SPECIAL NASD NOTICE TO MEMBERS 96-32

Members Reminded To Use Best Practices When Dealing In Speculative Securities

Suggested Routing

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

Executive Summary

In recent months, NASD Regulation, Inc., has observed instances of sharp price changes and increases in trading activity in stocks of low-priced companies. In response, NASD Regulation is issuing this *Special Notice to Members* to emphasize to its members their obligations to customers, particularly when dealing in speculative securities.

Questions or comments concerning this Notice may be directed to Daniel M. Sibears, Director, Regulation, at (202) 728-6911.

Discussion

NASD Regulation has undertaken a sales practice initiative in response to concerns related to trading in low-priced, speculative securities, including review for market manipulation, misrepresentations, high pressure sales tactics and fraudulent markups. Members are urged strongly to consider the following subjects that will be aggressively reviewed by NASD Regulation examination and enforcement staffs.

Suitability

Members are cautioned to take special care with respect to their suitability analyses where the securities involved are low-priced or speculative in nature. The NASD's suitability requirement under Article III, Section 2 of the Rules of Fair Practice is fundamental to fair dealings and is intended to promote ethical sales practices and high standards of professional conduct. Members' responsibilities include having a reasonable basis for recommending a particular security or strategy. In addition, the know-your-customer requirement embedded in Article III, Section 1 of the Rules of Fair Practice requires a careful review of the appropriateness of transactions in low-priced, speculative securities, whether solicited or unsolicited.

Disclosure Of Material Adverse Facts And Interests To Customers

When a registered representative recommends the purchase or sale of a stock to a customer, he or she must not only avoid affirmative misstatements, but must also disclose material adverse facts about which the salesperson is, or should be, aware. Particular care should be taken with respect to the accuracy and completeness of information concerning low-priced, speculative securities. In this connection, members should focus on the completeness of disclosure concerning securities issued by companies whose ability to operate as a going concern is subject to question or contingent on gaining additional financing. This includes disclosure of any conflicts of interest that could influence the salesperson's recommendation or the customer's decision to purchase or sell the security.

Valuations

Firms should also be very careful with respect to the value given to speculative, low-priced securities, not only with regard to proprietary inventory positions, but also to valuation as collateral underlying customer balances. Substantial additional margin must be required where the securities carried are subject to unusually rapid or violent changes in value.

Supervision

Supervision is the cornerstone of securities industry self-regulation and depends on members establishing and implementing supervisory procedures and systems designed to achieve compliance with the NASD Rules of Fair Practice and federal securities laws. Consequently, it is especially important that members consider the adequacy, reasonableness, and scope of their supervisory procedures in light of the recent volatility of some low-priced securities. When reviewing existing procedures, and determining the need for new or enhanced supervisory initiatives, members are reminded that they have final responsibility for ensuring that they comply fully with the requirements of Article III, Section 27 by establishing and maintaining a system to adequately supervise the activities of each registered representative and associated person. We note that Article III, Section 27 may be violated by a firm, an individual, or both, without the occurrence of separate underlying violations.

Heightened Supervisory Responsibility

Members assume a higher level of supervisory responsibility when they hire a representative with a significant regulatory history. Routine supervision is not sufficient when a member hires a representative who, for example, has a pattern of serious customer complaints or a disciplinary history, or for an existing representative who becomes the subject of such problems. In these instances, members must develop and impose special supervisory practices designed to address the particular areas of concern presented by the individual representative.

Cold Call Requirements

Members must supervise the cold calling activities of their sales force and ensure that all applicable telemarketing rules are complied with fully. This includes compliance with Article III, Section 21(g) of the Rules of Fair Practice, which requires each member to make and maintain a centralized "do not call" list of persons who do not wish to receive telephone solicitations from members or members' associated persons.

Members must be the effective first line of defense in our shared investor protection mission by ensuring that the rules, regulations, and best practices addressed in this Notice are actively and effectively implemented.