censured, fined \$50,000 and required to adopt and implement policies and procedures for compliance with MSRB Rules concerning minimum denominations. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it executed numerous trades in municipal securities below the minimum denomination, and failed to provide written disclosures to public customers as the MSRB requires. The findings stated that the firm's supervisory systems and procedures were not reasonably designed to ensure compliance with MSRB rules concerning minimum denomination restrictions and disclosure requirements. (NASD Case #2005002574201)

**Goldman, Sachs & Co. (CRD #361, New York, New York)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined \$20,000. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it executed proprietary short sales, failed to properly mark the order tickets as short and incorrectly reported each transaction as a long sale. The findings stated that the firm transmitted reports to OATS that contained inaccurate, incomplete or improperly formatted data. (NASD Case #20050023340-01)

**Harris Nesbitt Corp. n/k/a BMO Capital Markets Corp. (CRD #16686, New York, New York)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined \$22,500. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to properly report "riskless" principal transactions to ACT. The findings stated that the firm failed to report the correct symbol indicating whether it executed transactions in eligible securities in a principal or agency capacity to the NASDAQ Market Center and failed to report the correct symbol indicating whether

the transaction was a “buy,” “sell,” “sell short,” “sell short exempt” or “cross” for transactions in eligible securities. The findings also stated that the firm incorrectly designated a last sale report of a transaction in an eligible security reported within 90 seconds of execution as “.SLD” through the NASDAQ Market Center. The findings also included that the firm failed to provide written notification disclosing to its customers that it was a market maker in each security when it acted as principal for its own account, failed to provide written notification disclosing to its customers its correct capacity in transactions and failed to provide written notification to its customers that transactions were executed at an average price. NASD found that the firm made available a report on the covered orders in national market system securities that it received for execution from any person that included incorrect information. (NASD Case #20042000208-01)

**Hold Brothers On-Line Investment Services, LLC (CRD #36816, Jersey City, New Jersey)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured, fined \$50,000 and required to revise its written supervisory procedures concerning OATS. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it transmitted Combined Order/Route Reports to OATS that contained inaccurate, incomplete or improperly formatted data, in that the reports failed to include the User Order ID and inaccurate Market Participant Identifier (MPID) symbols, and failed to timely report Reportable Order Events (ROEs) to OATS. The findings stated that the firm’s supervisory system did not provide for supervision reasonably designed to achieve compliance with respect to the applicable securities laws, regulations and NASD rules concerning OATS. (NASD Case #20050003130-01)

**Intervest Securities Corporation (CRD #41799, New York, New York)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined \$20,000. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that, in connection with the recommendations to, and purchases of, public offerings by public customers, the firm failed to maintain records evidencing the basis for its suitability determinations; and for recommendations to, and purchases by, additional customers, the firm did not maintain

documentation that it had considered these customers’ investment objectives in determining suitability. (NASD Case #E102004087101)

**InTrade, LLC (CRD #104047, New York, New York)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined \$10,000. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it intermittently failed to submit required information to OATS. (NASD Case #20050002091-01)

**JMP Securities, LLC (CRD #22208, San Francisco, California)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined \$11,000. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it published quotations in an OTC equity security, or directly or indirectly submitted such quotations for publication, in a quotation medium, and did not have the documentation the SEC required in its records. The findings stated that the firm failed to file a Form 211 with NASD at least three business days before its quotations were published or displayed in a quotation medium. The findings also stated that the firm’s supervisory system did not provide for supervision reasonably designed to achieve compliance with the applicable securities laws, regulations and NASD rules relating to compliance with SEC Rule 15c2-11 and NASD Rule 6740. (NASD Case #20050021280-01)

**Keating Securities, LLC (CRD #36402, Greenwood Village, Colorado)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined \$25,000. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that, in connection with work being done on the firm’s electronic mail backup system, it failed to preserve any of its internal or external email communications. (NASD Case #E3A2005001301)

**LaBranche Financial Services, Inc. (CRD #7432, New York, New York)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured, fined \$10,000 and required to revise its written supervisory procedures regarding trade reporting. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry

of findings that it reported last sale reports of NASDAQ National Market securities through the NASDAQ Market Center it was not required to report, and improperly reported trade reports of NASDAQ National Market securities through the NASDAQ Market Center. The findings stated that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with applicable securities laws, regulations and NASD rules concerning trade reporting. **(NASD Case #20050000663-01)**

**Legg Mason Wood Walker, Incorporated (CRD #6555, Baltimore, Maryland)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined \$50,000. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it executed trades in municipal securities below the minimum denomination of the issues and outside the exceptions the MSRB established. The findings stated that the firm's supervisory systems and procedures were not reasonably designed to ensure compliance with MSRB rules concerning the minimum denomination restrictions and disclosure requirements. **(NASD Case #2005002113401)**

**Manhattan Beach Trading Financial Services, Inc. (CRD #30330, El Segundo, California)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined \$12,500. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it transmitted reports to OATS that contained inaccurate, incomplete or improperly formatted data, in that the reports failed to match to a NASDAQ Market Center trade report. The findings stated that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with the applicable securities laws, regulations and NASD rules concerning OATS reporting. **(NASD Case #20050005989-01)**

**Morgan Stanley DW Inc. (CRD#7556, Purchase, New York)** submitted a Letter of Acceptance, Waiver and consent in which the firm was censured, fined \$50,000 and required to adopt and implement policies and procedures reasonably designed to ensure compliance with MSRB rules concerning minimum denominations. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry

of findings that it executed trades in municipal securities below the minimum denomination of the issues and outside the exemptions the MSRB established. The findings stated the firm's supervisory systems and procedures were not reasonably designed to ensure compliance with MSRB rules concerning the minimum denomination restrictions and disclosure requirements. **(NASD Case #2005002113001)**

**Neuberger Berman, LLC (CRD #2908, New York, New York)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured, fined \$75,000 and required to review and assess the adequacy of its supervisory system and procedures concerning ensuring the accuracy of the firm's MSRB reporting for compliance with NASD rules and federal securities laws and regulations, and staffing and resources for ensuring the accuracy of its MSRB reporting. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that, under its MPID symbol "NBLB," through its broker-dealer affiliate, it reported municipal securities agency transactions to the MSRB as principal transactions, failed to report the yield for any of the transactions and reported the transactions with the wrong "buy" and "sell" indicators. The findings stated that the firm, through a clearing firm, reported municipal securities agency transactions that had been executed under the MPID symbol "NBLB" as having been executed under another MPID symbol. The findings also stated that the firm failed to establish written supervisory procedures reasonably designed to achieve compliance with MSRB rules concerning trade reporting. **(NASD Case #E102004030401)**

**Orion Securities, (USA) Inc. (CRD #38108, Toronto, Canada)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured, fined \$10,000 and required to revise its written supervisory procedures concerning SEC Rule 606 disclosures. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to make a report on its routing of non-directed orders in covered securities publicly available for a period of time. The findings stated that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with the applicable securities laws, regulations and NASD rules concerning SEC Rule 606 disclosures. **(NASD Case #20050033922-01)**

**RBC Dain Rauscher, Inc. (CRD #31194, Minneapolis, Minnesota)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined \$20,000. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to submit required information for reporting members to OATS. (NASD Case #20050004427-01)

**Reliant Trading (CRD #32496, St. Francis, Wisconsin)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined \$20,000. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to report municipal transactions to the MSRB. The findings stated that the firm effected transactions in debt securities and failed to report them to TRACE. The findings also stated that the firm failed to establish, maintain and enforce adequate written supervisory procedures reasonably designed to achieve compliance with applicable NASD rules related to TRACE reporting. (NASD Case #E8A2005017201)

**Stoeber, Glass & Company, Inc. (CRD #7031, New York, New York)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured, fined \$15,000 and required to revise the firm's written supervisory procedures regarding TRACE reporting. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to report transactions in TRACE-eligible securities executed on a business day during TRACE system hours to TRACE within 45 minutes of the execution time. The findings stated that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with respect to applicable securities laws, regulations and NASD rules concerning TRACE reporting. (NASD Case #20050001795-01)

**UVEST Financial Services Group, Inc. (CRD #13787, Charlotte, North Carolina)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined \$20,000. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to report transactions in TRACE-eligible securities executed on a business day during TRACE system hours to TRACE within 30 minutes of the execution time. The findings stated that the firm double-reported

transactions in TRACE-eligible securities and transactions to TRACE that it was not required to report. The findings also stated that the firm's supervisory system did not provide for supervision reasonably designed to achieve compliance with the applicable securities laws, regulations and NASD rules concerning TRACE reporting. (NASD Case #20050004550-01)

**W.G. Nielsen & Co. (CRD #41093, Denver, Colorado)** submitted a Letter of Acceptance, Waiver and Consent in which the firm was censured and fined \$10,000. Without admitting or denying the findings, the firm consented to the described sanctions and to the entry of findings that it failed to implement its anti-money laundering (AML) compliance program when dealing with investors purchasing interests in private placements through the firm, in that it did not verify the investors' identities as the joint Treasury-SEC rules pertaining to customer identification programs requires. (NASD Case #E3A20050033-01)

## Individuals Barred or Suspended

**Richard Henry Angelotti (CRD #2352882, Registered Representative, Sarasota, Florida)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$10,000 and suspended from association with any NASD member in any capacity for three months. Without admitting or denying the findings, Angelotti consented to the described sanctions and to the entry of findings that he participated in an outside business activity, for compensation, and engaged in private securities transactions without providing his member firm with prompt written notice.

