proprietary or confidential nature, including technical information; financial data, such as salaries; and personal information concerning individuals associated with the proposals. These matters are exempt under 5 U.S.C. 552b(c) (4) and (6) of the Government in the Sunshine Act.

Dated: March 18, 1996.

M. Rebecca Winkler,

Committee Management Officer.

[FR Doc. 96–6852 Filed 3–20–96; 8:45 am]

BILLING CODE 7555–01–M

Advisory Panel for Physiology and Behavior; Notice of Meeting

In accordance with the Federal Advisory Committee Act (Pub. L. 92–463, as amended), the National Science Foundation (NSF) announces the following meeting:

Name: Advisory Panel for Physiology and Behavior.

Date and Time: April 10th through 12th, 1996; 8:30 a.m.–5:00 p.m.

Place: National Science Foundation, Room 370, 4201 Wilson Blvd., Arlington, VA.

Type of Meeting: Part-open.

Contact Person: Dr. James Coleman, Program Director, Ecological & Evolutionary Physiology, Division of Integrative Biology and Neuroscience, Suite 685, National Science Foundation, 4201 Wilson Boulevard, Arlington, VA 22230, Telephone: (703) 306–1421.

Purpose of Meeting: To provide advice and recommendations concerning proposals submitted to NSF for financial support.

Minutes: May be obtained from the contact person listed above.

Agenda: Open Session: April 12th, 1996; 9:30 p.m. to 10:30 p.m.—for a discussion on research trends and opportunities assessment procedures in Ecological and Evolutionary Physiology.

Closed Session: April 10th and 11th, 8:30 a.m. to 5:00 p.m.; April 12th 8:00 a.m. to 9:30 a.m. and 10:30 a.m. to 5:00 p.m. To review and evaluate Ecological & Evolutionary Physiology proposals as part of the selection process for awards.

Reason for Closing: The proposals being reviewed include information of a proprietary or confidential nature, including technical information; financial data, such as salaries; and personal information concerning individuals associated with the proposals. These matters are exempt under 5 U.S.C. 552b(c), (4) and (6) of the Government in the Sunshine Act.

Dated: March 18, 1996.

M. Rebecca Winkler,

Committee Management Officer.

[FR Doc. 96–6853 Filed 3–20–96; 8:45 am]

BILLING CODE 7555–01–M

SECURITIES AND EXCHANGE COMMISSION

[Release No. 34–36975; File No. SR–CSE–96–01]

Self-Regulatory Organizations; The Cincinnati Stock Exchange; Order Granting Approval to Proposed Rule Change Relating to Clearance Identification Procedures for Members

March 14, 1996.

On January 16, 1996, The Cincinnati Stock Exchange (''CSE'' or ''Exchange'') submitted to the Securities and Exchange Commission (''Commission''), pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'')[1] and Rule 19b–4 thereunder,[2] a proposed rule change to require that members give up only their own or another CSE member's clearing number when executing a transaction on the Exchange.

The proposed rule change was published for comment in the Federal Register on February 9, 1996.[3] No comments were received on the proposal.

The Exchange proposes to add a third policy/interpretation to Article II, Section 5.1 of its by-laws. This policy would require the Exchange's members to give up only their own or another CSE member's clearing number when executing a transaction on the Exchange. The Exchange reasons that this requirement would ensure that the CSE has jurisdiction over all of the parties involved in executing and settling trades that occur on the Exchange.

The Exchange proposes to place this requirement in Article II, Section 5.1 of its by-laws (''Restrictions on Admittance to or Continuance in Membership Association'') instead of Chapter XIII, Rule 13.1 of its rules (''Comparison and Settlement Requirements'') because, in the CSE's opinion, this requirement is a condition of membership being placed on existing members, and it does not impact the Exchange's procedures regarding the comparison and settlement of trades.[4]

The Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange, and, in particular, with the requirements of Section 6(b).[5] Specifically the Commission believes the proposal is consistent with the Section 6(b)(5)[6] requirements that the rules of an exchange be designed to prevent fraudulent and manipulative acts, to foster cooperation and coordination with persons engaged in clearing, settling, and processing information with respect to transactions in securities and, in general, to protect investors and the public interest.

The Commission agrees that this give up requirement should ensure that the CSE may exercise jurisdiction over all of the parties involved in executing, clearing, and settling trades that occur on the Exchange. In turn, this should enhance the Exchange's ability to resolve issues involving the clearance and settlement of transactions that occur on the Exchange.[7]

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,[8] that the proposed rule change (SR–CSE–96–01) is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.[9]

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 96–6763 Filed 3–20–96; 8:45 am]

BILLING CODE 8010–01–M

[Release No. 34–36973; File No. SR–NASD–95–39, Amendment No. 3]

Self-Regulatory Organizations; Notice of Amendment No. 3 to Filing of Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Application of the Rules of Fair Practice to Transactions in Exempted Securities and an Interpretation of Its Suitability Rule

March 14, 1996.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act''), 15 U.S.C. 78s(b)(1), notice is hereby given that on September 18, 1995, the National Association of Securities Dealers, Inc. (''NASD'' or ''Association'') filed with the Securities and Exchange Commission (''SEC'' or ''Commission'') a proposed rule change regarding the application of the Rules of Fair Practice to transactions in exempted securities and an interpretation of the NASD's suitability

[1] 15 U.S.C. 78s(b)(1).

[2] 17 CFR 240.19b–4.

[3] Securities Exchange Act Release No. 36810 (Feb. 5, 1996), 61 FR 5050.

[4] *See* Letter dated February 12, 1996, from Robert P. Ackermann, Vice President, Regulatory Services, CSE, to Glen Barrentine, Senior Counsel/Team Leader, SEC.

[5] 15 U.S.C. 78f(b).

[6] 15 U.S.C. 78f(b)(5).

[7] The Commission notes that this requirement is similar to New York Stock Exchange, Inc. Rule 138 and American Stock Exchange, Inc. Rule 104.

[8] 15 U.S.C. 78s(b)(2).

[9] 17 CFR 200.30–3(a)(12).

rule.[1] On October 17, 1995, the NASD filed Amendment No. 1 to the proposed rule change. The Commission solicited comments on the proposed rule change and Amendment No. 1 from interested persons on October 24, 1995.[2] On January 22, 1996, the NASD filed Amendment No. 2 to the proposed rule change,[3] and on February 15, 1996, replaced Amendment No. 2 with Amendment No. 3. to the proposed rule change.[4] Amendment No. 3 is described in Items I, II, and III below, which Items have been prepared by the NASD. The Commission is publishing this notice to solicit comments on the amendments to the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

Below is the text of proposed changes to the original proposal. Proposed new language is italicized and deletions are in brackets.

Interpretation of the Board of Governors Prompt Receipt and Delivery Interpretation

* * * * *

(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) The member has possession of the security;

(B) The customer is long in his account with the member;

(C) The member or person associated with a member makes an affirmative determination that the customer owns the security and will deliver it in good deliverable form within three (3) business days of the execution of the order; or

(D) The security is on deposit in good deliverable form with a member of the Association, a member of a national securities exchange, a broker-dealer registered with the Securities and Exchange Commission, or any organization subject to state or federal banking regulations and that instructions have been forwarded to that depository to deliver the securities against payment.

* * * * *

Recommendations to Customers

Sec. 2. (a) 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.

(b) Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning:

(i) the customer's financial status;

(ii) the customer's tax status;

(iii) the customer's investment objectives; and

(iv) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer.

For purposes of this subsection 2(b), the term ''non-institutional customer'' shall mean a customer that does not qualify as an ''institutional account'' under Article III, Section 21(c)(4) of the Rules of Fair Practice.

Interpretation of the Board of Governors

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 Board believes it is appropriate to provide further guidance to members on their suitability obligations when making recommendations to institutional customers. The Board believes this Interpretation is applicable not only to government securities but to all debt securities, excluding municipals.[1] Furthermore, because of the nature and characteristics of the institutional customer/member relationship, the Board is extending this Interpretation to apply equally to the equity securities markets as well.

The NASD'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.

Article III, Section 2(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 Article III, Section 2(a) of the Rules of Fair Practice.[2]

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 Article III,

---

[1] A draft of the proposed Suitability Interpretation contained in the proposed rule change was first published for comment in Notice to Members 94–62 (August 1994) (''NTM 94–62''). The proposed Suitability Interpretation published in NTM 94–62 was revised, and a second draft was published for comment in Notice to Members 95–21 (April 1995) (''NTM 95–21''). Copies of NTM 94–62 and NTM 95–21 are included in File No. SR–NASD–95–39 as Exhibits 2 and 4 to the original rule filing respectively.

[2] *See* Securities Exchange Act Release No. 36383 (October 17, 1995), 60 FR 54530 (October 24, 1995). The Commission received nine comment letters in connection with the proposed rule change. *See infra* note 5.

