

NASD NOTICE TO MEMBERS 96-66

SEC Expands Scope Of Conduct Rules And Other NASD Rules To Government Securities; Approves New Suitability Interpretation

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

The Government Securities Act Amendments of 1993 (GSAA)¹ eliminated the statutory limitations on NASD[®] authority to apply sales-practice rules to transactions in exempted securities, including government securities, other than municipals.² On August 20, 1996, the Securities and Exchange Commission (SEC) approved amendments implementing the expanded sales-practice authority granted to the NASD pursuant to the GSAA.

General Provisions Rule 0114 is retitled "Effect on Transactions in Municipal Securities" and amended to apply the NASD Conduct Rules and other Rules to transactions in exempted securities, including government securities, other than municipals. Rule 0115 "Applicability" is amended to apply the NASD Conduct Rules and other Rules to members registered with the SEC solely under the provisions of Section 15(C) of the Securities Exchange Act of 1934 (Act), and to persons associated with such members.

The application of the Conduct Rules to government securities transactions is provided in Table 1 of this Notice. Amendments to the text of certain Conduct Rules are amended to further clarify their application to exempted securities, including government securities, other than municipals. As indicated in Table 1, certain Conduct Rules will not immediately apply to transactions in government securities. These are IM-2110-2 "Trading Ahead of Customer Limit Order"; IM-2110-3 "Front-Running Policy"; IM-2110-4 "Trading Ahead of Research Reports"; Rule 2440 "Fair Prices and Commissions"; IM-2440 "Mark-Up Policy"; and Rule 2760 "Offerings At the Market." The NASD intends to review the specific application of these rules to the government securities market. In the

interim, NASD members are reminded that actions for conduct generally encompassed by these Rules occurring in the government securities market may be brought under Rule 2110 "Standards of Commercial Honor and Principles of Trade."

Rule 1060 "Persons Exempt from Registration" is amended to eliminate the registration exemption for persons associated with a member whose functions are related solely and exclusively to transactions in exempted securities. Rule 1060, however, continues to exempt persons associated with a member whose functions are related solely and exclusively to transactions in municipal securities.

As indicated in Table 2, the NASD's Government Securities Rules are merged, where applicable, into the NASD's Conduct Rules and other Rules. Conforming amendments also are made throughout the *NASD Manual* to delete references to the Government Securities Rules and to replace the term *exempted securities* with the term *municipal securities*.

The SEC also approved the NASD Board of Governors interpretation regarding Suitability Obligations to Institutional Customers. The interpretation further clarifies how the NASD's Suitability Rule 2310 "Recommendations to Customers" is applicable to institutional customers. The new interpretation applies to all debt and equity securities, except municipals. Changes regarding Rule

¹ Government Securities Act Amendments of 1993, Pub. L. No. 103-202, § 1(a), 107 Stat. 2344 (1993).

² The terms *exempted securities*, *government securities*, and *municipal securities* are defined in Sections 3(a)12, 3(a)42, and 3(a)29 of the Act, respectfully. Rules for municipal securities are promulgative by the Municipal Securities Rulemaking Board.

2340 “Customer Account Statements,” Rule 3010 “Supervision,” Rule 3020 “Fidelity Bonds,” and Rule 3110 “Books & Records” will be effective on November 18, 1996. All other changes were effective on August 20, 1996.

Please refer to your NASD Manual Conversion chart for references to the old Rule language if necessary.

Questions regarding this Notice may be directed to any of the following NASD RegulationSM staff: Robert M. Broughton, Compliance, at (202) 728-8361, Samuel Luque, Jr., Associate Director, Compliance, at (202) 728-8472, and Thomas R. Cassella, Vice President, Compliance, at (202) 728-8237.

Description Of Amendments

General Provisions

The GSAA eliminated the statutory limitations on the NASD’s authority to apply sales-practice rules to transactions in exempted securities, including government securities. To implement the expanded statutory authority granted to the NASD, Rule 0114 has been retitled and amended to apply NASD Conduct Rules and other Rules to transactions in exempted securities, including government securities. Rule 0115 “Applicability” is amended to apply the NASD Conduct Rules and other Rules to members registered with the SEC solely under the provisions of Section 15(C) of the Act and persons associated with such members. Rule 0115, however, continues to exempt persons associated with a member whose functions are related solely and exclusively to transactions in municipal securities.

Registration Rules Of Associated Persons

Rule 1060 “Persons Exempt from

Registration” is amended to eliminate the registration exemption for persons associated with a member whose functions are related solely and exclusively to transactions in exempted securities. This amendment, therefore, applies the NASD registration requirements of persons associated with a member, to the personnel of sole-government securities broker/dealers, including persons selling options on government securities. Rule 1060, however, continues to exempt persons associated with a member whose functions are related solely and exclusively to transactions in municipal securities.

Conduct Rules

Paragraph (b) of Rule 2310 requires a member to make reasonable efforts to obtain certain information before the execution of a transaction recommended to a non-institutional customer. A new paragraph (c) is added to Rule 2310 to clarify that for purposes of paragraph (b) of Rule 2310, the definition of a *non-institutional customer* shall mean a customer that does not qualify as an “institutional account” under Rule 3110(c)(4). This clarification is made to distinguish the definition of *institutional account* that is referenced in Rule 2310(b) from the definition of *institutional customer* contained in the new Suitability Interpretation IM-2310-3 in the Conduct Rules.

The interpretation on “Free-Riding and Withholding” (IM-2110-1) is amended **not** to apply to government securities. Rule 3370 “Prompt Receipt and Delivery of Securities” also is amended by expanding the exemptions for corporate debt securities to all debt securities. All members, therefore, in connection with debt security transactions, will not be subject to the affirmative requirements of Rule 3370 before accepting a long-sale order from any customer; accepting a short-sale order for any

customer; or effecting a short sale for its own account in any security.