The suspension in any capacity is in effect from August 7, 2006 through November 6, 2006. (NASD Case #E072004089701)

**Gary Steven Artzt (CRD #2009945, Registered Principal, Marbella, Spain)** submitted an Offer of Settlement in which he was fined \$10,000 and suspended from association with any NASD member in any capacity for 45 days. Without admitting or denying the allegations, Artzt consented to the described sanctions and to the entry of findings that he failed to ensure that his member firm timely and completely complied with the undertakings specified in a previous Letter of Acceptance, Waiver and Consent.

The suspension in any capacity is in effect from September 5, 2006 through October 19, 2006. (NASD Case #E102004103701)

**Elias Emile Ashooh (CRD #867625, Registered Principal, Manchester, New Hampshire)** was barred from association with any NASD member in any capacity and ordered to pay \$13,900, plus interest, in restitution to a public customer. The sanctions were based on findings that Ashooh borrowed \$13,900 from a public customer despite his member firm's written supervisory procedures prohibiting such conduct. The findings stated that Ashooh attempted to borrow an additional \$10,750 from the customer, but his member firm did not process the customer's request. The findings also stated that Ashooh falsely certified to his member firm that he had no outstanding loans or other financial dealings with customers. (NASD Case #2005000923801)

**Daniel Forrest Barrett (CRD #1789580, Registered Representative, Irving, Texas)** was barred from association with any NASD member in any capacity. The sanction was based on findings that Barrett failed to respond to NASD requests to appear for an on-the-record testimony. The findings stated that Barrett recommended and effected unsuitable transactions in a public customer's account. The findings also stated that Barrett should have known the recommendation was unsuitable in light of the customer's age, financial status, investment objective and risk tolerance. (NASD Case #E062003043403)

**Cathy Louise Biehl (CRD #1415634, Registered Representative, Yakima, Washington)** submitted a Letter of Acceptance, Waiver and Consent in which she was fined \$8,000 and suspended from association with any NASD member in any capacity for six months. The fine must be paid before Biehl reassociates with any NASD member following the suspension, or before she requests relief from any statutory disqualification. Without admitting or denying the findings, Biehl consented to the described sanctions and to the entry of findings that she photocopied signatures onto account-related documents for public customers without the customers' authorization, knowledge or consent.

The suspension in any capacity is in effect from August 21, 2006 through February 20, 2007. (NASD Case #2005002294701)

**Chekelea Fikira Brazelton (CRD #5053255, Associated Person, Minneapolis, Minnesota)** submitted a Letter of Acceptance, Waiver and Consent in which she was barred from association with any NASD member in any capacity. Without admitting or denying the findings, Brazelton consented to the described sanction and to the entry of findings that, while taking the Series 6 examination, she took a piece of paper containing written formulae into her testing session and transferred the written formulae from the piece of paper to scratch paper the testing center distributed. (NASD Case #20050033691-01)

**Nesil Caliskanalp (CRD #4923941, Associated Person, Scottsdale, Arizona)** was barred from association with any NASD member in any capacity. The sanction was based on findings that Caliskanalp willfully failed to disclose material information on his Form U4. The findings stated that Caliskanalp failed to respond to NASD requests for information. (NASD Case #20050015978-01)

**Brandon John Cook (CRD# 2446836, Registered Representative, Reston, Virginia)** submitted a Letter of Acceptance, Waiver and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the findings, Cook consented to the described sanction and to the entry of findings that without a public customer's knowledge or authorization, he caused checks to be issued to the customer drawn against her securities account, forged her endorsement on the checks or caused her endorsement to be forged on them, negotiated the checks, caused the funds to be wired out of the customer's account to an account he controlled at another institution and used them for his own benefit. The findings stated that Cook failed to respond to NASD requests to provide information and appear for testimony. (NASD Case #2005003206201)

**Willie Lee Cotton, III (CRD #4792022, Registered Representative, Cincinnati, Ohio)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 10 business days. The fine must be paid before Cotton reassociates with any NASD member following the suspension, or before he requests relief from any statutory disqualification. Without admitting or denying the findings, Cotton consented to the described sanctions and to the entry

of findings that he failed to timely amend his Form U4 to disclose material information.

The suspension in any capacity is in effect from September 5, 2006 through September 18, 2006. (NASD Case #2005001922601)

**Thomas James Czarnik (CRD #1576079, Registered Representative, Niles, Illinois)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 30 days. Without admitting or denying the findings, Czarnik consented to the described sanctions and to the entry of findings that he engaged in outside business activities, for compensation, and failed to provide prompt written notice to his member firm.

The suspension in any capacity is in effect from September 5, 2006 through October 4, 2006. (NASD Case #E8A2004084701)

**Nancy Gold D'Anna (CRD #2889646, Registered Representative, Tuckahoe, New York)** submitted a Letter of Acceptance, Waiver and Consent in which she was fined \$5,000 and suspended from association with any NASD member in any capacity for 30 days. Without admitting or denying the findings, D'Anna consented to the described sanctions and to the entry of findings that she signed public customers' names to account-related documents without their knowledge or authorization.

The suspension in any capacity is in effect from September 5, 2006 through October 4, 2006. (NASD Case #2005002485302)

**Leonard Levite Daigle (CRD #2722527, Registered Representative, Grand Rapids, Minnesota)** submitted a Letter of Acceptance, Waiver and Consent in which he was suspended from association with any NASD member in any capacity for six months. In light of Daigle's financial status, no monetary sanction was imposed. Without admitting or denying the findings, Daigle consented to the described sanction and to the entry of findings that he engaged in private securities transactions and failed to provide his member firm with detailed written notice of the transactions and his proposed role therein, and without receiving prior written approval from his member firm to engage in the transactions.

The suspension in any capacity is in effect from September 5, 2006 through March 4, 2007. (NASD Case #20050001401-01)

**Miguel Angel Davilla (CRD #4621198, Registered Representative, Oviedo, Florida)** submitted a Letter of Acceptance, Waiver and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the findings, Davilla consented to the described sanction and to the entry of findings that, in order to earn production credits so that he could attend an upcoming sales meeting, he prepared Insurance Cover Memos and Allotment Authorization forms for public customers, falsely represented to his member firm that the customers wanted to buy insurance and forwarded the documents to his firm for processing without the customers' authorization. (NASD Case #2005002588901)

**Glen Steven Davis (CRD #1070334, Registered Principal, Portland, Oregon)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$25,000 and suspended from association with any NASD member in any supervisory or principal capacity for 23 business days. Without admitting or denying the findings, Davis consented to the described sanctions and to the entry of findings that he approved new broker codes for brokers when, in fact, he knew that the brokers were engaging in extensive market-timing activity. The findings stated that Davis did not monitor the brokers' activity to ensure that they did not use the new broker codes for illicit market-timing. The findings also stated that the brokers used these broker codes for the purpose of evading potential monitoring by mutual fund companies to detect and prevent market-timing.

The suspension in any supervisory or principal capacity was in effect from August 7, 2006 through September 7, 2006. (NASD Case #EAF0400370004)

**Frank Paul Eisele (CRD #76516, Registered Representative, Bronx, New York)** submitted a Letter of Acceptance, Waiver and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the findings, Eisele consented to the described sanction and to the entry of findings that he willfully failed to disclose material information on his Form U4. (NASD Case #2005002670601)

**Steven Emil Ennis (CRD #4415429, Registered Representative, Blaine, Minnesota)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for one year. The fine must be paid before Ennis reassociates with any NASD member following the suspension, or before he requests relief from any statutory disqualification. Without admitting or denying the findings, Ennis consented to the described sanctions and to the entry of findings that he forged a public customer's signature on a new account form and submitted it to his member firm. The findings stated that, when Ennis was questioned about this signature, he claimed that the customer's fiancé signed the form with her approval and impersonated the customer's fiancé over the telephone to attempt to provide verification for his claim.