[3] *See* letter from Suzanne E. Rothwell, Associate General Counsel, NASD, to Mark P. Barracca, Branch Chief, SEC, dated January 22, 1996.

[4] Amendment No. 2 responded to some of the comments received on the proposed rule change. Amendment No. 3 expands upon the discussion contained in Amendment No. 2 by including responses to all of the comment letters received on the proposed rule change. Amendment No. 3 to SR–NASD–95–39 completely replaces and supersedes Amendment No. 2. *See* letters from Joan C. Conley, Secretary, NASD, to Mark P. Barracca, Branch Chief, SEC, dated February 15, 1996, and March 4, 1996.

[1] Rules for municipal securities are promulgated by the Municipal Securities Rulemaking Board.

[2] 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).

Section 2(a) of the Rules of Fair Practice. 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 [intends to exercise] *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 [intends to exercise] *is exercising* independent 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.[3] Where a customer has delegated decision-making authority to an agent, such as an investment advisor 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 NASD 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.

* * * * *

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The self-regulatory organization has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

This amendment completely replaces and supersedes Amendment No. 2. This Amendment responds to public comments received by the SEC to the publication of the proposed rule change in Securities Exchange Act Release No. 36383 (October 17, 1995), 60 FR 54530 (October 24, 1995) (the ''Release'').[5] This

[3] *See*, note 2.

[5] The Commission received letters from the following: (1) Brian C. Underwood, Vice President-Director of Compliance, A.G. Edwards & Sons, Inc., dated November 14, 1995; (2) David J. Master, Chairman and CEO, Coastal Securities Ltd., dated November 28, 1995; (3) Betsy Dotson, Assistant Director Federal Liaison Center, Government Finance Officers Association, dated November 14, 1995; (4) Thomas M. Selman, Associate Counsel, Investment Company Institute, dated November 14, 1995; (5) Jane D. Carlin, Principal and Counsel, Morgan Stanley & Co. Incorporated, dated December 5, 1995; (6) Paul Saltzman, Senior Vice President and General Counsel, Public Securities Association, dated November 30, 1995; (7) Scott H.

Continued

amendment, in response to certain public comments, makes certain changes to the text of the proposed rule change, the statement of purpose section of the proposed rule change, and the applicability of certain Rules of Fair Practice in the chart (reproduced below) entitled ''Applicability of the Rules of Fair Practice to Exempted Securities, Including Government Securities (Except Municipals)'' (''Applicability Table'').

1. Purpose

a. Application of the NASD Rules of Fair Practice to Government Securities

Interpretation of the Board of Governors—Prompt Receipt and Delivery of Securities, Article III, Section 1 of the Rules of Fair Practice (''Prompt Receipt and Delivery Interpretation'')

The proposed rule change would expand the short-sale exemption under paragraphs (b)(2) (a) and (b) of the Prompt Receipt and Delivery Interpretation from corporate debt to all debt. One commenter suggests that the long-sale provisions under paragraph (b)(1) of the Prompt Receipt and Delivery Interpretation be similarly amended to exempt a member from making affirmative determinations required under that paragraph prior to accepting a long sale from any customer.[6] The commenter states that the Interpretation will otherwise require a dealer who purchases a government security from a customer to ascertain that the customer is ''long'' the security at the time of the transaction. The commenter argues that this affirmative determination requirement would be contrary to the practice in the government securities market that allows a customer to sell a security to a dealer and cover the sale with a subsequent purchase or repurchase transaction in the ''specials market''. The commenter states that this practice has been recognized by the Federal Reserve Board and is allowed under Regulation T. The commenter further argues that the ability of customers to finance such short positions along with their ability to keep their positions confidential from the executing dealer helps to make the government securities market extremely liquid.

The NASD acknowledges that, in some circumstances, it may be difficult for members to ascertain the position of a customer's account prior to accepting a long-sale in the government securities market. The NASD also recognizes that purchase and repurchase transactions in the government securities market reduce fails and increase the liquidity of the market. It is also important to note that the proposed rule change would amend Article III, Section 21(b)(i) of the Rules of Fair Practice to exempt all debt from the member requirement to mark order tickets ''long'' or ''short.'' In addition, the proposed rule change would amend paragraph (b)(2) of the Prompt Receipt and Delivery Interpretation to exempt all debt from the affirmative determination requirement regulating short sales. Consistent with these positions, the NASD proposes: (1) to amend paragraph (b)(1) of the Prompt Receipt and Delivery Interpretation to provide an exemption from the requirements applicable to long sales for exempt securities except for municipals; and (2) to make a conforming change to the Applicability Table to provide that the Prompt Receipt and Delivery Interpretation is ''Not Applicable''.

Interpretation of the Board of Governors—Execution of Retail Transactions in the Over-the-Counter Market, Article III, Section 1 of the Rules of Fair Practice (''Best Execution Interpretation'')

The proposed rule change would apply the Best Execution Interpretation to exempt securities including government securities, except for municipals. Two commenters state that members will have difficulty readily determining the best bid/ask price for a particular government security or similar security, or even the last sale price, as the government securities market and the over-the-counter (''OTC'') debt markets lack systems similar to the consolidated quotation system and the inter-market trading system.[7] One commenter states that the best execution concept has occurred largely in the context of the equity markets and questions the Interpretation's application to the fixed income principal markets where transactions are executed at a ''net price''.[8] The commenter argues that the application of the Best Execution Interpretation should be delayed and considered with the NASD's Mark-Up Proposal[9] in order to consider the extent to which both interpretations provide guidance in connection with pricing securities fairly. One commenter also argues that the NASD should provide guidance that government securities transactions ''be executed at a resultant price to the customer that is reasonable related to the market''.[10] The commenter argues that this concept more accurately reflects important issues in the government securities markets relating to the: (i) mechanics of odd-lot transactions; (ii) difficulty of obtaining the ''best price'' as that term is considered in the equity markets; and (iii) quotations of active versus non-active government issues of the same maturity in order to serve different customer needs, i.e., institutional liquidity-goals versus retail customer yield-goals. The commenter also argues that applying the Best Execution Interpretation to government securities is counter to the SEC's initiative of providing more market transparency to the government securities markets because, for example, it will force firms to continue to use verbal/paper ticket order desks.

The NASD believes that the general concept of the Best Execution Interpretation, *i.e.*, that a member should seek in executing customer transactions to obtain the best price for the customer, should apply in the government securities market even though certain specific provisions of the Best Execution Interpretation may not be applicable to the government securities market. The NASD's position regarding the applicability of the Best Execution Interpretation to government securities is consistent with its position that the concepts of the Interpretation apply as well to all OTC markets that the NASD regulates, including direct participation programs.[11] The NASD will further consider whether an amendment to the Best Execution Interpretation is necessary to clarify this position as it applies to government securities, but believes such an amendment is not necessary at this time given the clarification provided herein.

Rockoff, Managing Director, Director of Compliance, and Assistant General Counsel, Nomura Securities International, Inc., dated December 14, 1995; (8) Robert F. Prince, Chairman Federal Regulation Committee, and Zachary Snow, Chairman OTC Derivatives Products Committee, Securities Industry Association, dated December 17, 1995; and (9) David Rosenau, President, The Winstar Government Securities Company L.P., dated December 27, 1995. These letters will be referred to hereinafter by their number as indicated in this footnote.

[6] See Comment Letter No. 6, *supra* note 5.

[7] *See* Comment Letters Nos. 6 and 9, *supra* note 5.

[8] *See* Comment Letter No. 6, *supra* note 5.

[9] *See* NTM 94–62 (requesting comment on the proposed Interpretation of the Board of Governors application of the NASD Mark-Up Policy to Transactions in Government and Other Debt Securities).

[10] *See* Comment Letter No. 9, *supra* note 5.

[11] *See* NTM 91–69 (discussing the application of the Interpretation to transactions in direct participation program securities).

Interpretation of the Board of Governors—Front Running Policy, Article III, Section 1 of the Rules of Fair Practice (''Front Running Policy'')

The proposed rule change would apply the Front Running Policy to exempt securities including government securities, except for municipals. One commenter requests that the effectiveness of the Front Running Policy be delayed to determine how this policy applies to the government securities market.[12] The commenter argues that the Front Running Policy was intended to apply solely to equities and is currently limited to transactions that are required to be reported on the last sale reporting systems administered by Nasdaq, the Consolidated Tape Association or the Options Price Reporting Authority, whereas government securities transactions are not reported on such systems. The commenter further argues that whereas a member's advance knowledge of a block trade can have a substantial effect on an equity security, it is less clear that such prior knowledge permits a broker-dealer to predict and benefit from the effect of a transaction on the price of a government security transaction because of differences in the government securities markets. The commenter requests clarification, for purposes of the Front Running Policy, regarding what constitutes a ''block trade'' in the government securities markets, because government securities do not trade as ''shares.''

