

No. 3 to the proposal, because the amendment requires a dually listed issuer to promptly notify the CHX if the issue falls below the continued listing maintenance standards of another market. This notification will in turn allow the CHX to ensure that the interests of investors are protected because the CHX will conduct an immediate independent determination of whether the issuer should continue to be listed on the Exchange.

In granting accelerated approval for Amendments Nos. 1, 2, and 3, the Commission notes that it did not receive any comments on the original proposal, which was noticed for the full statutory period. In addition, the amendments strengthen and clarify the CHX's original proposal. Accordingly, for the reasons stated above, the Commission finds that there is good cause, consistent with Sections 19(b)²⁶ and 6(b)(5)⁽²⁷⁾ of the Act, to accelerate approval of Amendments Nos. 1, 2 and 3.

Interested persons are invited to submit written data, views, and arguments concerning Amendments No. 1, 2, and 3 including whether the amendments are consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 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 in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549. Copies of such filing also will be available for inspection and copying at the principle office of the CHX. All submissions should refer to File No. SR-CHX-98-07 and should be submitted by October 29, 1998.

IV. Conclusion

For the reasons stated above, the Commission believes the CHX's amended proposal is consistent with the Act and, therefore, has determined to approve it. The amended proposal provides the Exchange with greater flexibility in listing and maintenance standards for CHX listed securities,

while continuing to ensure the protection of investors and the public interest.

It is therefore ordered, pursuant to Section 19(b)(2) of the Act,²⁸ that the amended proposed rule change, SR-CHX-98-07, be and hereby is approved.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.²⁹

Margaret H. McFarland,

Deputy Secretary.

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40511; File No. SR-NASD-97-61]

Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change and Amendments Nos. 1 and 2 by the National Association of Securities Dealers, Inc., Relating to the Application of NASD's Mark-up Policy to Transactions In Government And Other Debt Securities

September 30, 1998.

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 August 20, 1997, the National Association of Securities Dealers, Inc. ("NASD" or "Association"), filed with the Securities Exchange Commission ("SEC" or "Commission") a proposed rule change. On August 26, 1998, the Association filed Amendment No. 1 to the proposed rule change.³ Amendment No. 1 replaces and supersedes the original proposed rule change and is described in Items I, II, and III below, which Items have been prepared by NASD Regulation, Inc. ("NASD Regulation"). On September 8, 1998, the Association filed Amendment No. 2 in which the Association consented to an extension of the time period to 60 days for Commission action specified in Section 19(b)(2) of the Act.⁴ The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

²⁸ 15 U.S.C. 78s(b)(2).

²⁹ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ Letter from Alden Adkins, Senior Vice President and General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, SEC (Aug. 26, 1998).

⁴ Letter from Alden Adkins, Senior Vice President and General Counsel, NASD Regulation, to Katherine A. England, Assistant Director, SEC (Sept 8, 1998).

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

NASD Regulation is proposing NASD Rule IM-2440-2 to provide guidance to the membership on mark-up and mark-down practices for debt securities, excluding municipal securities. NASD Regulation also proposes to renumber current Rule IM-2440 as Rule IM-2440-1. Below is the text of the proposed rule change. Proposed new language is in italics.

IM-2440-1. Mark-Up Policy

* * * * *

IM-2440-2. Interpretation Of The Board of Governors—Application Of the NASD Mark-Up Policy To Transactions In Government And Other Debt Securities⁵

As a result of the Government Securities Act Amendments of 1993 that expanded the NASD's sales practices authority to encompass government securities, the Board believes it is appropriate to provide guidance to the membership on mark-up and mark-down⁶ practices for such securities, as well as for other debt securities, except for municipal securities.⁷ The market for government and debt securities is as multidimensional as the securities themselves. The markets range from the Treasury securities market—representing the largest, most liquid securities market in the world—to markets for collateralized mortgage obligations and structured securities, which often are substantially less liquid and which include securities with features that are highly unique or are customized for particular investors. Therefore, the mark-ups and mark-downs charged on government and other debt securities must properly reflect the facts and circumstances of each particular transaction,⁸ including the specific type of

⁵ This interpretation does not address the application of the mark-up policy to transactions involving the domination and control of the market for a particular security. When a dealer dominates and controls the market for a particular security, that dealer's contemporaneous cost is the best evidence of the prevailing market price. The analysis of whether the market for any particular security is dominated or controlled should take into account the extent to which the particular security is fungible with other similar securities.