The suspension in any capacity is in effect from August 21, 2006 through August 20, 2007. (NASD Case #20050033860-01)

**David Kristian Evansen (CRD #1579910, Registered Representative, Boca Raton, Florida)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$10,000, suspended from association with any NASD member in any capacity for 30 business days and ordered to pay \$810, plus interest, in restitution to the parties involved in the cited transactions. Without admitting or denying the findings, Evansen consented to the described sanctions and to the entry of findings that he knowingly and intentionally entered priced limit orders for a contract in separate options for his account into his former member firm's systems that were routed to an International Securities Exchange (ISE) Electronic Access Member at prices he knew, or should have known, would improve the ISE best offer (ISE BBO) in the options, in that the full price and size of the orders would be reflected in the public quotation system as the best prices and sizes at which a market participant was willing to sell the options. The findings stated that the one-contract orders at the improved inside offer caused the primary market maker on the ISE in each option to lower its offer to the improved inside offer for nine contracts, creating an inside offer at the price of Evansen's one contract for a total of 10 contracts for which he entered orders to buy the contracts when he knew, or should have known, that they would be executed at the improved ISE BBO. The findings also

stated that Evansen would not have been able to buy the options at the lower prices if he had not entered the priced limit orders. The findings also included that after Evansen received the executions of the order that he had entered for his trading account at the firm, the ISE BBO returned to a higher offer. Evansen bought several options in this manner numerous times, therefore he obtained a financial benefit of \$810.

The suspension in any capacity is in effect from August 21, 2006 through October 2, 2006. (NASD Case #20050000359-01)

**Lonney James Evon (CRD #4809200, Registered Representative, Coldwater, Michigan)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for two months. The fine must be paid before Evon reassociates with any NASD member following the suspension, or before he requests relief from any statutory disqualification. Without admitting or denying the findings, Evon consented to the described sanctions and to the entry of findings that he forged a public customer's signature on his member firm's 1035/Switch letter that his member firm required before approving the transfer of assets from one mutual fund to another.

The suspension in any capacity is in effect from September 5, 2006 through November 4, 2006. (NASD Case #2005003446101)

**José Luis Fernandez (CRD #2903983, Registered Representative, South Miami, Florida)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$7,500 and suspended from association with any NASD member in any capacity for 30 business days. The fine must be paid before Fernandez reassociates with any NASD member following the suspension, or before he requests relief from any statutory disqualification. Without admitting or denying the findings, Fernandez consented to the described sanctions and to the entry of findings that he caused a public customer's variable annuity policy to be extended from a five-year policy to a seven-year policy without the customer's authorization, knowledge or consent.

The suspension in any capacity is in effect from August 21, 2006 through October 2, 2006. (NASD Case #2005002427001)

**David Nathaniel Garcia (CRD #1335400, Associated Person, Santa Fe, New Mexico)** was barred from association with any NASD member in any capacity. The sanction was based on findings that Garcia received funds from public customers to be applied to the payment of insurance premiums and instead, used the cash payments for office expenses and failed to submit the checks for insurance premium payments. The findings stated that Garcia failed to respond to NASD requests for information. (NASD Case #2005000551401)

**Jennifer Lynn Glowacki (CRD #4703747, Associated Person, Philadelphia, Pennsylvania)** was barred from association with any NASD member in any capacity. The sanction was based on findings that Glowacki failed to respond to NASD requests for information. The findings also stated that Glowacki willfully failed to disclose material information on her Form U4. (NASD Case #2005002369801)

**Jeffrey Scott Hart (CRD #2286859, Registered Representative, Holtsville, New York)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$2,500 and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the findings, Hart consented to the described sanctions and to the entry of findings that he failed to properly disclose an outside brokerage account held in his wife's name at another member firm over which he had discretionary trading authority.

The suspension in any capacity was effective from August 21, 2006 through September 1, 2006. (NASD Case #2005001735401)

**Charles Lowell Hedrick, Jr. (CRD #1049314, Registered Representative, Salt Lake City, Utah)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$12,000 and suspended from association with any NASD member in any capacity for six months. The fine must be paid before Hedrick reassociates with any NASD member following the suspension, or before he requests relief from any statutory disqualification. Without admitting or denying the findings, Hedrick consented to the described sanctions and to the entry of findings that he engaged in outside business activities, for compensation, without providing his member firm with prompt written notice.

The suspension in any capacity is in effect from August 21, 2006 through February 20, 2007. (NASD Case #2005002282601)

**John Vincent Hull (CRD #252861, Registered Representative, Liberty Lake, Washington)** submitted a Letter of Acceptance, Waiver and Consent in which he was barred from association with any NASD member in any capacity and required to cooperate with NASD or any other regulator in any further investigation and hearing relating to his former member firm, including but not limited to, meeting with and being interviewed by NASD, without the need of NASD to resort to Rule 8210, and testifying at any hearing. Without admitting or denying the findings, Hull consented to the described sanctions and to the entry of findings that he engaged in a series of pre-arranged and other manipulative trades, including trades with Canadian firms. The findings stated that Hull made a market in a thinly traded pink sheet stock, and moved his quotes and traded over 7.5 million shares of the stock, at the direction of an individual barred by NASD. The findings also stated that Hull's manipulative trading of the stock contributed to an increase of over 600 percent in the inside bid price of the stock, and his trading and other conduct created the false appearance of trading volume and market interest in the stock and artificially affected the security's market price. The findings also included that as a result of this trading, Hull generated \$18,500 in his wife's IRA account. (NASD Case #2005000094002)

**Craig L. Josephberg (CRD #2709288, Registered Representative, New York, New York)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$15,000 and suspended from association with any NASD member in any capacity for 35 days. Without admitting or denying the findings, Josephberg consented to the described sanctions and to the entry of findings that he opened several accounts for hedge fund clients for the purpose of market-timing mutual funds. The findings stated that Josephberg received increasing numbers of account blocks and trade rejects from mutual funds that were monitoring his clients' market-timing activities for excessive market-timing. The findings also included that Josephberg, in an effort to hide from mutual funds that monitored for brokers that engaged in excessive market-timing, requested new broker codes for his market-timing account and executed trades with the new broker codes in mutual

funds that had already blocked a trade he had attempted to execute with his pre-existing broker codes. NASD found that Josephberg was able to trade for clients in funds that may have been monitoring for and may have rejected trades associated with, his pre-existing broker codes generating \$34,000 in profits for his clients. In addition, the findings stated that Josephberg processed trades in a mutual fund after that fund had blocked his broker code from placing any further trades generating \$86,000 in profits for his clients.

The suspension in any capacity is effective from August 21, 2006 through September 24, 2006. (NASD Case #EAF0400370005)

**Susan Barbara Kalla (CRD #2807573, Registered Representative, Riverside, Connecticut)** submitted a Letter of Acceptance, Waiver and Consent in which she was fined \$30,000 and suspended from association with any NASD member as a research analyst for 30 days. Without admitting or denying the findings, Kalla consented to the described sanctions and to the entry of findings that, on numerous occasions, a member of Kalla's household effected a purchase or sale of securities issued by a company Kalla followed in their personal account in contravention of the restrictions against trading during periods before and after the issuance of a research report set forth in NASD Rule 2711(g)(2). The findings stated that some of the transactions were inconsistent with Kalla's recommendation as reflected in the most recent research report that she prepared concerning the respective company. The findings also stated that Kalla purchased and sold shares of a company's common stock in a securities account she owned individually at another member firm that was inconsistent with the recommendation reflected in her published research report. The findings also included that Kalla prepared research reports that failed to disclose that a member of her household owned shares of the company's common stock. In addition, the findings stated that Kalla maintained a personal securities account at two other NASD member firms and failed to promptly notify those firms in writing of her association with her member firm, and failed to promptly notify her member firm in writing about a personal securities account she maintained.

The suspension as a research analyst is in effect from September 4, 2006 through October 3, 2006. (NASD Case #E9A2005004701)

**Jonathan Edward Kruse, Sr. (CRD #862563, Registered Representative, Oak Harbor, Washington)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$25,750, which includes disgorgement of \$15,750 in financial benefits received, and suspended from association with any NASD member in any capacity for one year. The fine must be paid before Kruse reassociates with any NASD member following the suspension, or before he requests relief from any statutory disqualification. Without admitting or denying the findings, Kruse consented to the described sanctions and to the entry of findings that he engaged in private securities transactions without prior written notice to, and approval from, his member firm. The findings stated that Kruse settled a customer complaint by purchasing back securities he had sold them without informing his member firms.