In response, the NASD acknowledges that the Front Running Interpretation is drafted to apply only to equity securities. The NASD proposes to amend the Applicability Table to indicate that the Front Running Policy under Article III, Section 1 of the Rules of Fair Practice is ''Not Applicable.'' The NASD believes, however, that the member conduct prohibited by the Front Running Interpretation may occur under certain circumstances in the government securities markets. The NASD intends to review the application of the Front Running Interpretation to the government securities markets. In the interim, the NASD will remind members that actions for similar front running conduct occurring in the government securities markets may be brought under Article III, Section 1 of the Rules of Fair Practice.[13]

The NASD similarly notes that the Interpretation of the Board of Governors at paragraph 2125.07 regarding the trading ahead of customer limit orders and the Interpretation of the Board of Governors—Trading Ahead of Research Reports, are 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 markets and intends to review the application of these Interpretations to the government securities markets. In the interim, the NASD will remind members that actions for similar conduct occurring in the government securities markets may be brought under Article III, Section 1 of the Rules of Fair Practice. The NASD would further amend the Applicability Table by adding the recently approved Interpretation of the Board of Governors at paragraph 2125.07, and the Interpretation of the Board of Governors—Trading Ahead of Research Reports under Article III, Section 1 of the Rules of Fair Practice, with the statement that these Interpretations are ''Not Applicable,'' and followed by footnotes stating that violations for such conduct in the government securities markets may be brought under Article III, Section 1 of the Rules of Fair Practice.

Article III, Section 23 of the Rules of Fair Practice—Net Prices to Persons Not in Investment Banking or the Securities Business

The proposed rule change would apply Article III, Section 23 of the Rules of Fair Practice to exempt securities, except for municipals. One commenter requests clarification of the application of that section to the government securities markets.[14] In response, the NASD has determined that the requirements contained in Article III, Section 23 are superseded and more clearly provided for under: (i) Rule 10b–10 of the Act relating to Confirmation of Transactions; and (ii) Article III, Section 25 of the Rules of Fair Practice relating to Dealing with Non-Members. The NASD, therefore, proposes to amend the Applicability Table to indicate that Article III, Section 23 of the Rules of Fair Practice is ''Not Applicable; Superseded by SEC and NASD Rules.''

Article III, Section 35A of the Rules of Fair Practice/Schedule C to the By-laws

The proposed rule change would apply Schedule C of the By-Laws (''Schedule C''), regarding 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. The proposed rule change also would have the effect of applying Article III, Section 35A of the Rules of Fair Practice (''Section 35A'') to the options communications of such members with the public. One commenter states that Section 35A(b) requires a Compliance Registered Options Principal to approve such literature, but Schedule C requires a member to designate such a principal only according to Article III, Section 33.[15] Pursuant to the Applicability Table of the proposed rule change, however, the commenter notes that the NASD would not apply the provisions of Article III, Section 33 to government securities. The commenter requests clarification as to whether the proposed rule change will require a government securities broker-dealer to register an associated person as its ''Compliance Registered Options Principal'' under Part II, Section 2(f) of Schedule C in order to comply with Section 35A(b) of the Rules of Fair Practice that requires the registration of such a Principal in order to approve certain options advertisements, sales materials and other literature for government securities options transactions.[16] The commenter argues that this compliance issue is unclear because the registration provision under Part II, Section 2(f) of Schedule C provides that a member should designate a Compliance Registered Options Principal only according to the options provisions of Article III, Section 33 of the Rules of Fair Practice which would not be applicable to government securities.

In response, the NASD is currently reviewing the issue of whether a ''Compliance Registered Options Principal'' under Schedule C should be required for members that trade options on government securities, and the NASD intends to file in 1996 a proposed rule change regarding this registration issue. Therefore, the NASD is amending the Applicability Table to indicate that Article III, Section 35A(b) is ''Not Applicable/Under Review.'' Article III, Section 35A(b) will not be applicable to options advertisements, sales materials and other literature for government securities options transactions during this interim review period.

Article III, Section 45 of the Rules of Fair Practice—Customer Account Statements

The proposed rule change would phase-in the implementation of Article

[12] *See* Comment Letter No. 6, *supra* note 5.

[13] A footnote has been added to the Applicability Table to indicate that such conduct in the government securities market may be brought under Article III, Section 1 of the Rules of Fair Practice.

[14] *See* Comment Letter No. 6, *supra* note 5.

[15] *Id.*

[16] *Id.*

III, Sections 21, 27 and 32 of the Rules of Fair Practice to dealers in government securities within three months after the effective date of the rule change to provide members with sufficient time to change their internal procedures to comply with the rules. One commenter requests that the effective date of the application of Article III, Section 45 of the Rules of Fair Practice be provided the same implementation period. The NASD, upon review, concurs with this suggestion and proposes that Article III, Section 45 of the Rules of Fair Practice be implemented within three months after the effective date of the rule change to provide members with sufficient time to change their internal procedures to comply with this rule.

Set forth below is a table identifying the applicability of the Rules of Fair Practice to exempted securities, including government securities (except municipals). Proposed changes to the original table contained in the Release are indicated, with additions in italics and deletions in brackets.

APPLICABILITY OF THE RULES OF FAIR PRACTICE TO EXEMPTED SECURITIES, INCLUDING GOVERNMENT SECURITIES (EXCEPT MUNICIPALS)

	Article III	
Section 1	Business Conduct of Members	Applicable.
	Interpretations of the Board of Governors—.	
	Execution of Retail Transactions in the Over-the Counter Market	Applicable.
	Prompt Receipt and Delivery	*Not* Applicable.
	Forwarding of Proxy and Other Materials	Not Applicable.
	Free-Riding and Withholding	Amending to be Not Applicable.
	Interpretation on Limit Order Protection	Not Applicable.
	Interpretation of the Board of Governors ¶2125.07	*Not Applicable.**
	Front Running Policy	*Not Applicable.**
	Trading Ahead of Research Reports	*Not Applicable.**
Section 2	Recommendations to Customers	Applicable.
	Policy of the Board of Governors—Fair Dealing With Customers Policy	Applicable.
Section 3	Charges to Customers	Applicable.
Section 4	Fair Prices and Commission	Applicable.
	Interpretation of the Board of Governors—NASD Mark-Up Policy	Applicable.**
Section 5	Publication of Transactions and Quotations	Applicable.
	Interpretation of the Board of Governors—Manipulative and Deceptive Quotations.	Applicable.
Section 6	Offers at Stated Prices	Applicable.
	Policy of the Board of Governors—Policy With Respect to Firmness of Quotations.	Applicable.
Section 7	Disclosure of Prices in Selling Agreements	Applicable only to traditional underwriter arrangements.
Section 8	Securities Taken in Trade	Not Applicable.
	Interpretation of the Board of Governors—Safe Harbor and Presumption of Compliance.	Not Applicable.
Section 9	Use of Information Obtained in Fiduciary Capacity	Applicable.
Section 10	Influencing or Rewarding Employees of Others	Applicable.
Section 11	Payment Designed to Influence Market Prices, Other than Paid Advertising	Applicable.
Section 12	Disclosure on Confirmations	Not Applicable; superseded by SEC rules.
Section 13	Disclosure of Control	Not Applicable.
Section 14	Disclosure of Participation or Interest in Primary or Secondary Distribution	Applicable.
Section 15	Discretionary Accounts	Applicable.
Section 16	Offers ''At the Market''	Not Applicable.***
Section 17	Solicitation of Purchases on an Exchange to Facilitate a Distribution of Securities.	Applicable.
Section 18	Use of Fraudulent Devices	Applicable.
Section 19	Customers Securities or Funds	Applicable.
Section 20	Installment or Partial Payment Sales	Applicable.
Section 21	Books and Records	Applicable, except for proposed amendments to Subsection (b)(i).
Section 22	Disclosure of Financial Condition	Applicable.
Section 23	Net Prices to Persons Not in Investment Banking or Securities Business	*Not Applicable.*
Section 24	Selling Concessions	Not Applicable.
	Interpretation of the Board of Governors—Services in Distribution	Not Applicable.
Section 25	Dealing with Non-Members	Not Applicable.
	Interpretation of the Board of Governors—Transactions Between Members and Non-members.	Not Applicable.
Section 26	Investment Companies	Not Applicable.
Section 27	Supervision	Applicable.
Section 28	Transactions for or by Associated Persons	Applicable.
Section 29	Variable Contracts of an Insurance Co.	Not Applicable.
Section 30	Margin Accounts	Applicable.
Section 31	Securities Failed to Receive and Failed to Deliver	Not Applicable.
Section 32	Fidelity Bonds	Applicable.
Section 33	Options	Not Applicable.
Section 34	Direct Participation Programs Appendix F	Not Applicable.
Section 35	Communications With the Public	Applicable.