Rule 2320 “Best Execution and Interpositioning” is applicable to transactions in exempted securities, including government securities, other than municipals. The NASD believes members should seek in executing customer transactions in government securities to obtain the best available price for each customer. The NASD’s position regarding the applicability of Rule 2320 to government securities is consistent with its position that the concepts of the interpretation apply to all OTC markets that the NASD regulates, including direct participation programs. The NASD will further consider whether an amendment to the Best Execution Rule is necessary to clarify this position as it applies to government securities.

Rule 3110(b) “Marking of Customer Order Tickets” exempted only corporate debt from the marking of the customer order ticket requirement. As amended, all debt securities are exempt from the marking of the customer order ticket requirement. A person associated with a member, therefore, need not indicate on the memorandum for sale of a security whether the order is “long” or “short” if the transaction involves a debt security.

Rules Temporarily Excepted

IM-2110-3 “Front Running Policy” currently applies, by its terms, only to equity securities. In addition, IM-2110-2 “Trading Ahead of Customer Limit Order” and IM-2110-4 “Trading Ahead of Research Reports” are currently drafted to apply only to equity securities. Rule 2760 “Offerings At the Market” also is not applicable to the government securities markets. The NASD believes, however, that the member conduct prohibited by these rules may occur

under certain circumstances in the government securities market, and will review the application of these provisions to the government securities market to determine if specific rulemaking or interpretation is necessary. In the interim, NASD Regulation reminds members that actions for similar conduct occurring in the government securities market is covered under Rule 2110 “Standards of Commercial Honor and Principles of Trade.”

NASD Regulation is considering an interpretation of IM-2440 “Mark-Up Policy” for exempted securities and other debt securities. The current application of Rule 2440 “Fair Prices

and Commissions” and the Mark-Up Policy will not apply to transactions in exempted securities until adoption of an interpretation of the NASD Mark-Up Policy. NASD Regulation, however, reminds members that conduct in the government securities market is covered under Rule 2110 “Standards of Commercial Honor and Principles of Trade.”

Paragraph (b) of Rule 2220 “Options Communications with the Public” requires a Compliance Registered Options Principal to approve in advance all advertisements, sales literature (except completed worksheets), and educational material issued by a member or member orga-

nization pertaining to options. NASD Regulation, however, is considering whether the registration of such a Principle should be required under Rule IM-1022-1 “Registered Options Principals” for government securities options. In the interim, the requirements of Rule 2220(b) will not apply to options advertisements, sales materials, and other educational material pertaining to government securities options.

Table 1 below, identifies the applicability of the Conduct Rules to exempted securities, including government securities, other than municipals.

Table 1

CONDUCT RULES

2000. BUSINESS CONDUCT

2100. GENERAL STANDARDS

2110. Standards of Commercial Honor and Principles of Trade - Applicable

IM-2110-1. - “Free-Riding and Withholding” - Amended to Not Apply

IM-2110-2. - Trading Ahead of Customer Limit Order - Not Applicable*

IM-2110-3. - Front Running Policy - Not Applicable*

IM-2110-4. - Trading Ahead of Research Reports - Not Applicable*

2120. Use of Manipulative, Deceptive, or Other Fraudulent Devices - Applicable

2200. COMMUNICATIONS WITH CUSTOMERS AND THE PUBLIC

2210. Communications with the Public - Applicable

IM-2210-1. - Communications with the Public About Collateralized Mortgage Obligations (CMOs) - Applicable

IM-2210-2. - Communications with the Public About Variable Life Insurance and Variable Annuities - Applicable

IM-2210-3. - Use of Rankings in Investment Companies Advertisements and Sales Literature - Applicable

2220. Options Communications with the Public - Not Applicable, Under Review

2230. Confirmations - Not Applicable, Superseded by SEC Rules

IM-2230. - “Third Market” Confirmations - Not Applicable

2240. Disclosure of Control Relationship with Issuer - Not Applicable

2250. Disclosure of Participation or Interest in Primary or Secondary Distribution - Applicable

2260. Forwarding of Proxy and Other Materials - Not Applicable

IM-2260. - Suggested Rates of Reimbursement - Not Applicable

2270. Disclosure of Financial Condition to Customers - Applicable

- 2300. TRANSACTIONS WITH CUSTOMERS - Applicable
 - 2310. Recommendations to Customers (Suitability) - Applicable
 - IM-2310-1. - Possible Application of SEC Rule 15c2-6 - Not Applicable (applies only to equity securities)
 - IM-2310-2. - Fair Dealing with Customers - Applicable
 - IM-2310-3. - Suitability Obligations to Institutional Customers - Applicable
 - 2320. Best Execution and Interpositioning - Applicable
 - 2330. Customers' Securities or Funds - Applicable
 - IM-2330. - Segregation of Customers' Securities - Applicable
 - 2340. Customer Account Statements - Applicable
- 2400. COMMISSIONS, MARK-UPS AND CHARGES
 - 2410. Net Prices to Persons Not in Investment Banking or Securities Business - Not Applicable
 - 2420. Dealing with Non-Members - Amended to Not Apply
 - IM-2420-1. - Transactions Between Members and Non-Members - Not Applicable
 - IM-2420-2. - Continuing Commissions Policy - Not Applicable - Not Addressed by Board
 - 2430. Charges for Services Performed - Applicable
 - 2440. Fair Prices and Commissions - Not Applicable**
 - IM-2440. - Mark-Up Policy - Not Applicable**
 - 2450. Installment or Partial Sales - Applicable
- 2500. SPECIAL ACCOUNTS
 - 2510. Discretionary Accounts - Applicable
 - 2520. Margin Accounts - Applicable
 - IM-2520. - Computation of Elapsed Days - Applicable
- 2700. SECURITIES DISTRIBUTIONS
 - 2710. Corporate Financing Rule—Underwriting Terms and Arrangements - Not Applicable
 - 2720. Distribution of Securities of Members and Affiliates—Conflicts of Interest - Not Applicable
 - 2730. Securities Taken in Trade - Not Applicable
 - IM-2730. - Safe Harbor and Presumption of Compliance - Not Applicable
 - 2740. Selling Concessions, Discounts and Other Allowances - Not Applicable
 - IM-2740. - Services in Distribution - Not Applicable
 - 2750. Transactions with Related Persons - Not Applicable
 - IM-2750. - Transactions with Related Persons - Not Applicable
 - 2760. Offerings “At the Market” - Not Applicable*
 - 2770. Disclosure of Price in Selling Agreements - Applicable only to Traditional Underwriter Arrangements
 - 2780. Solicitation of Purchases on an Exchange to Facilitate a Distribution of Securities - Applicable
- 2800. SPECIAL PRODUCTS
 - 2810. Direct Participation Programs - Not Applicable
 - 2820. Variable Contracts of an Insurance Company - Not Applicable
 - 2830. Investment Company Securities - Not Applicable
 - IM-2830-1. - “Breakpoint” Sales - Was under Investment Company Securities §5266 - Not Applicable
 - IM-2830-2. - Maintaining the Public Offering Price - Not Applicable