The suspension in any capacity is in effect from August 7, 2006 through August 6, 2007. (NASD Case #2005001626001)

**Daniel Carlos Lacey (CRD #4312702, Registered Representative, Austin, Texas)** submitted an Offer of Settlement in which he was fined \$2,500 and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the allegations, Lacey consented to the described sanctions and to the entry of findings that he made an unsuitable recommendation to a public customer without having reasonable grounds for believing that his recommendation and the resulting variable annuity transaction were suitable for the customer based on her financial situation and needs. The findings stated that Lacey falsely represented to his member firm, in writing, that the transaction was unsolicited.

The suspension in any capacity is in effect from September 5, 2006 through September 18, 2006. (NASD Case #E062004000201)

**Richard Lewis Lee (CRD #1017833, Registered Representative, Taylorsville, Utah)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$5,000 and suspended from association with any

NASD member in any capacity for 90 days. The fine must be paid before Lee reassociates with any NASD member following the suspension, or before he requests relief from any statutory disqualification. Without admitting or denying the findings, Lee consented to the described sanctions and to the entry of findings that he entered into a promissory note with public customers in contravention of the firm's written procedures prohibiting registered persons from borrowing money from customers.

The suspension in any capacity is in effect from August 21, 2006 through November 18, 2006. (NASD Case #2005002016801)

**Mark L. Lewis (CRD #1568287, Registered Principal, Lansing, Michigan)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$2,500 and suspended from association with any NASD member in any capacity for 10 business days. The fine must be paid before Lewis reassociates with any NASD member following the suspension, or before he requests relief from any statutory disqualification. Without admitting or denying the findings, Lewis consented to the described sanctions and to the entry of findings that he borrowed \$650 from a public customer without first obtaining his member firm's written approval. Lewis' member firm's written procedures prohibited its representatives from accepting or borrowing funds from customers.

The suspension in any capacity was in effect from August 21, 2006 through September 1, 2006. (NASD Case #E8A2004106201)

**Suk Ku Lim (CRD# 2407363, Registered Representative, Arlington, Virginia)** submitted an Offer of Settlement in which he was fined \$10,000 and suspended from association with any NASD member in any capacity for 50 days. Without admitting or denying the allegations, Lim consented to the described sanctions and to the entry of findings that he shared in the loss of a public customer's account by paying her \$35,000 for sustained losses in her securities brokerage account. The findings stated that Lim entered into oral settlement agreements with public customers and did not provide prior notification to his member firm of such settlements.

The suspension in any capacity is in effect from September 5, 2006 through October 24, 2006. (NASD Case #E072003075201)

**Michael Kevin Maunsell (CRD #3224997, Registered Principal, Oxford, Connecticut)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$7,500 and suspended from association with any NASD member in any capacity for 30 days. The fine must be paid before Maunsell reassociates with any NASD member following the suspension, or before he requests relief from any statutory disqualification. Without admitting or denying the findings, Maunsell consented to the described sanctions and to the entry of findings that he made a recommendation to a public customer without having a reasonable basis for believing that such recommendation was suitable based on the customer's investment objectives, financial situation and needs.

The suspension in any capacity is in effect from September 4, 2006 through October 3, 2006. (NASD Case# 2005001930501)

**Feltus Barrow McKowen (CRD #1231747, Registered Representative, Baton Rouge, Louisiana)** submitted an Offer of Settlement in which he was suspended from association with any NASD member in any capacity for six months. In light of McKowen's financial status, no monetary sanction was imposed. Without admitting or denying the allegations, McKowen consented to the described sanction and to the entry of findings that he effected securities transactions in a public customer's accounts without the customer's prior knowledge or consent.

The suspension in any capacity is in effect from August 7, 2006 through February 6, 2007. (NASD Case #E052003017101)

**Fredd E. Montoya (CRD# 5084788, Associated Person, Miami, Florida)** submitted a Letter of Acceptance, Waiver and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the findings, Montoya consented to the described sanction and to the entry of findings that he willfully failed to disclose material facts on his Form U4. The findings stated that Montoya failed to respond to NASD requests for information. (NASD Case #2006004240801)

**Scott Douglas Patterson (CRD #1395972, Registered Representative, Memphis, Tennessee)** submitted an Offer of Settlement in which he was barred from association with any NASD member in any capacity. Without admitting or denying the allegations, Patterson consented to the described sanction and to the entry of findings that he forged a public customer's signature on documents necessary to effect the disbursements from a trust account and to effect the switch of the proceeds from one annuity to another. The findings stated that Patterson failed to respond to NASD requests for testimony. (NASD Case #2005002493201)

**Eric Jason Pydynowski (CRD #4287089, Registered Representative, Orlando, Florida)** submitted a Letter of Acceptance, Waiver and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the findings, Pydynowski consented to the described sanction and to the entry of findings that he submitted falsified life insurance applications to his member firm on which he forged the signatures of the purported applicants without their knowledge or authorization. (NASD Case #2005001555201)

**David Austin Pryor (CRD #1780676, Registered Representative, Kalamazoo, Michigan)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for two months. The fine must be paid before Pryor reassociates with any NASD member following the suspension, or before he requests relief from any statutory disqualification. Without admitting or denying the findings, Pryor consented to the described sanctions and to the entry of findings that he forged a public customer's signature on an application to open an IRA account with his member firm.

The suspension in any capacity is in effect from September 5, 2006 through November 4, 2006. (NASD Case #2005003580101)

**Daniel Peter Ray (CRD #2533515, Registered Representative, Rocky Point, New York)** submitted a Letter of Acceptance, Waiver and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the findings, Ray consented to the described sanction and to the entry of findings that he made improper use of customer funds, in that he cashed money orders

intended to purchase securities that were erroneously made out to him instead of his member firm, and then provided the proceeds to another registered representative so that the representative could satisfy gambling debts. (NASD Case #2005002115301)

**Queen Esther Robinson (CRD #1743613, Registered Representative, Chicago, Illinois)** submitted a Letter of Acceptance, Waiver and Consent in which she was suspended from association with any NASD member in any capacity for 30 days. In light of Robinson's financial status, no monetary sanction was imposed. Without admitting or denying the findings, Robinson consented to the described sanction and to the entry of findings that she engaged in an outside business activity without providing her member firm with prompt written notice.

The suspension in any capacity is in effect from August 21, 2006 through September 19, 2006. (NASD Case #20050008859-01)

**Michael Antoine Rooms (CRD #2187994, Registered Principal, Littleton, Colorado)**. The United States Court of Appeals for the Tenth Circuit upheld the SEC's decision affirming the NAC's bar of Rooms in all capacities. The sanction was based on the NAC's findings that Rooms violated certain provisions of the SEC's penny stock rules by, among other things, recommending and selling penny stocks to customers without providing certain required disclosures. The findings also stated that Rooms violated just and equitable principles of trade by attempting to obstruct NASD's investigation of the penny stock violations. Rooms used two methods to create the false impression that he had complied with the penny stock rules. First, he pressured his customers to sign forms that falsely indicated that the transactions had not been recommended—an important factor because the penny stock rules in question only apply to recommended sales. Second, he backdated the forms, giving the false impression that the customers had signed the forms contemporaneously with the transactions. The firm then provided the misleading forms to NASD as part of a document production. (NASD Case #C0620020003/E0619980215)

**Marcelo S. Samson (CRD #2701995, Registered Representative, Fountain Valley, California)** submitted a Letter of Acceptance, Waiver and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying

the findings, Samson consented to the described sanction and to the entry of findings that he willfully failed to amend his Form U4 to disclose material facts. The findings stated that Samson failed to respond to NASD requests for information. **(NASD Case #20050031428-01)**

**Zelman Sanders, III (CRD #4837422, Associated Person, East St. Louis, Illinois)** was barred from association with any NASD member in any capacity. The sanction was based on findings that Sanders failed to respond to NASD requests for information. The findings stated that Sanders failed to disclose material facts on his Form U4. **(NASD Case #E8A2004086101)**

**Todd Austin Scott (CRD #4403760, Registered Representative, Massillon, Ohio)** submitted a Letter of Acceptance, Waiver and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the findings, Scott consented to the described sanction and to the entry of findings that he received funds from public customers for investment purposes or to deposit in their brokerage accounts and instead, used some of the funds for his personal benefit or for the benefit of someone other than the customer. **(NASD Case #2005001739101)**

**Manmeet Sethi (CRD #2525427, Associated Person, White Plains, New York)** submitted a Letter of Acceptance, Waiver and Consent in which she was fined \$5,000 and suspended from association with any NASD member in any capacity for six months. The fine must be paid before Sethi reassociates with any NASD member, or before she requests relief from any statutory disqualification. Without admitting or denying the findings, Sethi consented to the described sanctions and to the entry of findings that she signed and caused to be signed customer names on certain account-related documents to facilitate the processing of their transactions without the customers' authorization or consent.