APPLICABILITY OF THE RULES OF FAIR PRACTICE TO EXEMPTED SECURITIES, INCLUDING GOVERNMENT SECURITIES (EXCEPT MUNICIPALS)—Continued

Section 35A	Options Communications With the Public	*Not Applicable/ Under Review.*
Section 36	Transactions with Related Persons	Not Applicable.
	Interpretations of the Board of Governors—Transactions With Related Persons.	Not Applicable.
Section 37	Operating Rules for ITS/CAES and CAES	Not Applicable.
Section 38	Regulation of Activities of Members Experiencing Financial and/or Operational Difficulties.	Applicable.
Section 39	Approval of Change in Exempt Status under SEC Rule 15c3–3	Applicable.
Section 40	Private Securities Transactions	Applicable.
Section 41	Short-Interest Reporting	Not Applicable.
Section 42	Prohibition on Transactions During Trading Halts	Not Applicable.
Section 43	Outside Business Activities	Applicable.
Section 44	The Corporate Financing Rule	Not Applicable.
Section 45	Customer Account Statements	Applicable.
Section 46	Adjustment of Open Orders	Not Applicable.
Section 47	Clearing Agreements	Applicable.
Section 48	Short Sale Rule	Not Applicable.
Section 49	Primary Nasdaq Market Maker Standards	Not Applicable.
	Article IV.—Complaints	
Section 1	Availability to Customers of Certificate, by-laws, Rules and Code of Procedures.	Applicable.
Section 2	Complaints by Public Against Members for Violations of Rules	Applicable.
Section 3	Complaints by District Business Conduct Committee	Applicable.
Section 4	Complaints by Board of Directors	Applicable.
Section 5	Reports and Inspection of Books for Purpose of Investigating Complaints	Applicable.
	Article V	
Section 1	Sanctions for Violations of Rules	Applicable.
Section 2	Interpretation of the Board of Governors—The Effect of a Suspension or Revocation of the Registration, if any, of a Person Associated with a Member or the Barring of a Person from further Association with any Member.	Applicable.
	Payment for Fines, Other Monetary Sanctions, or Costs	Applicable.
Section 3	Posts of Proceedings	Applicable.

** The NASD intends to review the application of this Interpretation to the government securities markets. In the interim, members are reminded that actions for similar conduct occurring in the government securities markets may be brought under Article III, Section 1 of the Rules of Fair Practice.*

** Article III, Section 4 of the Rules of Fair Practice and the NASD Mark-Up Policy currently apply to transactions in equity and corporate debt securities. The NASD is developing an Interpretation of the Mark-Up Policy with respect to exempt securities and other debt securities. Therefore, the current application of Article III, Section 4 of the Rules of Fair Practice and the NASD Mark-Up Policy will not apply to transactions in exempt securities until adoption of the proposed Interpretation of the NASD Mark-Up Policy with respect to all debt securities. However, current Article III, Section 4 of the Rules of Fair Practice and the Mark-Up Policy remain in full force and effect for all equity and corporate debt transactions. *See* letter from Elliott R. Curzon, Assistant General Counsel, NASD, to Mark P. Barracca, Branch Chief, Division of Market Regulation, SEC, dated October 17, 1995 (Amendment No. 1 to the proposed rule change).

**** The NASD intends to review the application of this Interpretation to the government securities markets. In the interim, members are reminded that actions for similar conduct occurring in the government securities markets may be brought under Article III, Section 1 of the Rules of Fair Practice.*

b. Interpretation of the Board of Governors—Suitability Obligations to Institutional Customers, Article III, Section 2 of the Rules of Fair Practice

Amendment to the Text of the Proposed Interpretation

One commenter pointed out that in the sixth and seventh paragraphs of the proposed Suitability Interpretation the NASD states that the two most important factors in determining a member's suitability obligations are a customer's capability to evaluate investment risk independently and the extent to which the customer ''intends to exercise independent judgment in evaluating a member's recommendation.'' [17] The commenter notes that the NASD goes on to state in the ninth paragraph that a member's obligation to determine suitability is fulfilled if it determines that the customer is capable of evaluating risk and ''is making independent investment decisions.'' The commenter states that such language in the Suitability Interpretation is confusing as it appears to create two different standards, *i.e,* ''intends to exercise independent judgment'' versus ''is making independent investment decisions.'' The commenter suggests replacing the phrase ''intends to exercise'' with the phrase ''is exercising'' to eliminate this confusion.

Upon review, the NASD proposes to conform the language contained in the sixth and seventh paragraphs by replacing the phrase ''intends to exercise'' with the phrase ''is exercising.'' This change is consistent with the purpose of the Suitability Interpretation to provide guidance to members in fulfilling their obligation under Article III, Section 2(a) to have reasonable grounds for believing that the recommendation to a customer for the purchase, sale or exchange of any security is suitable for the customer upon the basis of factors, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs. Under this rule, the member's suitability obligation relates to the member's

[17] *See* Comment Letter No. 5, *supra* note 5.

recommendation and not to a future transaction date. Under the proposed Suitability Interpretation, therefore, a member should be considering whether a customer ''is making independent investment decisions'' in connection with the member's present recommendation(s) rather than speculating on the customer's intent to exercise independent judgment at some future transaction date.

Regulatory Status of Language Contained in NASD Notice to Members Requesting Member Comment

One commenter expressed concern that the earlier proposals of the Suitability Interpretation contained in Notice to Members 94–62 (''NTM 94–62'') and Notice to Members 95–21 (''NTM 95–21'')[18] may be interpreted by end-users and private litigants to support the proposition that there has been a shift in the underlying substantive policy position on the part of both the NASD and the Commission to increase a member's suitability obligations to institutional accounts.[19] The commenter specifically expressed strong opposition to the language contained in NTM 94–62 that ''the member's relationship with the customer gives rise to a duty to help the customer determine reasonable investment parameters.''

It is the position of the NASD that language contained in any NASD Notice to Members publishing a proposal for comment prior to the filing of resulting NASD rule changes with the SEC should be deemed to have no regulatory status unless the NASD states otherwise. The primary regulatory purpose of the NASD publishing draft proposals for member comment, such as earlier versions of the Suitability Interpretation, is to receive member comment on the initiative without adopting any final position on the particular matter. Any subsequent revisions to proposed rule language or in narrative discussion contained in Notices to Members are not intended by the Association to imply any position regarding the merit of the published language or discussion. The attachment of any regulatory significance to language and discussion contained in Notices to Members publishing a proposal for comment would be contrary to and harm the self-regulatory process envisioned by Section 15A of the Act, as amended, whereby the Association, through the contributions of industry and non-industry volunteers, is able to publish often controversial regulatory proposals for member comment. Therefore, the language contained in NTM 95–21 and NTM 94–62 should not be interpreted by end-users, private litigants, or others, to support the proposition that there has been a shift in any underlying substantive policy position on the part of the NASD to change a member's suitability obligations to institutional accounts.

Member Determination Regarding the Institutional Customer's Capability To Evaluate Investment Risk Independently

One commenter states that three additional factors should be included for consideration by a member in determining an institutional customer's capability to evaluate investment risk independently.[20] The commenter considers the following to be typical indicia of financial sophistication and sufficient trading experience: (i) Whether or not the customer is engaged in the financial industry or in the business of managing its own or others' investments; (ii) whether the customer has in-house investment professionals charged with the responsibility for recommending or making investment decisions on behalf of the customer; and (iii) whether the customer has independently adopted investment guidelines and provides explicit investment guidelines to the member broker-dealer.

The NASD acknowledges that additional factors may be of value to members when considering whether an institutional customer is capable of evaluating investment risk independently. The NASD's proposed Suitability Interpretation states that the considerations included therein 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. The NASD will look at the listed factors in the Suitability Interpretation in the context of an examination of a member, but recognizes that in certain cases the listed factors may be inappropriate or other factors may also be pertinent to the specific situation.

One commenter argues that the Suitability Interpretation should require that broker-dealers provide specific types of information to customers with regard to specific transactions, such as the instrument's behavior under a variety of conditions, types of risk incurred with certain instruments, and valuation information.[21] The commenter suggests that the absence of affirmative broker-dealer duties may lead to a debate regarding what constitutes a recommendation that triggers the NASD's suitability rule contained in Article III, Section 2 of the Rules of Fair Practice.

The NASD is not seeking by the proposed rule change to adopt the Suitability Interpretation in order to impose additional duties on members which are not already imposed by current Article III, Section 2 of the Rules of Fair Practice, by general anti-fraud principles contained in Section 10(b) of the Act and other provisions of the federal securities laws, or in Article III, Section 18 of the NASD's Rules of Fair Practice.[22] With respect to the issue raised regarding what constitutes a recommendation, the NASD stated in the Release that a significant amount of caselaw has been developed as a result of NASD disciplinary actions and SEC enforcement cases with respect to this concept, which is available as guidance to the membership.