2840. Trading in Index Warrants, Currency Index Warrants, and Currency Warrants - Not Applicable	
2860. Options - Not Applicable	
IM-2860-1. - Position Limits - Not Applicable	
IM-2860-2. - Diligence in Opening Options Accounts - Not Applicable	
2870. Nasdaq Index Options - Not Applicable	
2871. Definitions - Not Applicable	
2872. Nasdaq Index Options Services Available - Not Applicable	
2873. Registration, Qualification and Other General Requirements Applicable to All Nasdaq Index Options Market Makers - Not Applicable	
2874. Character of Index Options Quotations Entered into the Nasdaq Index Options Service by all Nasdaq Index Options Market Makers - Not Applicable	
2875. Commitment Rules Applicable to Options Market Makers in Nasdaq Index Options - Not Applicable	
2876. Sanctions Applicable to Nasdaq Index Options Market Makers - Not Applicable	
2877. Requirements Applicable to Nasdaq Index Options Order Entry Firms - Not Applicable	
2878. Transaction Reporting and Other Reporting Requirements - Not Applicable	
2879. Authorization of Nasdaq Index Option Market Making - Not Applicable	
2880. Nasdaq Index Option Contracts Authorized for Trading - Not Applicable	
2881. Series of Nasdaq Index Options for Trading - Not Applicable	
2882. Unit of Trading - Not Applicable	
2883. Suspension of Authorization of Nasdaq Index Option Contracts - Not Applicable	
2884. Trade Comparison Procedures for Nasdaq Index Options - Not Applicable	
2885. Clearance and Settlement Procedures for Nasdaq Index Options - Not Applicable	
2900. RESPONSIBILITIES TO OTHER BROKERS OR DEALERS	
2910. Disclosure of Financial Condition to Other Members - Applicable	
3000. RESPONSIBILITIES RELATING TO ASSOCIATED PERSONS, EMPLOYEES, AND OTHERS' EMPLOYEES	
3010. Supervision - Applicable	
3020. Fidelity Bonds - Applicable	
3030. Outside Business Activities of an Associated Person - Applicable	
3040. Private Securities Transactions of an Associated Person - Applicable	
3050. Transactions for or by Associated Persons - Applicable	
3060. Influencing or Rewarding Employees of Others - Applicable	
3070. Reporting Requirements - Applicable	
3100. BOOKS AND RECORDS, AND FINANCIAL CONDITION	
3110. Books and Records - Applicable	
IM-3110. - Customer Account Information - Applicable	
3120. Use of Information Obtained in Fiduciary Capacity - Applicable	
3130. Regulation of Activities of Members Experiencing Financial and/or Operational Difficulties - Applicable	
IM-3130. - Restrictions on a Member's Activity - Applicable	
3131. Regulation of Activities of Section 15(C) Members Experiencing Financial and/or Operational Difficulties - Applicable	

3140. Approval of Change in Exempt Status Under SEC Rule 15c3-3 - Applicable

3200. SETTLEMENTS

3210. Securities “Failed to Receive” and “Failed to Deliver” - Not Applicable

3220. Adjustment of Open Orders - Not Applicable

3230. Clearing Agreements - Applicable

3300. TRADING

3310. Publication of Transactions and Quotations - Applicable

IM-3310. - Manipulative and Deceptive Quotations - Applicable

3320. Offers at Stated Prices - Applicable

IM-3320. - Firmness of Quotations - Applicable

3330. Payment Designed to Influence Market Prices, Other than Paid Advertising -Applicable

3340. Prohibition on Transactions During Trading Halts - Not Applicable

3350. Short Sale Rule - Not Applicable

IM-3350. - Short Sale Rule - Not Applicable

3360. Short Interest Reporting - Not Applicable

3370. Prompt Receipt and Delivery of Securities - Not Applicable

* The NASD is reviewing the application of this interpretation to the government securities market.

Currently, the NASD Front Running Interpretation applies only to equity securities. The NASD believes, however, that the member conduct prohibited by the Front Running Interpretation may occur under certain circumstances in the government securities market. In the interim, the NASD believes that actions for similar front running conduct occurring in the government securities market is covered under Rule 2110.

Trading ahead of customer limit orders and trading ahead of research reports, also are currently drafted to apply only to equity securities. The NASD believes the conduct addressed by these interpretations also may occur under certain circumstances in the government securities market and intends to review the application of these interpretations to the government securities market. The NASD also believes that actions for similar conduct occurring in the government securities market is covered under Rule 2110.

** The NASD is developing an Interpretation of IM-2440 “Mark-Up Policy” for exempted securities and other debt securities. The current application of Rule 2440 “Fair Prices and Commissions” and the NASD Mark-Up Policy will not apply to transactions in exempted securities until adoption of an Interpretation of the NASD Mark-Up Policy. The NASD clarified, however, that conduct violating the Mark-Up Policy is covered under Rule 2110.

