

NASD NOTICE TO MEMBERS 97-46

SEC Approves Rule Prohibiting Payments For Market Making

Suggested Routing

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Executive Summary

On July 3, 1997, in Release No. 34-38812 (SEC Release), the Securities and Exchange Commission (SEC) approved new NASD[®] Rule 2460 (Rule), which explicitly prohibits any payment by issuers or the issuers' affiliates and promoters, directly or indirectly, to a member for publishing a quotation, acting as a market maker, or submitting an application in connection therewith. The Rule is intended, among other things, to assure that members act in an independent capacity when publishing a quotation or making a market in an issuer's securities. **The new Rule is effective immediately.** The text of the new Rule and *Federal Register* version of the SEC Release are attached.

Questions concerning this *Notice* should be directed to David A. Spotts, Office of General Counsel, NASD Regulation, Inc. (NASD RegulationSM) at (202) 728-8014.

Background

NASD Regulation originally proposed this new Rule and requested comment from members and the public in *Notice to Members 96-83* in December, 1996. As stated in the earlier *Notice*, it has been a long-standing policy and position of the NASD that a broker/dealer is prohibited from receiving compensation or other payments from an issuer for quoting or making a market in an issuer's securities or for covering the member's out-of-pocket expenses for making a market, or for submitting an application to make a market in an issuer's securities.¹ As stated in *Notice to Members 75-16* (February, 1975), such payments may be viewed as a conflict of interest since they may influence the member's decision as to whether to quote or make a market in a security and, thereafter, the prices that the member would quote.

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

The new Rule establishes a fair practice standard to a particular course of conduct of a member and members should be mindful that certain actions of a member in charging an issuer a fee for making a market, or accepting an unsolicited payment from an issuer where the member makes a market in the issuer's securities, could also subject the member to violations of the anti-fraud provisions of federal securities laws and NASD Rule 2120. Further, the payment by an issuer to a market maker to facilitate market making activities could also involve the member in potential violations of the registration requirements of Section 5 of the Securities Act of 1933.

For a complete description of the new Rule, members should review in detail the attached *Federal Register* version of the SEC Release.²

Text Of New Rule

(Note: All rule language is new.)

2460. Payments for Market Making

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

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

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

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

imposed by a self-regulatory organization.

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

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

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

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

Endnotes

¹See *Notices to Members 75-16* (February, 1975) and *92-50* (October, 1992).

²The new Rule as originally proposed for public comment included a third exception, which was intended to encourage members to conduct an initial SEC Rule 15c2-11 review of the issuer and the security by permitting reimbursement of the member's reasonable out-of-pocket expenses related to this review. The third exception was eliminated from the rule proposal due to concerns that such payments could violate Section 17(b) of the Securities Act of 1933 and could be used inappropriately to avoid the limitations of the Rule.

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