One commenter argues that the relevance of the customer's use of consultants, investment advisers or bank trust departments should depend on the extent of the use and nature of the outside advice.[23] The Commenter also questions whether outside managers for investment pools and trustees fall within the scope of this factor. The NASD agrees that the relevance of a customer's use of professional advisers will depend on the extent of the use of such outside advice. In addition, the proposed Suitability Interpretation states that where a customer has delegated decision-making authority to an agent, such as an investment advisor or a bank trust department, the Interpretation shall be applied to the agent. The Suitability Interpretation, therefore, would apply to any delegated agents of the customer, including outside managers for investment pools, trustees, and other agents.

One commenter argues that the relevance of the customer's general level of experience in the financial markets and with types of instruments under consideration will depend not only on the expertise of the staff but on the nature of changing markets as well.[24] The commenter argues that the relevance of the customer's ability to understand economic features or the complexity of the security involved may turn on the nature of information provided to the investor regarding the features of a specific instrument. The

[18] *See supra* note 1.

[19] *See* Comment Letter No. 6, *supra* note 5.

[20] *See* Comment Letter No. 5, *supra* note 5.

[21] *See* Comment Letter No. 3, *supra* note 5.

[22] *See infra* discussion under ''Other Comments.''

[23] *See* Comment Letter No. 3, *supra* note 5.

[24] *Id.*

commenter also argues that a customer's track record or an affirmative statement by the customer that it has the ability to independently evaluate the effect of the market on a security are unreliable indicators of a customer's ability to independently evaluate the effect of the market on the security. The NASD agrees that the relevance of factors listed in the Suitability Interpretation will vary depending on numerous circumstances. Both the Suitability Interpretation and the discussion of the proposed rule change in the Release emphasized that the factors listed in the Suitability Interpretation are merely guidelines and that the inclusion or absence of any of these factors is not dispositive of the determination of suitability. With regard to the member's consideration of a customer's track record, the NASD addressed this concern in the Release by stating that it believes that a member in an ongoing member/customer relationship will often gain knowledge of factors pertaining to the customer's capability to independently evaluate investment risk, as well as whether the customer intends to and is making independent investment judgments. The NASD believes that a customer's track record or an affirmative statement by the customer are helpful factors for consideration, though not dispositive in themselves.

Member Determination Regarding the Institutional Customer's Making of Independent Investment Decisions

One commenter argues that the factor regarding the ''presence or absence of a pattern of acceptance of a member's recommendation'' is too broad and should apply only to ''captive'' account situations, where a single broker-dealer is effectively controlling substantially all investment decisions of an account.[25] In response, the NASD believes that it would be inappropriate to limit to ''captive accounts'' the member's consideration of the presence or absence of a pattern of a customer's acceptance of a member's recommendation. The NASD believes that a member should be allowed to consider this factor whenever it is appropriate and reasonable to the member's determination.

One commenter argues that three of the listed factors warrant reconsideration as determinative factors or rebuttable presumptions that the member has fulfilled its suitability obligation.[26] Another commenter also argues that the Suitability Interpretation should be amended to create a rebuttable presumption that a member's recommendations to defined institutional customers are suitable.[27] In response, the NASD does not believe it is appropriate to create a safe harbor for members' suitability obligations nor to change or reduce members' obligations under the suitability rule in Article III, Section 2 of the Rules of Fair Practice.

One commenter requests clarification that the lack of a written agreement will not work against investors in disputed cases, and that the inclusion of such a provision in the rule does not indicate a preference for such agreements.[28] The NASD believes that the act of developing such agreements with a customer may be helpful to a member in determining its suitability obligations to the customer, but the existence or absence of such an agreement is not intended to create a presumption as to whether the member has or has not fulfilled its suitability obligations under Article III, Section 2 of the Rules of Fair Practice.

One commenter argues that member consideration of the customer's use of other information as a means of limiting a broker-dealer's suitability obligation may discourage investors from becoming more informed and responsible.[29] The NASD does not agree that the referenced factor or any of the factors listed in the Suitability Interpretation will discourage institutional customers from being more informed and responsible. Rather, this factor recognizes that in many cases institutional customers rely on financial information other than that provided by the member and may, in fact, be subject to a fiduciary obligation to do so.

One commenter argues that member consideration of ''the extent to which the member has received from the customer current comprehensive portfolio information in connection with discussion of recommended transactions'' may not be prudent for the institutional investor with concerns that a member's detailed knowledge of the institution's holdings may affect the institution's ability to trade certain portions of the portfolio or may adversely affect the market for the institution's holdings.[30] The commenter, however, supports the Interpretation's provision that the member consider the extent to which the member has not been provided important information regarding the institution's portfolio or investment objectives.[31] The commenter considers this latter provision to include a jurisdiction's[32] investment guidelines and risk constraints, as well as relevant state and local law. The commenter recommends replacing both of the above considerations with language that would focus on whether the customer has provided ''material relevant to a particular transaction'' and requiring that the member make a reasonable request to obtain relevant portfolio or investment objectives information. The NASD agrees with the commenter that any material relevant to a particular transaction provided by a customer would help members fulfill their suitability obligations under the Suitability Interpretation. The NASD, however, believes that such material information would include current comprehensive portfolio information in connection with the transaction and that the more specific guideline is appropriate even though a customer may not be willing to provide such information. The NASD recognizes the commenter's concerns and reminds members that the Suitability Interpretation states that all the factors are merely guidelines, and that the inclusion or absence of any of these factors is not dispositive in the determination of suitability.

Application of Suitability Interpretation to Certain Agents Delegated by the Institutional Customer

The Suitability Interpretation would require that if an institutional customer has delegated investment authority to an agent such as an investment advisor or money manager, then the Interpretation applies to the agent rather than the customer. One commenter believes that investment professionals employed by institutional customers should bear the total responsibility for their investment decisions made on behalf of their institutional customers, *i.e.*, where the customer relies on an investment professional, the determination of suitability should be presumed to be made by the investment professional.[33] The NASD has stated in the Release that it does not believe it is appropriate to create a safe harbor for members' suitability obligations nor to change or reduce members' obligations under the

[25] *See* Comment Letter No. 5, *supra* note 5.

[26] *See* Comment Letter No. 6, *supra* note 5.

[27] *See* Comment Letter No. 8, *supra* note 5.

[28] *See* Comment Letter No. 3, *supra* note 5.

[29] *Id.*

[30] *Id.*

[31] *Id.*

[32] The commenter's reference to the term ''jurisdiction'' reflects that the commenter represents state and local government officials and other public finance specialists involved in all the disciplines comprising public finance.

[33] *See* Comment Letters Nos. 1 and 8, *supra* note 5.

suitability rule in Article III, Section 2 of the Rules of Fair Practice.[34]

Application of Suitability Interpretation to Institutional Customer: $10 Million Threshold

The Suitability Interpretation provides that for its purposes, an institutional customer shall be any entity other than a natural person. It also provides that in determining the applicability of the Suitability Interpretation to an institutional customer, the NASD will consider the dollar value of the securities that the institutional customer has in its portfolio and/or under management. It further states that while it is potentially applicable to any institutional customer, the guidance contained therein 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.

One commenter argues that the $10 million threshold is contrary to language contained in the Congressional report on the Government Securities Act Amendments of 1993, which states that no distinction should be made in the application of the NASD's rules between investors on the basis of size of portfolio.[35] The commenter also argues that the $10 million portfolio threshold contradicts other language in the Suitability Interpretation that states that the Interpretation is potentially applicable to any institutional customer. The commenter further states the $10 million portfolio threshold provision is, therefore, confusing, difficult to apply, and requests clarification on: (i) what is meant by the reference to securities in the aggregate in its portfolio and/or under management; (ii) what is the period during which the $10 million portfolio size criteria applies; (iii) what is intended by the phrase ''under management''; and (iv) what connection the portfolio size has to the rest of the rule. The commenter also requests clarification on how institutional investors with a portfolio less than the threshold will be treated and recommends that if the threshold amount remains, that it be significantly higher than $10 million because otherwise the Interpretation would inappropriately apply to certain small governmental entities with portfolios that are nominal in the context of government operations.