Amendments Merging Government Securities Rules Into Conduct Rules

Provisions of the Government Securities Rules are added to Rules 3110(c)(3), 3130, 3140, 8110, 8120, 8130, 8140, and 8310 of the Conduct Rules. Section 6 of the Government Securities Rules is new Rule 3131. References are also added, where applicable, to certain Conduct Rules regarding Section 402.2(c) of the Treasury Department. To effect the amendments, a number of the provisions contained in the above-referenced Rules are reorganized and renumbered.

Table 2 indicates the Conduct Rule and any related rule to which each Government Securities Rule has been merged. Table 2 also indicates the paragraph of the Conduct Rule or related rule to which any provision of a Government Securities Rule has been added.

Table 2**Government Securities Rules**

<i><u>Government Securities Rules</u></i>	<i><u>New Codified Citation</u></i>
Sec. 1 Adoption of Rules	Rule 0111 – No change
Sec. 2 Applicability Subsection (a) Subsection (b)	Rule 0114 and 0115(a) Rule 0115 (b) and (c) – No change
Sec. 3 Definitions in By-Laws and Rules of Fair Practice	Rule 0120 and 0121 – No change
Sec. 4 Books and Records	Rule 3110
Sec. 5 Supervision	Rule 3010 – No change
Sec. 6 Regulation and Activities of Members Experiencing Financial and/or Operational Difficulties	Rule 3131
Explanation of Board of Governors— Restrictions on a Member's Activities	IM-3130(d)
Sec. 7 Approval of Change in Exempt Status under SEC Rule 15c3-3	Rule 3140
Sec. 8 Communications with the Public	Rule 2210 – No change.
Sec. 9 Availability to Customer of Certificate, By-Laws, Rules, and Code of Procedure	Rule 8110 – No change.
Sec. 10 Complaints:	
Subsection (a) Complaints by Public Against Members	Rule 8120
Subsection (b) Complaints by District Business Conduct Committees	Rule 8130
Subsection (c) Complaints by the Board of Governors	Rule 8140
Sec. 11 Reports and Inspection of Books for Purpose of Investigating Complaints	Rule 8210 – No change.
Resolution of Board of Governors—Suspension of Members for Failure to Furnish Information Duly Requested	Rule 8220 – No change.
Sec. 12 Sanctions for Violation of the Rules	Rule 8310
Sec. 13 Payment of Fines or Costs	Rule 8320 – No change
Sec. 14 Costs of Proceedings	Rule 8330 – No change

IM- 2310-3 “Suitability Obligations To Institutional Customers”³

Rule 2310 “Recommendations to Customers” has set forth NASD’s requirements relative to members’ suitability obligations when making recommendations since the inception of the NASD. Rule 2310(a) “Suitability Rule” requires that in recommending to a customer the purchase, sale, or exchange of any security, a member must have reasonable grounds for believing that the recommendation is suitable for such customer based on the facts, if any, disclosed by such customer as to his or her other security holdings and financial situation and needs. With the enactment of the GSAA, the NASD has decided to provide further guidance to members on their suitability obligations and has proposed guidelines for its members regarding how members may fulfill their “customer specific” suitability obligations when making recommendations to institutional customers.⁴

The new Suitability Interpretation (Interpretation) is predicated on a determination that the two most important considerations in determining the scope of a member’s suitability obligation in making recommendations to an institutional customer are (1) the customer’s capability to evaluate investment risk independently, and (2) the extent to which the customer is exercising independent judgment. The Interpretation further describes factors that may be relevant in a member’s evaluation of these two important considerations. The NASD has emphasized that these factors are guidelines that will determine whether a member has fulfilled its suitability obligations for a specific institutional customer transaction and that the absence or inclusion of any of these factors is not dispositive of the suitability determination.

The NASD’s approach to determining the scope of a member’s suitability obligation in making recommendations to an institutional customer appropriately responds to the varied nature of institutional customers and the varied significance of a member’s recommendation by different institutional customers. In the latter circumstance, a broker/dealer frequently has knowledge about the investment and its risks and costs that are not possessed by or easily available to the investor. Some sophisticated institutional customers, however, may in fact possess both the capability to understand how a particular securities investment could perform, as well as the desire to make their own investment decisions, without reliance on the knowledge or resources of the broker/dealer. However, other investors that meet a definition of *institutional customer* may not possess the requisite capability to understand the particular investment risk, or may not be exercising independent judgment in making a particular investment decision, and so may be largely dependent on the broker/dealer’s analysis and recommendation in evaluating whether to purchase a recommended security.

The Interpretation recognizes the varied nature of institutional investor profiles, even among investors that meet some definition of *institutional investor*. It accommodates a wide range of relationships because it does not establish rigid thresholds or requirements, but rather provides its members with some reasonable factors by which a member can determine the nature of its relationship with a customer. The Interpretation recognizes that there can be instances in which an institutional customer possesses a general capability to understand certain kinds of investments, but does not have the requisite capability to understand the particular investment under consideration.

In such a circumstance, the Interpretation notes that a broker/dealer’s suitability obligation would not be diminished based solely on the financial wherewithal of the customer.

The factors enumerated in the Interpretation, which could be relevant to the two considerations referenced above, provide members with appropriate points to consider in satisfying their suitability obligations. However, members should understand that these considerations are not necessarily the only relevant factors, but merely guidelines to use when determining whether a member has fulfilled its suitability obligations for a specific institutional customer transaction. They neither create nor reduce a member’s suitability obligation and their relevance would vary depending on numerous circumstances. Moreover, these enumerated factors are not meant to create a checklist, which would be inappropriate in these circumstances because it could lead to a mechanical application of the Interpretation without adequate consideration by the broker/dealer of whether the customer understands the transaction or product or whether its customer-specific suitability obligations are being met.