The suspension in any capacity is in effect from September 5, 2006 through March 4, 2007. **(NASD Case #2005002485303)**

**Gregory Francis Summers (CRD #1080556, Registered Representative, Watchung, New Jersey)** submitted an Offer of Settlement in which he was fined \$50,000 and suspended from association with any NASD member in any capacity for 15 months. The fine must be paid before Summers reassociates with any NASD member following the suspension, or before he requests relief from any statutory disqualification. Without admitting or denying the allegations, Summers consented to the described sanctions and to the entry of findings that he caused his member firm to tender shares of a Class B common stock to the issuer in response to its tender offer, although his member firm did not have a net long position of the shares tendered. The findings stated that Summers effected trades in the security to create the false impression that his member firm, through its affiliate, had a net long position of shares on the date when he caused his firm to tender the shares to the issuer. The findings also stated that Summers, in effecting trades for an entity, executed transactions in the security that involved no change in the beneficial ownership for the purpose of creating or inducing a false appearance of activity in an eligible security. The findings also included that Summers, by effecting the trades, caused to be published or circulated a notice or communication that purported to report transactions as a purchase or sale of securities when he did not believe, or had no reasonable basis to believe, that the transactions were *bona fide*.

The suspension in any capacity is in effect from August 7, 2006 through November 6, 2007. **(NASD Case #E052003030702)**

**Jerry Todd Swicegood (CRD #1446723, Registered Principal, Manteo, North Carolina)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$10,000 and suspended from association with any NASD member in any capacity for 20 business days. Without admitting or denying the findings, Swicegood consented to the described sanctions and to the entry of findings that he settled securities-related customer complaints against him without notifying his member firm and provided false information to his former member firm in response to its inquiry concerning the settlement of the customer complaint.

The suspension in any capacity was in effect from August 7, 2006 through September 1, 2006. **(NASD Case #2005002683001)**

**Bryan Christopher Terra (CRD #4717215, Registered Representative, Monroe, Louisiana)** was barred from association with any NASD member in any capacity. The sanction was based on findings that Terra, in his capacity as a personal banker, came into possession of a \$650 check for deposit to a customer's bank account and converted the customer's funds by depositing the check into his personal bank account. The findings stated that Terra failed to respond to NASD requests for information. (NASD Case #2005000870801)

**Timothy Robin Touloukian (CRD #2803832, Registered Representative, New York, New York)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$15,000 and suspended from association with any NASD member in any capacity for 45 days. Without admitting or denying the findings, Touloukian consented to the described sanctions and to the entry of findings that he opened several accounts for hedge fund clients for the purpose of market-timing mutual funds. The findings stated that Touloukian received increasing numbers of account blocks and trade rejects from mutual funds that were monitoring his clients' market-timing activities for excessive market timing. The findings also included that Touloukian, in an effort to hide from mutual funds that monitored for brokers that engaged in excessive market timing, requested new broker codes for his market-timing account and executed trades with the new broker codes in mutual funds that had already blocked a trade he had attempted to execute with his pre-existing broker codes. NASD found that Touloukian was able to trade for clients in funds that may have been monitoring for, and may have rejected trades associated with, his pre-existing broker codes, generating \$30,000 in profits for his clients.

The suspension in any capacity is effective from August 7, 2006 through September 20, 2006. (NASD Case #EAF0400370003)

**John Fitzgerald Tyus (CRD #1475677, Registered Representative, Jamaica, New York)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the findings, Tyus consented to the described sanctions and to the entry of findings that he borrowed \$30,000 from a public customer without first obtaining written approval from his member firm.

The suspension in any capacity is in effect from August 21, 2006 through September 1, 2006. (NASD Case# 2005003253401)

**Michael Howard Whims (CRD #464828, Registered Representative, Redmond, Washington)** submitted a Letter of Acceptance, Waiver and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the findings, Whims consented to the described sanction and to the entry of findings that he affixed, or caused to be affixed, public customers' signatures to his firm's switch letters in order to effect the liquidation of certain mutual fund shares and the purchase of other mutual fund shares without the customers' knowledge or consent. (NASD Case #2005002177401)

**Robert Philip Yorba, III (CRD #1086000, Registered Representative, Del Mar, California)** submitted a Letter of Acceptance, Waiver and Consent in which he was fined \$5,000 and suspended from association with any NASD member in any capacity for six months. Without admitting or denying the findings, Yorba consented to the described sanctions and to the entry of findings that, in an attempt to stop a public customer from transferring her accounts to another firm, and without the customer's knowledge, authorization and consent, he created a letter to his firm and affixed a copy of the customer's signature through which she purportedly asked the firm to disregard her earlier transfer request.

The suspension in any capacity is in effect from August 21, 2006 through February 20, 2007. (NASD Case #20050013421-01)

**Stanley Yung aka Quang Chi Dung (CRD #4165273, Registered Representative, San José, California)** submitted a Letter of Acceptance, Waiver and Consent in which he was barred from association with any NASD member in any capacity. Without admitting or denying the findings, Yung consented to the described sanction and to the entry of findings that, with an accomplice's help, he reactivated an inactive customer's savings account and without the knowledge, authorization or consent of a second customer, arranged for the transfer of \$60,000 from that customer's account to the savings account, had his accomplice cash out the savings account, received the cash proceeds, and used the funds for his own personal use and benefit. The findings stated that Yung withdrew \$50,000 from a

third customer's account without the customer's knowledge, authorization or consent and transferred the funds into his accomplice's own bank account. However, the bank froze the accomplice's bank account before the funds could be removed from it. (NASD Case #20050025144-01)

## Individual Fined

**Carole Gurgone Ferraro (CRD #1174904, Registered Representative, Boynton Beach, Florida)** submitted an Offer of Settlement in which she was censured and fined \$10,000. Without admitting or denying the allegations, Ferraro consented to the described sanctions and to the entry of findings that she recommended and effected securities transactions in public customers' account without having reasonable basis for believing the transactions were suitable for the customers. (NASD Case #C0520050005)

## Decisions Issued

The following decision has been issued by the Office of Hearing Officers and has been appealed to or called for review by the NAC as of August 4, 2006. The NAC may increase, decrease, modify or reverse the findings and sanctions imposed in the decisions. Initial decisions whose time for appeal has not yet expired will be reported in the next *Notice to Members*.

**Geoffrey Ortiz (CRD #1808280, Registered Representative, Malibu, California)** was barred from association with any NASD member in any capacity. The sanction was based on findings that Ortiz made, or caused to be made, handwritten markings on public customers' ACCESS Account Applications that materially changed the terms of the agreement between the firm and the customers, and placed, or caused to be placed, the customers' initials on the amended applications without the customers' knowledge, authorization or consent. The findings stated that Ortiz increased, or caused to be increased, the applicable annual fee for the customers' ACCESS accounts and submitted the amended applications to his member firm without the customers' knowledge, authorization or consent. The findings also stated that Ortiz provided false and misleading information in response to NASD requests for information and during an on-the-record interview.

This decision has been appealed to the NAC and the sanction is not in effect pending consideration of the appeal. (NASD Case #E0220030425-01)

## Complaints Filed

NASD issued the following complaints. Issuance of a disciplinary complaint represents the initiation of a formal proceeding by NASD in which findings as to the allegations in the complaint have not been made, and does not represent a decision as to any of the allegations contained in the complaint. Because these complaints are unadjudicated, you may wish to contact the respondents before drawing any conclusions regarding the allegations in the complaint.

**Michael Lawrence Baldwin (CRD #1966870, Registered Principal, Kansas City, Missouri)** was named as a respondent in an NASD complaint alleging that he recommended and effected excessive securities transactions in a public customer's account without having reasonable grounds for believing the transactions were suitable for the customer in light of the customer's financial situation and needs. The complaint alleges that Baldwin failed to approve option order tickets before they were submitted to his member firm's clearing firm for execution, and failed to ensure that the options transactions were appropriate for the customer accounts. (NASD Case #E0420030367-01)

**Jeffrey Michael Martinous (CRD #3011007, Registered Representative, Quincy, Massachusetts)** was named as a respondent in an NASD complaint alleging that without a public customer's consent or authority, he sold the customer's funds and used the proceeds to purchase shares of another fund. The complaint also alleges that without the customer's consent or authority, Martinous signed, or caused to be signed, the customer's signature on documents that were required to effect a mutual fund transaction. (NASD Case #20050016241-01)

**Donald Joseph Tintle (CRD #4855119, Associated Person, Middletown, Connecticut)** was named as a respondent in an NASD complaint alleging that he misused public customer funds, in that he received checks totaling \$27,000 from customers for investment purposes and deposited the funds in a bank account he controlled. The complaint also alleges that Tintle sent an

email to a customer falsely representing that she owned shares of a common stock and falsely represented to the customers that he possessed various securities licenses. The complaint also alleges that Tintle failed to respond to NASD requests for information and documents. (NASD Case #2005003330001)

### **Firms Suspended for Failure to Supply Financial Information**

The following firm was suspended from NASD membership for failing to comply with formal written requests to submit financial information to NASD. The action was based on the provisions of NASD Rule 9552.