⁶ A mark-up is the difference between the price that the dealer, acting as a principal, charged to the customer and the prevailing market price for the security. Lehman Brothers Inc., Exchange Act Release No. 37673 (Sept. 12, 1996). A mark-down is the difference between the price that the dealer, acting as principal, paid to the customer and the prevailing market price for the security.

⁷ Rules for municipal securities are promulgated by the Municipal Securities Rulemaking Board.

⁸ Whether the amount of mark-ups charged on a particular transaction is excessive depends on whether, based on all the relevant facts and circumstances, the price charged the customer is reasonably related to the prevailing inter-dealer

Continued

²⁶ 15 U.S.C. 78s(b).

²⁷ 15 U.S.C. 78f(b)(5).

government or other debt securities involved. This interpretation is intended to clarify the application of the Association's Mark-Up Policy in determining the prevailing market price for principal transactions in government and other debt securities. This interpretation is not intended to provide new guidance with respect to the percentage amounts that would constitute excessive mark-ups or mark-downs in particular cases. The Association and the SEC have made clear that the appropriate mark-up or mark-down from the prevailing market price for most types of government and other debt securities is usually substantially less than 5 percent.

As described below, the prevailing market price for a security against which to measure a mark-up or mark-down is based primarily on the dealer's contemporaneous cost or, in certain cases, contemporaneous inter-dealer transaction prices in that specific security. For example, when a dealer is not acting as a market maker, the Association and the SEC have consistently held that, absent countervailing evidence, the best evidence of the prevailing market price is the dealer's contemporaneous cost of acquiring the securities.⁹ Countervailing evidence of the prevailing market price may be considered only where the dealer made no contemporaneous transactions or can show that in the particular circumstances the dealer's contemporaneous cost is not indicative of the prevailing market price.¹⁰ This may occur, for example, when the debt securities were bought from knowledgeable customers below the prevailing market price, or where, in the interim, interest rates have changed or other market events have occurred.

In contrast, integrated dealers, i.e., dealers that not only sell to retail customers, but also act as wholesale market makers, in active, competitive markets, are permitted to calculate their mark-ups from their contemporaneous sales prices to other dealers.¹¹ In this case, these contemporaneous transactions constitute highly reliable evidence of the prevailing market price of a security. In the debt securities markets, a market maker is a dealer who, with respect to a particular security, furnishes bona fide competitive bid and offer quotations on request and is ready, willing, and able to effect transactions in reasonable quantities at his or her quoted prices with other brokers or dealers.

The use of contemporaneous cost also applies to riskless principal transactions. The Commission has held that when a dealer that is not a market maker effects a riskless principal transaction, the dealer's cost must always be used as the base on which to calculate mark-ups.¹² Similarly,

contemporaneous resale price would constitute evidence of prevailing market price for mark-downs.

When government or other debt securities trade actively, inter-dealer transactions may be rare on non-existent. Therefore, establishing the prevailing market price in a transaction involving an actively traded bond, note, or other debt obligation may be difficult. In such circumstances, absent countervailing evidence, the contemporaneous cost to the dealer of acquiring the security should be used as the basis for determining the appropriate mark-up. A transaction is "contemporaneous" if it occurs close enough in time to a later transaction that it would not be contemporaneous if it is followed by intervening changes in interest rates or other market events that reasonable would be expected to affect the market price.