³ The following discussion regarding IM-2310-3 has been generally excerpted from the SEC Discussion of this Interpretation in Release 34-37588 (August 20, 1996); [FR 44160 (August 27, 1996) at 44110.] NASD Regulation has edited and shortened the original language when appropriate for purposes of this Notice.

⁴ The NASD Interpretation will apply to all securities, except for municipals. Municipal Securities Rulemaking Board (MSRB) Rule G-19 governs the suitability obligations for municipal securities. Like Rule 2310(a), MSRB Rule G-19 makes no distinction between institutional and non-institutional customers in requiring that a broker, dealer, or municipal securities dealer must have reasonable grounds for believing that a recommendation is suitable.

In keeping with its purpose to provide guidance and not create or reduce a member's suitability obligations, the NASD intentionally did not create a safe harbor or provide for a rebuttable presumption in the Interpretation. The decision not to create a safe harbor or rebuttable presumption is consistent with the purposes of the Act. A safe harbor or a rebuttable presumption that applied to institutions that were likely to rely on a broker/dealer's guidance regarding a security could lead to serious abuses that are inconsistent with the purposes of the Act. For example, a safe harbor could allow a broker/dealer to recommend a risky security to an institutional investor without consideration of the appropriateness of the investment for the investor, and despite knowing that the customer did not understand the product. Moreover, a safe harbor or a rebuttable presumption assumes that all institutions with similar amounts to invest possess similar or equal financial acumen, which has not proven to be the case.

The NASD, however, has not sought to define such a class. Rather, the Interpretation has taken a flexible approach in defining the term *institutional investor* by **not** including financial criteria in the term; for purposes of the Interpretation, an institutional customer may be any entity other than a natural person. The Interpretation potentially would apply to all institutional investors, though more appropriately to institutional investors with portfolios of at least \$10 million in securities.⁵ The NASD believes that excluding institutional investors from the protections of the suitability rule based on objective financial criteria would arbitrarily discriminate among institutional investors based on factors such as asset size, portfolio size, or institutional type that are not necessarily determinative of financial

sophistication. The NASD choice not to rely on objective criteria that may mask what is really an unsophisticated investor is believed reasonable in the context of a standard that incorporates factors that reflect the nature of the investor, and where the suitability of the recommendation itself depends on the nature of the investor. Categorizing investors by isolated financial criteria may improperly attribute the capability to evaluate investment risk independently, and exercise independent judgment, to a customer without an appropriate analysis of the investor's true characteristics.

Moreover, in view of the great diversity of institutional customers, the Interpretation affords broker/dealers the flexibility to negotiate understandings and terms with a particular customer. Such agreements, freely negotiated between consenting parties, can be useful in establishing, prior to a transaction, the obligations and responsibilities of both parties. The NASD approach assists broker/dealers and customers to define their own expectations and roles with respect to their specific relationship.

In response to arguments that if an investor employs an investment professional, that professional should wholly bear the responsibility for the investment decision it makes, the Interpretation clarifies that while the institution would still be covered by the suitability rule, the factors analysis of the Interpretation would apply to any delegated agents of customers, including any professional advisers that an investor may employ.

The Interpretation does not impose additional duties on members that are not already imposed by NASD suitability rules, general anti-fraud provisions of the federal securities laws, or Rule 2129 "Use of Fraudulent Devices." The Interpretation does not

impose a books and records requirement nor does it create an evidentiary checklist for NASD compliance review. These considerations are provided merely for guidance purposes and do not impose any additional duties or reduce any existing obligations. Moreover, the Interpretation does not make the broker/dealer a guarantor of the investment.

Implementation

Rules 2340, 3010, 3020, and 3110 will **not** be effective until November 20, 1996. All other amendments were effective as of August 20, 1996.

Text Of Amendments

(Note: New text is underlined; deletions are bracketed.)

BY-LAWS

ARTICLE I

DEFINITIONS

(a) through (r) No change.

(s) "rules of the Corporation" means all rules of the Corporation including the Certificate of Incorporation, By-Laws, Rules of Fair Practice, [Government Securities Rules,] Code of Procedure, Uniform Practice Code, any other rules, and any interpretations thereunder.

⁵ The \$10 million portfolio designation does not create a presumption that institutions that exceed the \$10 million portfolio amount satisfy the Interpretation's factors and thus are not covered by the protections of the suitability rule. Rather, the Interpretation indicates that the analysis of the suitability obligation to be conducted using the factors set forth in the interpretation is more appropriate for these larger institutions than for institutions with a smaller portfolio.

RULES OF THE ASSOCIATION

0114. Effect on Transactions in [Exempted] Municipal Securities

The Rules shall not be construed to apply to contracts made prior to the effective date of the Rules or to transactions in [exempted] municipal securities (as defined in Section 3(a)(12) of the Act).

0115. Applicability

(a) These Rules shall apply to all members and persons associated with a member[, other than those members registered with the Commission solely under the provisions of Section 15C of the Act and persons associated with such members]. Persons associated with a member shall have the same duties and obligations as a member under these Rules.

(b) through (c) No change.

1022. Categories of Principal Registration

(a) No change.

(b) Limited Principal—Financial and Operations

(1) through (3) No change.

(4) A member, or an applicant for membership in the Association, may upon written request, be exempted by the President of the Association, or his delegate, from the requirement to have a Limited Principal—Financial and Operations if:

(A) it has been expressly exempted by the Commission from SEC Rule 15c3-1(b)(3)(iii);

(B) it is subject to the provisions of SEC Rule 15c3-1(a)(2) [or (3)] or to Section 402.2(c) of the rules of the Treasury Department.

(5) No change.

(c) through (g) No change.

1060. Persons Exempt from Registration

(a) The following persons associated with a member are not required to be registered with the Association:

(1) through (3) No change.