The NASD responded to such concerns when it stated in the Release that it ''agrees that portfolio size is not dispositive of a member's suitability obligations, but believes it is appropriate for the NASD to consider the portfolio size of the customer in determining the applicability of the proposed Suitability Interpretation. The NASD believes that there is a greater likelihood that the member can apply the proposed Suitability Interpretation to an institutional customer with at least $10 million invested in securities in the aggregate in its portfolio and/or under management, but the NASD has no intent to create a presumption either above or below that aggregate dollar amount that the Interpretation will, in fact, apply to a particular institutional customer. In connection with concerns regarding the NASD's method of calculating the $10 million test, the NASD intends to look for guidance for such calculations to SEC Rule 144A.'' [36]

One commenter supports the $10 million threshold but states that this threshold suggests that the dealer is more likely to be able to reach the determination called for by the Suitability Interpretation for accounts of at least that size.[37] One commenter requests clarification that a member's suitability obligations and the guidance provided by the Interpretation apply identically to all registered investment companies regardless of the amount of assets that a particular investment company has under management.[38] The commenter is concerned that the Interpretation will otherwise inadvertently lead to discrimination against smaller investment companies. The commenter argues that all investment companies are subject to equal treatment under the Investment Company Act of 1940 and must operate within the same competitive environment in which they are expected to obtain professional, experienced investment management for their shareholders. One commenter similarly argued that the Interpretation will have an adverse impact on all smaller institutional accounts.[39] The commenter argues that the burden on competition is not necessary or appropriate for such smaller accounts.

The NASD believes the commenters referenced in the preceding paragraph have misinterpreted the reference to $10 million to imply a definitive threshold that distinguishes capable from non-capable institutional customers. The NASD further believes that the additional provisions in the paragraph containing the $10 million dollar reference eliminate any inference that $10 million is a definitive threshold. Also, as noted above, the NASD stated in the Release that it does not intend to create a presumption either above or below that aggregate dollar amount that the Interpretation will, in fact, apply to a particular institutional customer. The $10 million threshold, therefore, in the context of the complete paragraph does not and should not result in inadvertent discrimination against either investment companies or other institutional customers with less than $10 million invested in securities in the aggregate in their portfolios and/or under management.

Another commenter supports the threshold and states that the $10 million provision acknowledges that although certain investors with substantial assets do not fall within the NASD definition of ''institutional account'' in Article III, Section 21 of the Rules of Fair Practice (which establishes a $50 million asset threshold), they are nevertheless capable of evaluating investments and exercising independent investment judgment.[40] The NASD agrees with this commenter's understanding of the $10 million provision contained in the Suitability Interpretation.

The proposed rule change would also amend Article III, Section 2(b) of the Rules of Fair Practice to clarify that for purposes of the account information requirements, the definition of a ''non-institutional customer'' shall mean a customer that does not qualify as an ''institutional account'' under Article III, Section 21(c)(4) of the Rules of Fair Practice. One commenter argues that the information-gathering requirement in Article III, Section 2(b) should apply only to customers that are not considered institutional customers under the Suitability Interpretation.[41] The commenter states that a member will be required to attempt to gather the information required by Article III, Section 2(b) from a customer (such as an entity with total assets of less than $50 million) even if the member reasonably concludes, consistent with the proposed Suitability Interpretation, that the institutional customer is capable of understanding the risks of the recommended transaction and intends to exercise independent judgment in evaluating the member's recommendation.

It is the position of the NASD that the proposed rule change to Article III, Section 2(b) of the Rules of Fair Practice is to distinguish this requirement from

[34] *See also* Comment Letters Nos. 6 and 8, *supra* note 5.

[35] *See* Comment Letter No. 3, *supra* note 5.

[36] *See* Securities Exchange Act Release No. 36383, *supra* note 2, at 54549.

[37] *See* Comment Letter No. 6, *supra* note 5.

[38] *See* Comment Letter No. 4, *supra* note 5.

[39] *See* Comment Letter No. 1, *supra* note 5.

[40] *See* Comment Letter No. 5, *supra* note 5.

[41] *See* Comment Letter No. 6, *supra* note 5.

the suitability obligations under Article III, Section 2(a) of the Rules of Fair Practice and the Suitability Interpretation. The proposed rule change clarifies that fulfilling the suitability obligation under the Suitability Interpretation does not reduce the member's other obligation under Article III, Section 2(b) to customers that do not qualify as institutional accounts under Article III, Section 21(c)(4) of the Rules of Fair Practice, even though some of these customers would be considered institutional customers according to the Suitability Interpretation. The NASD considers the account information requirements contained under Article III, Section 2(b) to be an obligation with regulatory merit separate from and not superseded by the guidance contained in the Suitability Interpretation.

Additional Comments

One commenter states that Article III, Section 2(a) of the Rules of Fair Practice is an unclear rule.[42] The NASD disagrees with this statement. The source of the language for Article III, Section 2(a) of the Rules of Fair Practice dates from the 1930s Investment Bankers Code drafted during the days of the National Recovery Administration. The NASD believes that during those difficult financial times it would not have been unusual for the involved business and government leaders to have determined that the U.S. financial markets could not be revived and flourish in an business environment with a fair practice standard of *caveat emptor.* The NASD believes the drafters of the suitability rule language must have developed the suitability rule to establish a basic obligation that a broker-dealer is responsible for its recommendations, similar to the basic responsibility of a manufacturer for the quality of its product. In developing the rule, it is believed that the drafters recognized that a workable suitability rule could not go so far as to provide detailed guidance for all circumstances, yet must address all circumstances. The result of their efforts is the language subsequently adopted as the NASD's suitability rule in Article III, Section 2(a) of the Rules of Fair Practice. The historical use of this rule has demonstrated that it sets a standard of behavior that is workable and enforceable when applied to the specific facts and situations giving rise to a complaint of violation. Contrary to the commenter's suggestion that Article III, Section 2(a) is an unclear rule, the NASD believes that the suitability rule is an important and proven regulatory standard of fair dealing in the securities industry much the same as the NASD's requirement under Article III, Section 1 of the Rules of Fair Practice that a member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade. The NASD believes that the language contained in its suitability rule has achieved its intended purpose of protecting the investing public and maintaining confidence in the U.S. securities markets and has, thereby, contributed to the global competitiveness and growth of the U.S. financial markets since the 1930s.

The commenter also argues that the Suitability Interpretation would impose an ''unclearly articulated burden of proof'' on a member regarding how to fulfill suitability obligations to institutional customers.[43] The NASD disagrees. The Suitability Interpretation would provide a member with significantly more guidance than now exists under Article III, Section 2(a) of the Rules of Fair Practice regarding when the member is considered to have ''reasonable grounds for believing'' that it has fulfilled its suitability obligations under Article III, Section 2(a) of the Rules of Fair Practice.

The commenter also argues that the Suitability Interpretation unfairly allocates responsibilities between the customer and the broker-dealer and is confusing because it would: (i) Impose new duties on members to obtain certain information from institutional customers regarding the Interpretation's listed factors and to keep books and records regarding their suitability determinations for future examination by the NASD; (ii) fails to provide a clear definition of ''institutional investor'' and ''recommendation;'' and (iii) fails to establish a rebuttable presumption that a member's recommendations to institutional customers are suitable.

The commenter states that the Suitability Interpretation imposes new duties that do not currently exist as Article III, Section 2(a) of the Rules of Fair Practice requires only that a member make a suitability determination ''upon the basis of the facts, *if any,* disclosed by such customer,'' and Article III, Section 2(b) of the Rules of Fair Practice requires only that a member must make reasonable efforts to obtain current information with regard to non-institutional accounts. The commenter argues that the text of these two subsections of Article III, Section 2 of the Rules of Fair Practice suggests that it is not currently mandatory for members to obtain the information set forth in the list of relevant factors for institutional investors. Another commenter also argues that the Suitability Interpretation should not increase member documentation or record keeping requirements.[44]

The NASD agrees that Article III, Section 2(a) of the Rules of Fair Practice does not contain books and records requirements, and the NASD does not bring actions under Section 2(a) on this basis. The Suitability Interpretation also does not contain books and records requirements. Members, however, are responsible for demonstrating the fulfillment of their suitability obligations under Article III, Section 2(a) in NASD examinations. Members would have the same responsibility under the Suitability Interpretation. With regard to the member obligations contained in the Suitability Interpretation, the NASD states in the Release that in revising earlier drafts of the Suitability Interpretation, the NASD intended to eliminate the appearance that the listed factors create an evidentiary checklist for NASD compliance review by replacing the phrase ''the Board has identified certain factors which are considered when the NASD conducts its review for compliance'' in the fourth paragraph of the Suitability Interpretation contained in the proposed rule change, with the phrase ''the Board has identified certain factors which may be relevant when considering compliance.'' [45] Thus, the NASD agrees with the commenter that the responsibilities of the member are limited under Article III, Section 2(a) of the Rules of Fair Practice in that the member is not the guarantor of the investment nor responsible for the absence of information not provided by the institutional customer.

In a related comment, one commenter also objects that the proposed Suitability Interpretation would impose a ''heavy burden of proof'' when dealing in an institutional context.[46] The NASD's position is that a member is responsible for demonstrating in an NASD examination or investigation that it has fulfilled its obligations under Article III, Section 2(a) of the Rules of Fair Practice, in the same manner that the member must demonstrate

[42] *See* Comment Letter No. 7, *supra* note 5. The commenter states that the Suitability Interpretation proposed to be adopted under Article III, Section 2 ''muddies an already unclear rule.''