(The date the suspension commenced is listed after the entry. If the firm has complied with the requests for information, the listing also includes the date the suspension concluded.)

**CMG Institutional Trading LLC**  
Chicago, Illinois  
(April 19, 2006 - August 30, 2006)

**The Draken Group, Inc.**  
Lawrenceville, Georgia  
(August 15, 2006)

### **Firm Suspended Pursuant to NASD Rule 9553 for Failure to Pay Arbitration Fees**

(The date the suspension began is listed after the entry. If the suspension has been lifted, the date follows the suspension date.)

**Salomon Grey Financial Corporation**  
Dallas, Texas  
(August 2, 2006)

### **Individuals Revoked for Failing to Pay Fines and/or Costs in Accordance with NASD Rule 8320**

**Jonathan Bruce Abrams**  
River Edge, New Jersey  
(August 10, 2006)

**Dean Daniell Giasi**  
Staten Island, New York  
(August 10, 2006)

**Michael Louis Lieb**  
Kettering, Ohio  
(August 10, 2006)

**Marc Christopher Newton**  
Pickerington, Ohio  
(August 10, 2006)

### **Individuals Barred Pursuant to NASD Rule 9552(h)**

**Richard Joseph Arena, Jr.**  
E. Patchogue, New York  
(August 9, 2006)

**Sandeep Bardia**  
Maspeth, New York & Newark, Delaware  
(August 28, 2006)

**Clark M. Chasten, II**  
Glenwillow, Ohio  
(August 7, 2006)

**Charles Dean Crystal**  
Colorado Springs, Colorado  
(August 9, 2006)

**John Derek Elwin**  
Lake Worth, Florida  
(August 7, 2006)

**Damascus Isaiha Lee**  
Brooklyn, New York  
(August 7, 2006)

**Kenneth Lee McLaughlin**  
Akron, Ohio  
(August 21, 2006)

**Todd Michael Newman**  
Royal Palm Beach, Florida  
(August 28, 2006)

**Mark Ivan Sikkenga**  
Kalamazoo, Michigan  
(August 21, 2006)

**Thomas William Yurachek**  
St. Charles, Missouri  
(August 1, 2006)

### **Individuals Suspended Pursuant to NASD Rule 9552(d)**

(The date the suspension began is listed after the entry. If the suspension has been lifted, the date follows the suspension date.)

**Michael Andrew Capul**  
Manhasset Hills, New York  
(August 21, 2006)

**Luther Carl Cooper**  
New York, New York  
(August 28, 2006)

**Michael L. Donaldson**  
Jamaica, New York  
(August 29, 2006)

**John Michael Legreca**  
Port Charlotte, Florida  
(August 2, 2006)

**Cheryl Janette Suggs**  
Rockingham, North Carolina  
(August 1, 2006)

**Timothy Donald Trimmer**  
North Myrtle Beach, South Carolina  
(August 29, 2006)

### **Individuals Suspended Pursuant to NASD Rule Series 9554 for Failure to Comply with an Arbitration Award or a Settlement Agreement**

(The date the suspension began is listed after the entry. If the suspension has been lifted, the date follows the suspension date.)

**Matthew Harold Adams**  
Westbury, New York  
(August 2, 2006)

**Neal Albert Bohlman**  
St. Louis, Missouri  
(August 28, 2006)

**May Yan Brisbin**  
Glendale, California  
(August 23, 2006)

**Ronald Louis Bronson**  
Boca Raton, Florida  
(August 1, 2006)

**Mark Vernon Brown**  
New Port Richey, Florida  
(August 7, 2006)

**Walter Buhay, II**  
Charlestown, Massachusetts  
(August 28, 2006)

**Sean Francis Carrington**  
Thiells, New York  
(August 3, 2006)

**Carl Edward Cherasia**  
Toms River, New Jersey  
(August 3, 2006)

**Stephen Andrew Comeau**  
Ft. Lauderdale, Florida  
(August 1, 2006)

**David Edward Cook**  
Warren, Ohio  
(August 1, 2006)

**Dermot J. Durnin**  
San Francisco, California  
(August 23, 2006)

**Ali Feke**  
Irvine, California  
(August 3, 2006)

**Michael Edward Frontera**  
Staten Island, New York  
(August 2, 2006)

**Steven P. Galko**  
Dallas, Texas  
(August 21, 2006)

**Jose Enrique Garcia, Jr.**  
El Paso, Texas  
(August 21, 2006)

**Thomas Randall Griffin**  
San Antonio, Texas  
(August 3, 2006)

**Christopher Alan Halstead**  
Hoboken, New Jersey  
(August 1, 2006)

**Francis Hartley-Edwards**  
San Francisco, California  
(August 24, 2006)

**Timothy Joseph Heitmann**  
Washington, District of Columbia  
(August 21, 2006)

**Cheryl Diane Jimerson**  
Sayville, New York  
(August 2, 2006)

**Randy Rene Jones**  
Sandy, Oregon  
(August 23, 2006 - August 28, 2006)

**Andrew Scott Koppel**  
Baltimore, Maryland  
(August 1, 2006)

**Rafael Leal**  
El Paso, Texas  
(August 3, 2006)

**Michael Joseph Mazzarisi**  
Cumming, Georgia  
(August 21, 2006)

**James Curtis McCauley**  
Longview, Texas  
(August 1, 2006)

**Mark Wellington McKoan**  
Bradenton, Florida  
(August 3, 2006)

**Franklyn Ross Michelin**  
Boca Raton, Florida  
(August 2, 2006)

**Brad Jason Mitchell**  
Aventura, Florida  
(August 21, 2006)

**Edmund Burke Pearson**  
Dayton, Ohio  
(August 3, 2006)

**Edward Joseph Strafaci**  
Colts Neck, New Jersey  
(August 3, 2006)

**Roland Paul Sturgill, Jr.**  
Nokomis, Florida  
(August 1, 2006)

**Stephen Jefferson Sumner**  
Orlando, Florida  
(August 8, 2006)

**David William Svete**  
Spring Valley, Ohio & Dayton, Ohio  
(August 3, 2006)

**Elise Clydean Tanner**  
Kansas City, Missouri  
(August 1, 2006)

**Richard Hartwell Thompson**  
Dallas, Texas  
(August 3, 2006)

**Marcus Rodney Valenzuela**  
Plantation, Florida  
(August 1, 2006)

**Lynn Elizabeth Welch**  
Bayonne, New Jersey  
(August 3, 2006)

## **NASD Fines BRUT \$2.2 Million for Publishing Erroneous Execution Quality Reports, Other Violations**

NASD ordered New York's BRUT, LLC to pay \$2.2 million for rule violations relating to publication of erroneous order execution quality reports, backing away from the firm's posted quotes, failure to maintain two-sided quotations, failure to comply with the rules applicable to trade-throughs and locked and/or crossed markets, non-retention of emails, OATS deficiencies and inadequate supervision. In addition to the fine, BRUT agreed to revise certain of the firm's written supervisory procedures within 30 days.

BRUT's erroneous order execution reports related to orders sent to the firm's ECN. BRUT's share of monthly NASDAQ trading volume amounted, at times, to more than 13 percent of NASDAQ executions. "Monthly order execution reports provide data that must be made public under federal securities regulations," said NASD Senior Executive Vice President Stephen Luparello. "BRUT's inaccurate reports compromised the ability of the investing public and other market participants to accurately assess execution quality and compare venues for execution."

NASD found that from October 2001—shortly after the requirement to publish order execution reports took effect—through July 2005, BRUT published execution reports that contained critical errors. Specifically, when subscribers of BRUT's ECN entered orders that included a "reserve size component," BRUT's treatment of these reserve size orders resulted in execution reports that did not include the full size of each such order. Instead, after each portion of a reserve size order was executed, the newly displayed portion of the original order was counted as a separate order in BRUT's execution reports. The incorrect treatment of reserve size orders impacted BRUT's reported order size, reduced the order execution time and increased the number of covered orders.