(4) persons associated with a member whose functions are related solely and exclusively to:

(A) effecting transactions on the floor of a national securities exchange and who are registered as floor members with such exchange;

(B) transactions in [exempted] municipal securities[, except as provided in Rule 1110 hereof.]; or

(C) transactions in commodities.

(b) No change.

IM-2110-1. “Free-Riding and Withholding”

(a) Introduction

(1) through (3) No change.

(4) This interpretation will not apply to government securities as defined in Section 3(a)(42) of the Act.

(b) through (m) No change.

2210. Communications with the Public

(a) through (b) No change.

(c) Filing Requirements and Review Procedures

(1) - (2) No change.

(3)(A) No change.

(B) Except for advertisements related to exempted securities (as defined in Section 3(a)(12) of the Act), municipal securities, direct participation programs or investment company securities, members subject to the requirements of paragraph (c)(3)(A) or (B) of this Rule may, in lieu of filing with the Association, file advertisements on the same basis, and for the same time periods specified in those subparagraphs, with any registered securities exchange having standards comparable to those contained in this Rule.

(4) No change.

(5) In addition to the foregoing requirements, every member’s advertising and sales literature shall be subject to a routine spot-check procedure. Upon written request from the Department, each member shall promptly submit the material requested. Members will not be required to submit material under this procedure which has been previously submitted pursuant to one of the foregoing requirements and, except for material related to exempted securities (as defined in Section 3(a)(12) of the Act), municipal securities, direct participation programs or investment company securities, the procedure will not be applied to members who have been, within the Association’s current examination cycle subjected to a spot-check by a registered securities exchange or other self-regulatory organization using procedures comparable to those used by the Association.

(6) No change.

(7) Material which refers to investment company securities or direct participation programs, or exempted securities (as defined in Section 3(a)(12) of the Act) solely as part of a listing of products and/or services offered by the member, is excluded from the requirements of subparagraphs (1) and (2).

(d) through (f) No change.

2310. Recommendations to Customers (Suitability)

(a) through (b) No change.

(c) For purposes of this Rule, the term “non-institutional customer” shall mean a customer that does not qualify as an “institutional account” under Rule 3110(c)(4).

IM-2310-3. Suitability Obligations to Institutional Customers

Preliminary Statement as to Members’ Obligations

As a result of broadened authority provided by amendments to the Government Securities Act adopted in 1993, the Association is extending its sales practice rules to the government securities market, a market with a particularly broad institutional component. Accordingly, the Association believes it is appropriate to provide further guidance to members on their suitability obligations when making recommendations to institutional customers. The Association believes this interpretation is applicable not only to government securities but to all debt securities, excluding municipals.² Furthermore, because of the nature and characteristics of the institutional customer/member relationship, the Association is extending this interpretation to apply equally to the equity securities markets as well.

The Association’s suitability rule is fundamental to fair dealing 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, as well as having reasonable grounds for believing the recommendation is suitable for the customer to whom it is made. Members are expected to meet the same

high standards of competence, professionalism, and good faith regardless of the financial circumstances of the customer.

Rule 2310(a) requires that,

In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

This interpretation concerns only the manner in which a member determines that a recommendation is suitable for a particular institutional customer. The manner in which a member fulfills this suitability obligation will vary depending on the nature of the customer and the specific transaction. Accordingly, this interpretation deals only with guidance regarding how a member may fulfill such “customer-specific suitability obligations” under Rule 2310(a).²²

While it is difficult to define in advance the scope of a member’s suitability obligation with respect to a specific institutional customer transaction recommended by a member, the Board has identified certain factors which may be relevant when considering compliance with Rule 2310(a). These factors are not intended to be requirements or the only factors to be considered but are offered merely as guidance in determining the scope of a member’s suitability obligations.

Considerations Regarding the Scope of Members’ Obligations to Institutional Customers

The two most important considerations in determining the scope of a member’s suitability obligations in

making recommendations to an institutional customer are the customer’s capability to evaluate investment risk independently and the extent to which the customer is exercising independent judgment in evaluating a member’s recommendation. A member must determine, based on the information available to it, the customer’s capability to evaluate investment risk. In some cases, the member may conclude that the customer is not capable of making independent investment decisions in general. In other cases, the institutional customer may have general capability, but may not be able to understand a particular type of instrument or its risk. This is more likely to arise with relatively new types of instruments, or those with significantly different risk or volatility characteristics than other investments generally made by the institution. If a customer is either generally not capable of evaluating investment risk or lacks sufficient capability to evaluate the particular product, the scope of a member’s customer-specific obligations under the suitability rule would not be diminished by the fact that the member was dealing with an institutional customer. On the other hand, the fact that a customer initially needed help understanding a potential investment need not necessarily imply that the customer did not ultimately develop an understanding and make an independent investment decision.

A member may conclude that a customer is exercising independent

² Rules for municipal securities are promulgated by the Municipal Securities Rulemaking Board.

²² This interpretation does not address the obligation related to suitability that requires that a member have “... a ‘reasonable basis’ to believe that the recommendation could be suitable for at least some customers.” In the Matter of the Application of F.J. Kaufman and Company of Virginia and Frederick J. Kaufman, Jr., 50 SEC 164 (1989).

judgment if the customer's investment decision will be based on its own independent assessment of the opportunities and risks presented by a potential investment, market factors and other investment considerations. Where the broker-dealer has reasonable grounds for concluding that the institutional customer is making independent investment decisions and is capable of independently evaluating investment risk, then a member's obligation to determine that a recommendation is suitable for a particular customer is fulfilled.^{***} Where a customer has delegated decision-making authority to an agent, such as an investment adviser or a bank trust department, this interpretation shall be applied to the agent.