[43] *See* Comment Letter No. 7, *supra* note 5.

[44] *See* Comment Letter No. 8, *supra* note 5.

[45] *See* Securities Exchange Act Release No. 36383, *supra* note 2, at 54553.

[46] *See* Comment Letter No. 7, *supra* note 5.

compliance with its obligations under any federal security law. Thus, a member may determine that it is necessary to establish internal procedures that will facilitate a demonstration that the member has met its regulatory obligations. This responsibility exists under Article III, Section 2(a) today.

With regard to the commenter's specific proposal that the Suitability Interpretation provide an objective definition of the term ''institutional investor,'' the NASD believes this approach would arbitrarily discriminate between institutional investors based on factors such as asset size, portfolio size or institutional type. The NASD states in the Release that the Suitability Interpretation provides guidance to members on the relevant considerations that should be examined by a member in fulfilling its suitability obligations to all institutional customers and does not unfairly discriminate between institutional customers based on such factors.[47] The NASD further states in the Release that it believes this regulatory approach is in furtherance of the Act, as amended.[48]

With respect to the commenter's proposal that a definition of ''recommendation'' be adopted, the NASD stated in the Release that Article III, Section 2 of the Rules of Fair Practice has been applicable to members' recommendations since the inception of the NASD.[49] A significant amount of case law has been developed as a result of NASD disciplinary actions with respect to this provision, which is available as guidance to the membership. The NASD believes that defining the term ''recommendation'' is unnecessary and would raise many complex issues in the absence of the specific facts of a particular case.

With regard to the commenter's proposal that the Suitability Interpretation provide a rebuttable presumption that member recommendations to institutional customers are suitable, the NASD states in the Release that it believes that a member's suitability obligation under Article III, Section 2(a) of the Rules of Fair Practice remains with the member until fulfilled and that, therefore, the creation of a ''clear rebuttable presumption'' through the fulfillment of certain procedures would not be appropriate.[50] In addition, as set forth below, such a rebuttable presumption would only be acceptable if a definable class of institutional investors could be identified that would not need the protection of the NASD's suitability rule under all conceivable circumstances.

The commenter also suggests there is regulatory precedent for its position that the Suitability Interpretation should be amended to provide for a rebuttable presumption that member transactions with institutional investors are suitable. The commenter cites Rule 144A under the Securities Act of 1933, as amended (''1933 Act''), which provides exemptions from the registration requirements of the 1933 Act by allowing unregistered securities to be resold to objectively defined ''qualified institutional investors'' (''QIBs''). The commenter also cites Rule 15a–6 of the Securities Exchange Act of 1934, as amended (''Exchange Act''), which provides exemptions for certain foreign brokers and dealers from the broker-dealer registration requirements of Section 15(a)(1) and 15B(a)(1) of the Exchange Act when, among other things, such foreign broker-dealers deal under certain conditions with ''U.S. institutional investors'' or ''major U.S. institutional investors.''[51] The commenter states that it is difficult to understand why the NASD's suitability rule is ''sacrosanct'' relative to the above statutorily-required securities and broker-dealer registration requirements.

The NASD notes that Rule 144A under the 1933 Act allows unregistered securities to be resold to certain institutional buyers who are of sufficient size they are presumed to have the sophistication[52] to purchase securities based upon disclosure documents meeting the anti-fraud requirements rather than the SEC standardized disclosure forms. In the NASD's opinion, Rule 144A is not a safe harbor from disclosure because, regardless of the lack of reliance on the SEC's disclosure documents and pre-offering registration with the SEC, disclosure regarding the securities offered is generally provided to QIBs in order for the offering to be in compliance with the anti-fraud provisions of the federal securities laws.[53] The creation of a ''rebuttable presumption'' under the NASD's suitability rule would, however, create a safe harbor from the NASD's fair practice standard that a member shall reasonably believe that its recommendation is suitable, which the NASD believes is totally inappropriate. As important, the NASD is unable to identify a class of institutional investors that would not need the protection of the NASD's suitability rule under all conceivable circumstances. For the above reasons, the NASD believes that a proposed ''rebuttable presumption'' for the NASD's suitability rule in connection with transactions with institutional customers is significantly different than the SEC's Rule 144A safe harbor for resales of unregistered securities to QIBs.

With regard to the commenter's argument that there is precedent for providing a status safe harbor in the Suitability Interpretation based on Rule 15a–6 of the Exchange Act, the NASD believes that these provisions are too different for any comparison and precedent to be used. Rule 15a–6 of the Exchange Act does not waive major investor protection standards for U.S. institutions, whereas the NASD believes a safe harbor in the Suitability Interpretation would waive such protections. Rule 15a–6, *inter alia*, provides an exemption from broker-dealer registration (referred to as the direct contact exemption) that generally permits certain foreign broker-dealers[54] to engage in solicited transactions with ''U.S. institutional investors'' or ''major U.S. institutional investors'' through a registered broker-dealer acting as an intermediary. The rule permits foreign broker-dealers to contact U.S. institutional investors only with the participation of an associated person of a registered broker-dealer. Rule 15a–6 also generally permits certain foreign broker-dealers to send research reports

[47] *See* Securities Exchange Act Release No. 36383, *supra* note 2, at 54549.

[48] *See supra* discussion under ''Application of Suitability Interpretation to Institutional Customer: $10 Million Threshold.''

[49] *See* Securities Exchange Act Release No. 36383, *supra* note 2, at 54556.

[50] *Id.* at 54553.

[51] The discussion of Rule 144A and Rule 15a–6 contained in this Release was prepared by the NASD's Office of General Counsel. Accordingly, the discussion of Rule 144A and Rule 15a–6 contained herein is not a description or interpretation of the rules by the Commission or Commission staff. *See* Securities Exchange Act Release No. 27017 (July 11, 1989), 54 FR 30013 (July 18, 1989).

[52] Rule 144A relies on an extremely high standard of $100 million invested in securities in order to ensure that potential investors have sufficient sophistication to make investment decisions without need for SEC registration.

[53] In fact, the introduction to Rule 144A specifically states that ''[t]his section relates solely to the application of Section 5 of the Act and not to antifraud or other provisions of the Federal securities laws.''

[54] Rule 15a–6(a) exempts only foreign brokers or dealers, which are defined in paragraph (b)(3) to mean persons not resident in the United States that are not offices or branches of, or natural persons associated with, registered broker-dealers, and whose securities activities fall within the definitions of ''broker'' or ''dealer'' in sections 3(a)(4) or 3(a)(5) of the Exchange Act. The definition in paragraph (b)(3) expressly includes any U.S. person engaged in business as a broker or dealer entirely outside the United States. This definition also includes foreign banks to the extent that they operate from outside the United States, but not their U.S. branches or agencies.

under certain conditions [55] to ''major U.S. institutional investors'' and to engage in unsolicited transactions from such investors without a registered broker-dealer acting as an intermediary.[56] The SEC has stated that under these conditions, it believes that direct distribution would be consistent with the free flow of information across national boundaries without raising substantial investor protection concerns.[57] The NASD believes that different procedures adopted under Rule 15a–6 for solicited and unsolicited transactions and for ''U.S. institutional investors'' and ''major U.S. institutional investors'' demonstrates that the SEC sought to carefully preserve the safeguards offered by broker-dealer registration, and not adopt an across-the-board exemption similar to the securities registration exemption provided by Rule 144A for QIBs. In this connection, the SEC states in the adopting release that ''* * * the Commission does not believe that sophistication is in all circumstances an effective substitute for broker-dealer regulation.'' [58] The exemption adopted under Rule 15a–6 that permits unregistered foreign broker-dealers to send research reports under certain conditions to a ''major U.S. institutional investor'' and permits such institutions in certain circumstances to engage in unsolicited transactions is narrowly drawn. The NASD believes that the definition of ''major U.S. institutional investor'' sets a very high standard [59] for a very small exemption and recognizes the reality that such U.S. investors interested in foreign securities are capable of accessing research and entering into transactions with unregistered foreign broker-dealers with respect to foreign securities. Rule 15a–6, therefore, is significantly more narrow than that proposed by the commenter with respect to the NASD's suitability rule that would relieve members of their suitability obligations with respect to the entire class of institutional investors. Moreover, the provisions of Rule 15a–6 are intended to accommodate regulatory comity and facilitate access to foreign markets by certain U.S. institutional investors.