The effect of the errors contained in BRUT's execution reports varied. Certain errors may have resulted in certain execution quality statistics appearing to be better than was actually the case. Other errors may have resulted in execution quality statistics appearing to be either better or worse than was actually the case.

NASD also found other regulatory violations by the firm. At certain times between April 2004 and June 2005, BRUT failed to execute certain orders presented to the firm at its published quotation in an amount up to its published quotation size. In addition, in certain instances between April 2003 and June 2005, BRUT failed as an ITS/CAES market maker to maintain a continuous two-sided quotation for certain securities. Further, in certain instances between September 2003 and September 2005, BRUT submitted millions of OATS reports that were rejected, inaccurate, incomplete, improperly formatted or late. Finally, BRUT failed to implement effective supervisory systems and written supervisory procedures reasonably designed to detect and prevent the kinds of violations detailed above.

In settling this matter, BRUT neither admitted nor denied the charges, but consented to the entry of NASD's findings.

## **NASD Fines Four ING Broker-Dealers \$7 Million For Directed Brokerage Violations**

NASD announced a total of \$7 million in fines against four broker-dealers affiliated with ING America Insurance Holdings, Inc. (ING) in connection with the receipt of directed brokerage in exchange for preferential treatment for certain mutual fund companies.

The four broker-dealers are Financial Network Investment Corporation, Inc. of El Segundo, CA., which was fined over \$3.4 million; ING Financial Partners Inc. of Des Moines, IA., which was fined nearly \$1.3 million; Multi-Financial Securities Corporation, Inc. of Denver, CO., which was fined over \$1.2 million; and Prime Vest Financial Services, Inc. of St. Cloud, MN., which was fined over \$1 million.

NASD charged that the conduct by the four ING broker-dealers violated its Anti-Reciprocal Rule, which prohibits arrangements in which brokerage commissions are used to compensate firms for selling mutual fund shares. The rule is also designed to ensure that execution of portfolio transactions is guided by the principle of "best execution" and not by other considerations.

"The use of directed brokerage commissions from a mutual fund as an incentive towards the marketing or preferred treatment of those funds is an impermissible

use of customer assets,” said James S. Shorris, NASD Executive Vice President and Head of Enforcement. “NASD will continue to pursue mutual fund sales practices that put the interests of firms ahead of the interests of customers.”

To date, NASD has brought more than 30 enforcement actions for similar violations.

NASD found that from 2001 through 2003, the four broker-dealers, which together constituted the ING Advisors Network, an umbrella business unit affiliated with ING, provided a host of marketing benefits to 10 mutual fund complexes that participated in the shelf-space (or revenue-sharing) program, known as the Strategic Partners Program. These benefits, which were generally not provided to non-Strategic Partners, included yearly sales goals, special placement on the ING firms’ Intranet Web sites, direct links to the Web sites of the participating fund companies, increased exposure to the registered representatives of the ING firms, participation in annual national meetings, waiver of ticket charges for registered representatives on sales of participants’ funds and other marketing opportunities.

In return, mutual funds paid the ING broker-dealers millions of dollars to participate in the Strategic Partner program. Eight of the 10 participating mutual fund complexes paid a portion of their fees by directing approximately \$25.7 million in mutual fund portfolio brokerage commissions to the four broker-dealers, despite the fact that none of the firms played any role in the execution of the trades that generated the commissions. The remaining two fund companies paid their fees in cash.

In settling with NASD, the ING broker-dealers neither admitted nor denied the allegations, but consented to the entry of NASD’s findings.

## **NASD Orders Citigroup To Pay Over \$1.1 Million For Failing To Prevent Brokers’ Submission Of False Information To Mutual Funds**

### **Brokers Improperly Obtained Mutual Fund Sales Load Waivers by Falsely Claiming Customers Were Disabled—Even Hedge Funds**

NASD fined Citigroup Global Markets Inc. \$400,000 for supervisory and recordkeeping violations in connection with a ploy by more than 100 of its brokers to improperly obtain waivers of mutual fund sales charges by falsely claiming that their customers were disabled. The firm was also ordered to pay \$715,000 in restitution to the affected mutual fund entities.

NASD found that the ruse was carried out from June 2001 through June 2002. With respect to possible improper waivers pre-dating June 2001, the firm agreed to contact the distributors of affected mutual funds, notify them that there may have been improper disability waivers and give them an opportunity to make additional restitution claims. To date, NASD has taken disciplinary action against five Citigroup registered representatives relating to this misconduct. NASD investigations into other Citigroup brokers are continuing.

NASD also ordered Citigroup to review its policies, systems, procedures and training relating to Contingent Deferred Sales Charge (CDSC) waivers in mutual fund transactions. For one year, Citigroup must also provide a quarterly certification to NASD that it has reviewed all CDSC disability waivers granted, has verified that they were appropriately granted (or corrected those waivers that were not appropriately granted), and has retained required supporting documentation. The firm was also required to provide appropriate training regarding CDSC waivers to its retail managers and representatives.

“Firms are obligated to be alert for supervisory ‘red flags’ and address systemic weaknesses that could permit widespread abusive behavior,” said NASD Executive Vice President and Head of Enforcement James S. Shorris. “In this case, because Citigroup effectively failed to address a known problem, its representatives were able to improperly exploit the mutual funds’ fee waiver provisions that were specifically reserved for disabled individuals—extending

them even to hedge funds. This widespread failure contributed to the ability of Citigroup representatives to process over 2,400 improper waivers based on false disability claims.”

A CDSC is the sales charge that mutual fund companies impose on investors who sell/redeem their Class B shares within a certain period after purchase. CDSCs may be waived under certain circumstances as defined by the mutual fund prospectus—typically death, disability or a qualified distribution. In order to obtain a disability-based waiver for a customer, a broker is often required to obtain and/or submit certain documentation evidencing the customer’s eligibility for a CDSC waiver as defined by the IRS or the particular fund’s prospectus. The eligibility for a CDSC waiver is further narrowed by the timing of the disability; the waivers are generally available only when the customer becomes disabled after the mutual fund purchase. Further, in most cases, the disability-based waiver can be taken only within one year of the date the customer becomes disabled.

NASD found that, from June 1, 2001 through June 30, 2002, Citigroup representatives improperly entered disability waivers for hundreds of customers in connection with 2,419 mutual fund transactions totaling \$47 million. Those registered representatives, in most cases, misrepresented on Citigroup’s electronic order entry system that their customers were entitled to CDSC waivers because they were disabled. In several instances, Citigroup registered representatives even entered CDSC waivers for hedge funds, thereby claiming that those entities were “disabled” individuals as defined by the Internal Revenue Service or in the applicable prospectus.

NASD also found that Citigroup failed to maintain, update and enforce reasonable internal policies, systems and procedures in a number of respects, including:

- The firm’s electronic order entry system provided an unsupervised method for its representatives to obtain CDSC waivers for customers. Citigroup failed to develop any exception reports, or otherwise provide for reasonable steps to ensure registered representatives’ compliance with the applicable prospectus terms.
- While Citigroup issued a Compliance Memo in 1999 to its managers and directors

advising that CDSC waivers could not be granted “except in circumstances specified in the fund prospectus,” the firm failed to implement policies or procedures reasonably designed to ensure compliance with this directive.

- In those instances where a fund prospectus and/or dealer agreement specifically required the representative to obtain and/or submit certain documentation to support the CDSC waiver claim or, at minimum, to determine that the customer had become disabled, Citigroup had no system or procedures designed to ensure compliance with these documentation requirements and in fact failed to ensure that its registered representatives had obtained and/or submitted this information or otherwise complied with such requirements.

In addition, Citigroup failed to act on “red flags” and provide for effective follow-up and review, or otherwise monitor mutual fund transactions, to ensure that CDSC waivers were granted in accordance with the terms of the applicable mutual fund prospectus:

- Following disciplinary actions filed in 1997 against two of the firm’s registered representatives for obtaining CDSC waivers for their customers under false pretenses, the firm failed to implement any new procedures reasonably designed to prevent recurrence of such misconduct, and otherwise failed to conduct a meaningful follow-up and review in subsequent years to determine whether it had successfully addressed the problems noted in the cases.
- In several instances, Citigroup registered representatives entered CDSC waivers for multi-million dollar mutual fund transactions by hedge funds, making the inexplicable claim that those entities were “disabled individuals” as defined by the IRS or in the applicable prospectus. Even when four of the transactions, totaling approximately \$21 million, were blocked by the mutual fund companies, Citigroup failed to scrutinize those transactions.

- Over a 13-month period, CDSC waivers based on an improper and/or unsupported claim of customer disability were entered in 2,419 transactions totaling approximately \$47 million, an extraordinarily high number for approximately 100 brokers. Yet Citigroup failed to scrutinize those transactions or make inquiry of the brokers entering those transactions. For example, one representative entered disability-based CDSC waivers for over 80% of his customer base. Most of those customers were not disabled, and, in many cases, they subsequently used the proceeds to make new investments.