A determination of capability to evaluate investment risk independently will depend on an examination of the customer's capability to make its own investment decisions, including the resources available to the customer to make informed decisions. Relevant considerations could include:

- the use of one or more consultants, investment advisers or bank trust departments;
- the general level of experience of the institutional customer in financial markets and specific experience with the type of instruments under consideration;
- the customer's ability to understand the economic features of the security involved;
- the customer's ability to independently evaluate how market developments would affect the security; and
- the complexity of the security or securities involved.

A determination that a customer is making independent investment decisions will depend on the nature of the relationship that exists between the member and the customer. Relevant considerations could include:

- any written or oral understanding that exists between the member and the customer regarding the nature of the relationship between the member and the customer and the services to be rendered by the member;
- the presence or absence of a pattern of acceptance of the member's recommendations;
- the use by the customer of ideas, suggestions, market views and information obtained from other members or market professionals, particularly those relating to the same type of securities; and
- the extent to which the member has received from the customer current comprehensive portfolio information in connection with discussing recommended transactions or has not been provided important information regarding its portfolio or investment objectives.

Members are reminded that these factors are merely guidelines which will be utilized to determine whether a member has fulfilled its suitability obligations with respect to a specific institutional customer transaction and that the inclusion or absence of any of these factors is not dispositive of the determination of suitability. Such a determination can only be made on a case-by-case basis taking into consideration all the facts and circumstances of a particular member/customer relationship, assessed in the context of a particular transaction.

For purposes of this interpretation, an institutional customer shall be any

entity other than a natural person. In determining the applicability of this interpretation to an institutional customer, the Association will consider the dollar value of the securities that the institutional customer has in its portfolio and/or under management. While this interpretation is potentially applicable to any institutional customer, the guidance contained herein is more appropriately applied to an institutional customer with at least \$10 million invested in securities in the aggregate in its portfolio and/or under management.

IM-2420-1. Transactions Between Members and Non-Members

(a) No change.

(b) Transactions in "Exempted Securities"

[Rule 0114 provides that the Rules shall not apply to transactions, whether between members or between members and non-members, in] Rule 2420 shall not apply to "exempted securities," which are defined by Section 3(a)(12) of the Act. The Rule[s] therefore does not apply to transactions in government or municipal securities if within the definition of "exempted securities." Members may join with non-members or with banks in a joint account, syndicate or group to purchase and distribute an issue of "exempted securities" and may trade such securities with non-members or with banks at different prices or on different terms and conditions than are accorded to members of the general public.

(c) through (d) No change.

3110. Books and Records

(a) No change.

^{***} See note 2.

(b) Marking of Customer Order Tickets

(1) A person associated with a member shall indicate on the memorandum for the sale of any security whether the order is “long” or “short,” except that this requirement shall not apply to transactions in [corporate] debt securities. An order may be marked “long” if (A) the customer’s account is long the security involved or (B) the customer owns the security and agrees to deliver the security as soon as possible without undue inconvenience or expense.

(2) A person associated with a member shall indicate on the memorandum for each transaction in a non-Nasdaq security, as that term is defined in the Rule 6700 Series, the name of each dealer contacted and the quotations received to determine the best inter-dealer market.

(c) Customer Account Information

Each member shall maintain accounts opened after January 1, 1991 as follows:

(1) through (2) No change.

(3) for discretionary accounts, in addition to compliance with subparagraphs (1) and (2) above, and Rule 2510(b) of these Rules, the member shall:

(A) obtain the signature of each person authorized to exercise discretion in the account; [and]

(B) record the date such discretion is granted[.]; and

(C) in connection with exempted securities other than municipals, record the age or approximate age of the customer.

(d) through (g) No change.

(4) No change.

3130. Regulation of Activities of Members Experiencing Financial and/or Operational Difficulties

(a) Application—For the purposes of this Rule, the term “member” shall be limited to any member of the Association who is not designated to another self-regulatory organization by the Commission for financial responsibility pursuant to Section 17 of the Act and SEC Rule 17d-1 thereunder. Further, the term shall not be applicable to any member who is subject to paragraphs (a)(2)(iv), (a)(2)(v) or (a)(2)(vi) [and (a)(3)] of SEC Rule 15c3-1, or is otherwise exempt from the provisions of said rule.

(b) through (c) No change.

IM-3130. Restrictions on a Member’s Activity

(a) This explanation outlines and discusses some of the financial and operational deficiencies which could initiate action under Rules 3130 and 3131. Paragraphs (b)(2) and (c)(2) of [the Rule] Rules 3130 and 3131 recognize that there are various unstated financial and operational reasons for which the Association may impose restrictions on a member so as to prohibit its expansion or to require a reduction in overall level of business. These provisions are deemed necessary in order to provide for the variety of situations and practices which do arise and which, if allowed to persist, could result in increased exposure to customers and to broker/dealers.

(b) through (c) No change.

(d) For purposes of paragraphs (b)(2) and (c)(2) of Rule 3131, a member may be considered to be in or approaching financial or operational difficulty in conducting its operations and therefore subject to restrictions if it is determined by the Association

that any of the parameters specified therein are exceeded or one or more of the following conditions exist:

(1) The member has experienced significant reduction in excess liquid capital in the preceding month or in the three-month period immediately preceding such computation.

(2) The member has experienced a substantial change in the manner in which it processes its business which, in the view of the Association, increases the potential risk of loss to customers and members.

(3) The member’s books and records are not maintained in accordance with the provisions of Section 404.2 of the Treasury Department rules.

(4) The member is not in compliance, or is unable to demonstrate compliance, with applicable capital requirements of Section 402 of the Treasury Department rules.

(5) The member is not in compliance, or is unable to demonstrate compliance, with Section 403.4 of the Treasury Department rules (Customer Protection—Reserve and Custody of Securities).

(6) The member is unable to clear and settle transactions promptly.

(7) The member’s overall business operations are in such a condition, given the nature and kind of its business that, notwithstanding the absence of any of the conditions enumerated in subparagraphs (1) through (6), a determination of financial or operational difficulty should be made.