The commenter also argues, contrary to its prior argument, that ''even though the NASD does not intend to create a safe harbor, the Proposal adopts the framework of a safe harbor when it suggests that 'where the broker-dealer has reasonable grounds for concluding that the institutional customer is making independent investment decisions and is capable of independently calculating investment risk, then a member's obligation to determine that a recommendation is suitable for a particular customer is fulfilled.' '' The NASD disagrees; there are no safe harbors in the suitability Interpretation. The Suitability Interpretation clarifies, by discussion and examples of relevant factors, the standard to establish the ''reasonable grounds'' that a member should have under Article III, Section 2(a) of the Rules of Fair Practice regarding the suitability of its recommendations to institutional customers. Under the Suitability Interpretation, a member is unable to determine whether its obligation to an institutional customer under Article III, Section 2(a) of the Rules of Fair Practice is fulfilled unless the member engages in a subjective inquiry and analysis of the factors in the Suitability Interpretation and any other relevant factors. The Suitability Interpretation requires the member to have sufficient knowledge of the customer in order to rely on the Interpretation in fulfilling its obligation under Article III, Section 2(a) of the Rules of Fair Practice. The NASD states in the Release [60] that it believes such knowledge is often gained in an ongoing member/customer relationship, but acknowledges that a consideration would include 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.

2. Statutory Basis

The NASD believes that the proposed rule change, as amended, is consistent with the provisions of Section 15A(b)(6) of the Act,[61] which requires that the rules of the Association be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest in that the rule change will implement the Association's expanded sales practice authority over exempted securities, except for municipals, by creating one set of sales practice rules for members by merging the Government Securities Rules into the Rules of Fair Practice and applying, where applicable, the Rules of Fair Practice to those members registered with the SEC solely under the provisions of Section 15C of the Act and to transactions in exempted securities, including government securities, except municipals. The proposed rule change, as amended, will also further the above purposes of the Act by adopting a new Interpretation of the Board of Governors—Suitability Obligations to Institutional Customers under Article III, Section 2 of the Rules of Fair Practice to: (i) apply the NASD's suitability rule under Article III, Section 2(a) of the Rules of Fair Practice to transactions in exempted securities including government securities, except municipals; and (ii) provide guidance to members on their suitability obligations when making recommendations to institutional customers, of which the government securities markets has a particularly broad institutional component. The proposed rule change, as amended, will also further the above-purposes of the Act by: (i) Making clarifying amendments to certain sections and Interpretations under Articles III and IV of the Rules of Fair Practice relating to the government securities business; (ii) making technical changes to NASD By-Laws, Schedules of the By-Laws, the Rules of Fair Practice, and the Code of Procedure to replace references to provisions of the Government Securities Rules with references to the appropriate Rules of Fair Practice, and to delete the terms ''exempted security'' or ''exempted'' securities, or, replace these terms with the term ''municipal securities,'' as

[55] The research report must not recommend the use of the foreign broker-dealer to effect trades in any security, and the foreign broker-dealer must not initiate follow-up contact with the major U.S. institutional investors who receive the research, or otherwise induce or attempt to induce the purchase or sale of any security by those major U.S. institutional investors.

[56] If, however, the foreign broker-dealer already had a relationship with a registered broker-dealer that facilitated compliance with the direct contact exemption in the rule, the rule would require all trades resulting from the provision of research to be effected through that registered broker-dealer pursuant to the provisions of that exemption.

[57] *See* Securities Exchange Act Release No. 27017 (July 11, 1989), 54 FR 30013 (July 17, 1989).

[58] *Id*.

[59] Paragraph (b)(4) of Rule 15a–6 of the Exchange Act generally defines ''major U.S. institutional investor'' as a U.S. institutional investor with assets, or assets under management, in excess of $100 million, or a registered investment adviser with assets under management in excess of $100 million. Paragraph (b)(7) of Rule 15a–6 of the Exchange Act generally defines ''U.S. institutional investor'' as a registered investment company, bank, savings and loan association, insurance company, business development company, small business investment company or employee benefit plan defined in Rule 501(a)(1) of Regulation D under the Securities Act, a private business development company as defined in Rule 501(a)(2), an organization described in Section 501(c)(3) of the Internal Revenue Code, as defined in Rule 501(a)(3) or a trust defined in Rule 501(a)(7).

[60] *See* Securities Exchange Act Release No. 36383, *supra* note 2, at 54555.

[61] 15 U.S.C. § 78o–3.

applicable; and (iii) modifying references to SEC Rules 15c3–1 and 15c3–3 to reflect SEC amendments to those rules.

(B) Self-Regulatory Organization's Statement on Burden on Competition

The NASD believes that the proposed Suitability Interpretation contained in the proposed rule change, as amended, is consistent with the intent of the Act as amended by the Government Securities Amendments.[62] The proposed Suitability Interpretation expands the suitability rule contained under Article III, Section 2(a) of the Rules of Fair Practice to all securities transactions, including transactions in exempted securities, except for municipals. While the proposed Suitability Interpretation acknowledges that a member's relationships with institutional customers may be different from the normal member/retail customer relationship, it does not unfairly discriminate against such institutional customers. The proposed rule change applies the suitability rule under Article III, Section 2 of the Rules of Fair Practice to both retail and institutional customers in connection with all securities transactions, other than municipals. The proposed Suitability Interpretation provides members with an appropriate analysis of their suitability obligations to institutional customers based on the institutional customer's capability to evaluate investment risk independently and the extent to which the customer is exercising independent judgement in evaluating the member's recommendation.[63]

On the basis of the foregoing, the NASD does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

No written comments were solicited or received as to Amendment No. 3 to the proposed rule change.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. § 552, will be available for inspection and copying at the Commission's Public Reference Section, 450 Fifth Street, N.W., Washington, D.C. 20549. Copies of such filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to File No. SR–NASD–95–39 and should be submitted by April 22, 1996.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 96–6765 Filed 3–20–96; 8:45 am]

BILLING CODE 8010–01–P

[62] The Association received one comment letter that argued that the proposed Suitability Interpretation distinguished between institutional and retail customers and, therefore, was contrary to the intent of the Government Securities Amendments. See Comment Letter No. 3, supra note 5.

[63] *See* H.R. 103–225, 103rd Cong., 1st Sess. (September 23, 1993).

[Release No. 34–36976; File no. SR–Phlx–96–07]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the Philadelphia Stock Exchange, Inc., To Adopt a Market Index Option Hedge

Exemption March 14, 1996.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (''Act'')[1] and Rule 19b–4 thereunder,[2] notice is hereby given that on February 13, 1996, the Philadelphia Stock Exchange, Inc. (''Phlx'' or ''Exchange'') filed with the Securities and Exchange Commission (''Commission'') the proposed rule change as described in Items I, II, and III below, which Items have been prepared by the self-regulatory organization.[3] The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The Phlx, pursuant to Rule 19b–4 of the Act, proposes to amend Commentary .01 to Phlx Rule 1001A to establish a hedge exemption from broad-based (market) index option position limits.

Specifically, the Phlx proposes to exempt from position and exercise limits[4] any position in a market index option that is hedged by share positions in at least 20 stocks, or securities convertible into such stock, in four industry groups comprising the index, of which no one component security accounts for more than 15% of the value of the portfolio hedging the index option position. Under the proposal, no position in a market index option may exceed two-times[5] the broad-based index option position specified in Phlx Rule 1001A(a).[6] In addition, the underlying value of the option position may not exceed the value of the underlying portfolio employed as the hedge. The proposed exemption would be available to public customers, as well as to firm and proprietary traders.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Phlx included statements concerning the purpose of and basis for the proposed rule change, and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. The

[1] 15 U.S.C. § 78s(b)(1) (1988).

[2] 17 CFR 240.19b–4 (1994).

[3] On February 26, 1996, the Phlx filed an amendment to the rule proposal. *See* letter from Gerald D. O'Connell, First Vice President, Market Regulation and Trading Operations, Phlx, to Michael Walinskas, Branch Chief, Office of Market Supervision, Division of Market Regulation, Commission, dated February 26, 1996 (''Amendment No. 1''). Amendment No. 1 made several minor changes to the rule proposal in order to make it correspond to the final draft of the narrow-based (industry) index option hedge exemption that was recently approved for the Phlx by the Commission. *See* Securities Exchange Act Release No. 36858 (February 16,1 996), 61 FR 7295 (February 27, 1996) (File No. SR–Phlx–95–45).

[4] Position limits impose a ceiling on the number of option contracts which an investor or group of investors acting in concert may hold or write in each class of options on the same side of the market (*i.e.*, aggregating long calls and short puts or long puts and short calls). Exercise limits prohibit an investor or group of investors acting in concert from exercising more than a specified number of puts or calls in a particular class of options within five consecutive business days.

[5] For instance, if the position limit for a market index option is 25,000 contracts, an additional 50,000 contracts under this proposal would be permitted, for a total of 75,000 contracts.

[6] Under Phlx Rule 1001A(a), the Value Line Composite Index (''VLE''), the U.S. Top 100 Index (''TPX''), and the National Over-the-Counter Index (''XOC'') each have a position limit of 25,000 contracts, of which no more than 15,000 contracts can be in the nearest expiration month. The Phlx notes that the Big Cap Index (''MKT'') is no longer listed on the Exchange.