NASD also found that the improper CDSC waivers entered by Citigroup's registered representatives caused the firm's books and records to contain false information regarding the disability status of customers and their entitlement to such waivers.

In concluding this settlement, Citigroup neither admitted nor denied the charges, but consented to the entry of NASD's findings.

To date, NASD has filed disciplinary actions against five Citigroup registered representatives for seeking CDSC waivers based on false claims that their customers were disabled. On Nov. 2, 2005, NASD barred former Citigroup broker Patricia Kwan from association with any member firm. Kwan consented to the bar without admitting or denying NASD's findings. On Feb. 14, 2006, NASD's Department of Enforcement filed a complaint against two current and two former Citigroup brokers—Timothy Behany, Edward M. VanGrouw, Carl Martin Trevisan and David Joseph Cottam. The complaint is currently being litigated.

Under NASD rules, a firm or individual named in a complaint can file a response and request a hearing before an NASD disciplinary panel. Possible remedies include a fine, censure, suspension or bar from the securities industry, and disgorgement of gains associated with the violations.

The issuance of a disciplinary complaint represents the initiation of a formal proceeding by NASD in which findings as to the allegations in the complaint have not been made and does not represent a decision as to any of the allegations contained in the complaint. Because this complaint is unadjudicated, interested persons may wish to contact the respondent before drawing any conclusions regarding the allegations in the complaint.

### **Prudential Securities, Inc. Ordered to Pay Regulators \$600 Million to Resolve Fraud, Other Charges Relating to Improper Market Timing**

#### **NASD Investigation Uncovers More Than \$116 Billion in Mutual Fund Transactions Conducted Through 1,600 Customer Accounts in Market Timing Scheme; Firm Also Had Deficient Procedures Relating to Prevention of Late Trading**

NASD, federal and state securities regulators and the Department of Justice announced parallel settlements and a total of \$600 million in monetary sanctions against Prudential Securities, Inc. (PSI)—now known as Prudential Equity Group—for misconduct relating to improper market timing. NASD's settlement with PSI resolves charges of fraudulent activities and supervisory deficiencies relating to mutual fund market timing and for recordkeeping violations.

PSI also entered into separate settlements with the Department of Justice, the Securities and Exchange Commission (SEC), the New York Attorney General's Office, New York Stock Exchange Regulation, the New Jersey Bureau of Securities and the Massachusetts Securities Division to resolve charges relating to this misconduct.

PSI has been ordered to pay \$270 million into a distribution fund administered by the SEC, which will be used to compensate the affected mutual funds and shareholders for losses sustained as a result of the improper market timing activity. The Department of Justice imposed an additional fine of \$325 million, and the Massachusetts Securities Division imposed a separate \$5 million civil penalty.

In its investigation, NASD found that from at least January 1, 2001, to July 1, 2003, certain of PSI's registered representatives engaged in deceptive activities in order to make improper market timing transactions in mutual funds on behalf of their clients. As a result, at least 1,600 customer accounts were collectively able to purchase and sell mutual fund shares worth more than \$116 billion, earning those clients more than \$162 million in net profits. Those market timing transactions also earned PSI nearly \$50 million in gross commissions.

"The scale of the fraudulent market timing activity that was allowed to occur through this firm and that went unchecked by the firm's supervisory systems is unprecedented," said NASD Senior Executive Vice President Stephen Luparello. "The firm was aware that this activity was occurring and yet failed to take action to halt the conduct—except in its own proprietary mutual funds."

NASD found that the PSI brokers defrauded mutual funds and their shareholders by misrepresenting their own identities and the identities of their brokerage clients to engage in market timing after the mutual funds had placed blocks attempting to prohibit such trading. The brokers used multiple customer account numbers and representative numbers (also referred to as "FA numbers" at the firm) to evade the trading restrictions (blocks) that certain mutual funds imposed on market timing transactions. For example, following the imposition of a block, the brokers placed the market timing trades in another account or, if an FA number had been restricted, the brokers placed trades using another FA number. PSI failed to prevent this activity.

NASD found that PSI received in excess of 1,000 letters and emails from more than 50 different mutual fund companies relating to the market timing activities of just five brokers in its Boston branch office. In numerous cases, PSI did not prevent subsequent trading that circumvented these blocks. In January 2003, based on the number of block letters it had received, PSI announced a market timing policy, two years after it had already stopped market timing in its proprietary mutual funds. The policy required PSI's brokers to adhere to the restrictions on the frequency of trading set forth in each mutual fund's disclosure documents. PSI, however, did not enforce that policy and the improper market timing continued.

In addition, NASD found that even though the firm had been aware since at least 1998 that several of its offices had brokers that primarily engaged in market timing transactions, PSI failed to have an adequate supervisory system and written supervisory procedures relating to market timing activities, mutual fund exchanges and detecting and preventing any late trading of mutual fund shares.

Late trading is the unlawful practice of placing mutual fund orders after the fund has calculated its daily net asset value (NAV)—typically at 4 p.m. EST—but receiving the price based upon that earlier, 4 p.m. calculation. Firms accepting mutual fund orders after the 4 p.m. NAV calculation are supposed to execute them at the following day's NAV. Firms executing mutual fund orders must establish and maintain supervisory systems and procedures reasonably designed to detect and prevent the occurrence of late trading.

NASD found that PSI, like other firms, processed mutual fund orders after the market close. PSI, however, lacked a reasonably designed supervisory system to ensure that only orders submitted by the customers before the market close received that day's NAV. Moreover, the volume of market timing business in the Boston branch office created significant risk of late trading. Nevertheless, certain PSI brokers routinely failed to document the time the customer order was received. Therefore, PSI would not have been able to detect and prevent any unlawful late trading in mutual fund shares.

Finally, NASD found that PSI failed to maintain accurate books and records relating to mutual fund transactions.

In concluding this settlement, PSI neither admitted nor denied NASD's charges, but consented to the entry of NASD's findings.

## **NASD Hearing Panel Fines American Funds Distributors \$5 Million for Directed Brokerage Violations**

An NASD Hearing Panel ruled that American Funds Distributors, Inc. (AFD) violated NASD's Anti-Reciprocal Rule by directing brokerage commissions to securities firms that were the top sellers of American Funds mutual funds from 2001 through 2003. The panel censured AFD and imposed a \$5 million fine. The ruling resolves charges brought by NASD's Department of Enforcement in February 2005.

AFD is the principal underwriter and distributor of American Funds, the second largest mutual fund family in the United States. The directed brokerage commissions—amounting to more than \$98 million during the relevant period—were paid by AFD's parent company, Capital Research and Management Company (CRMC), which is also the investment advisor to American Funds.

According to the panel's decision, the "evidence in this case shows ... that AFD requested and arranged for CRMC to direct brokerage to its 50 leading retail firms" and that those recommendations were "conditioned upon their past sales of American Funds—indeed, that they were among the top 50 in the prior year's sales—and ... the target amount AFD recommended was conditioned upon the specific amount of sales attained by the retailer."

The panel noted that the Anti-Reciprocal Rule was intended to abolish "reciprocal business practices in connection with the distribution of mutual fund shares, *i.e.*, the use of portfolio brokerage of mutual funds to reward broker-dealers for sales of mutual fund shares." Describing AFD's use of brokerage commissions to reward top-selling firms, the panel said, "This sort of reciprocal use of mutual fund brokerage is precisely what the rule was intended to proscribe ... A clearer use of directed brokerage to further reciprocal arrangements, contrary to the purpose of (the Anti-Reciprocal Rule), is difficult to imagine."

But the panel rejected NASD Enforcement's arguments that AFD engaged in a pattern of misconduct over a period of years that was intentional or at least reckless. It noted that AFD's use of directed brokerage was consistent with practices that had arisen in the mutual fund industry over a number of years, that regulators did not express concern about those practices until 2001, and that, unlike its competitors, AFD acted voluntarily to change those practices when regulators began expressing those concerns.

"Under these circumstances, the Panel found that AFD's violations while serious, were not egregious."

The panel rejected NASD Enforcement's call for sanctions in the amount of the total directed brokerage payments, noting that the trades were placed and the commissions were actually paid by CRMC—which is not subject to NASD regulation. Emphasizing that the sanctions can only address AFD's misconduct; the panel imposed what it termed "a very substantial fine" of \$5 million.

Unless the matter is appealed to NASD's National Adjudicatory Council (NAC), or is called for review by the NAC, the hearing panel's decision becomes final after 45 days.