(8) The member is registered as a Futures Commission Merchant and its net capital is less than required by Section 402.1(d) of the Treasury Department rules.

[(d)](e) If the Association determines that any of the conditions specified in paragraphs (c) or (d) of this explanation exist, it may require that the member take appropriate action by effecting one or more of the following actions until such time as the Association determines they are no longer required:

(1) through (13) No change.

3131. Regulation of Activities of Section 15C Members Experiencing Financial and/or Operational Difficulties

(a) Application—For the purposes of this Rule, the term “member” shall be limited to any member of the Association registered with the Commission pursuant to Section 15C of the Act that is not designated to another self-regulatory organization by the Commission for financial responsibility pursuant to Section 17 of the Act and Rule 17d-1 thereunder. Further, the term shall not be applicable to any member that is subject to Section 402.2(c) of the rules of the Treasury Department, or is otherwise exempt from the provisions of said rule.

(b) A member, when so directed by the Association, shall not expand its business during any period in which:

(1) Any of the following conditions continue to exist, or have existed, for more than fifteen (15) consecutive business days:

(A) A firm’s liquid capital is less than 150 percent of the total haircuts or such greater percentage thereof as may from time to time be prescribed by the Association.

(B) A firm’s liquid capital minus total haircuts is less than 150 percent of its minimum dollar capital requirement.

(C) The deduction of ownership equity and maturities of subordinated debt scheduled during the next six months would result in any one of the conditions described in (A) or (B) of this subparagraph (1).

(2) The Association restricts the member for any other financial or operational reason.

(c) A member, when so directed by the Association, shall forthwith reduce its business:

(1) To a point enabling its available capital to comply with the standards set forth in subparagraphs (b)(1)(A), (B), or (C) of this Rule if any of the following conditions continue to exist, or have existed, for more than fifteen (15) consecutive business days:

(A) A firm’s liquid capital is less than 125 percent of total haircuts or such greater percentage thereof as may from time to time be prescribed by the Association.

(B) A firm’s liquid capital minus total haircuts is less than 125 percent of its minimum dollar capital requirement.

(C) The deduction of ownership equity and maturities of subordinated debt scheduled during the next six months would result in any one of the conditions described in (A) or (B) of this subparagraph (1).

(2) As required by the Association when it restricts a member for any other financial or operational reason.

3140. Approval of Change in Exempt Status Under SEC Rule 15c3-3

(a) Application—For the purposes of this Rule, the term “member” shall be limited to any member of the

Association who is subject to SEC Rule 15c3-3 and is not designated to another self-regulatory organization by the Commission for financial responsibility pursuant to Section 17 of the Act and SEC Rule 17d-1 promulgated thereunder. Further, the term shall not be applicable to any member that is subject to Section 402.2(c) of the rules of the Treasury Department.

(b) A member operating pursuant to any exemptive provision as contained in subparagraph (k) of SEC Rule 15c3-3 under the Act (Rule 15c3-3), shall not change its method of doing business in a manner which will change its exemptive status from that governed by subparagraph (k)(1) or (k)(2)([b]ii) to that governed by subparagraph (k)(2)([a]i); or from subparagraph (k)(1), (k)(2)([a]i) or (k)(2)([b]ii) to a fully computing firm that is subject to all provisions of Rule 15c3-3; or commence operations that will disqualify it for continued exemption under Rule 15c3-3 without first having obtained the prior written approval of the Association.

(c) No change.

3370. Prompt Receipt and Delivery of Securities

(a) No change.

(b) Sales

(1) Long Sales

No member or persons associated with a member shall accept a long sale order from any customer in any security (except exempt securities other than municipals) unless:

(A) through (D) No change.

(2) through (5) No change.

8120. Complaints by Public Against Members for Violations of Rules

Any person feeling aggrieved by any act, practice or omission of any member or any person associated with a member of the Association, which such person believes to be in violation of the Act, the rules and regulations thereunder, the rules of the Municipal Securities Rulemaking Board, or any of the Rules of the Association, may, on the form to be supplied by the Board of Governors, file a complaint against such member or such persons associated with a member in regard thereto with any District Business Conduct Committee of the Association, and any such complaint shall be handled in accordance with the Code of Procedure, as set forth in the Rule 9000 Series.

8130. Complaints by District Business Conduct Committees

Any District Business Conduct Committee which, on information and belief, is of the opinion that any act, practice, or omission of any member of the Association or any person

associated with a member is in violation of the Act, the rules and regulations thereunder, the rules of the Municipal Securities Rulemaking Board, or any of the Rules of the Association, may, on the form to be supplied by the Board of Governors, file a complaint against such member or such person associated with a member in regard thereto with itself or with any other District Business Conduct Committee of the Association, as the necessities of the complaint may require, and any such complaint shall be handled in accordance with the Rule 9000 Series and in the same manner as if it had been filed by an individual or member.

8140. Complaints by the Board of Governors

The Board of Governors shall have authority when on the basis of information and belief it is of the opinion that any act, practice or omission of any member of the Association or of any person associated with a member is in violation of the Act, the rules and regulations thereunder, the rules of the Municipal Securities Rulemaking Board, or any Rule of the Associ-

ation to file a complaint against such member or such person associated with a member in respect thereto or to instruct any District Business Conduct Committee to do so, and any such complaint shall be handled in accordance with the Rule 9000 Series.

8310. Sanctions for Violation of the Rules

Any District Business Conduct Committee, Market Surveillance Committee, the National Business Conduct Committee (NBCC), any other committee exercising powers assigned by the Board, or the Board, in the administration and enforcement of these Rules, the Act, the rules and regulations thereunder, or the rules of the Municipal Securities Rulemaking Board, and after compliance with the Rule 9000 Series, may:

(a) through (f) No change.

[GOVERNMENT SECURITIES RULES]

[Deleted in their entirety.]