Accordingly, when inter-dealer transactions are not available, a dealer that effects a transaction in government or other debt securities with a customer and determines the mark-up or mark-down on a basis other than its own contemporaneous cost must be prepared to provide evidence that is sufficient to overcome the presumption that contemporaneous cost provides the best measure of the prevailing market price. In this case, factors that the Board believes may be taken into consideration for a mark-up or a mark-down include but are not limited to:¹³

1. Prices of any dealer transactions in the security in question with institutional accounts with which any dealer regularly effects transactions in the same or a similar security;

2. Contemporaneous inter-dealer quotations in the security in question made through an inter-dealer quotation mechanism through which transactions do in fact occur in that security at prices that are reasonably related to the displayed quotations;

3. Yields calculated from prices of inter-dealer transactions in "similar" securities, as defined below;

4. Yields calculated from prices of transactions with institutional accounts in "similar" securities; and

5. Yields calculated from validated inter-dealer quotations in "similar" securities. In considering yields of "similar" securities, members may not rely on a limited number of transactions that are not fairly representative of the yields of transactions of "similar" securities taken as a whole.

Ideally, a "similar" security should be sufficiently similar to the security under

review that it would serve as a reasonable alternative to an investor seeking the risk profile of an investment in the security under review. At a minimum, the security or securities should be sufficiently similar that a market yield for the security under review can be fairly estimated by interpolation or extrapolation from the yields of the "similar" security" or securities. Where a security has several components, appropriate consideration may also be given to the prices or yields of the various components of the security.

The degree to which a "security is similar" as that term is used in Items 3, 4, and 5 above, may be determined by factors that include but are not limited to:

1. Credit quality considerations, such as whether the security is issued by the same or similar entity, bears the same or similar credit rating, or is supported by a similarly-strong guarantee or collateral;

2. The extent to which the security trades at a comparable spread over Treasuries of similar duration;

3. General structural characteristics of the issue, such as coupon, maturity, duration, complexity or uniqueness of the structure, callability, the likelihood that the security will be called, tendered or exchanged, and other embedded options; and

4. Technical factors such as the size of the issue, the size of the transactions or quotations being compared, the float and recent turnover of the issue and legal restrictions on transferability.

In the case of those debt securities that trade with significant equity-like characteristics (that is, where the value of the security is highly dependent on the particular circumstances of the issuer rather than responding to changes in interest rates in a manner typical of most other debt securities), the use of comparisons with similar securities of unrelated companies will generally not be relevant.

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

In its filing with the Commission, the NASD 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. NASD Regulation 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

I. Purpose

The Government Securities Act of 1986 ("GSA") established a federal system for the regulation of brokers and dealers who transact business in

market price. SEC v. Feminella, 947 F. Supp. 722, 729 (S.D.N.Y. 1996).

⁹ See, e.g., F.B. Horner & Associates, Inc., 50 S.E.C. 1063 (1992).

¹⁰ Lehl v. SEC, 90 F.3d 1483, 1485-96 (10th Cir. 1996); First Independence Group, Inc. v. SEC, 37 F.3d 30, 32 (2d Cir. 1994); Orkin v. SEC, 31 F.3d 1056, 1064 (11th Cir. 1994).

¹¹ Alstead, Dempsey & Co., 47 S.E.C. 1034 (1984).

¹² Kevin B. Waide, et al. S.E.C. 932, 935-37 (1992) ("Waide"). See also Strategic resource management,

Inc., Exchange Act Release No. 36618 (Dec. 21, 1995), (market makers in equity securities are not subject to the Waide analysis).

¹³ In analyzing the factors, the relative importance of the factors, listed depends on the facts and circumstances relating to the transaction, such as the order size, timeliness of the source of information, and the relative spread of the quotations. In addition, because the ultimate evidentiary issue is the prevailing market price, isolated transactions or quotations generally will not have much, if any, weight or relevance. Finally, in the case of a mark-up charged by a dealer that is not a market maker, the price must be based on the bid side of the market or, in the case of a mark-down, the offer side.

government securities and certain other exempted securities. The GSA, however, did not grant the NASD authority to apply its sales practice rules to such transactions. In December 1993, Congress enacted the Government Securities Act Amendments of 1993, which eliminated the statutory limitations on the NASD's authority to apply its sales practice rules to transactions in exempted securities, including government securities, but excluded municipal securities ("previously exempted securities").

On July 15, 1994, the NASD Board of Governors ("NASD Board") authorized publishing the proposed mark-up interpretation for member comment. (See Notice to Members ("NTM") 94-62 (Aug. 1994).¹⁴ The mark-up interpretation filed in SR-NASD-97-61 on August 20, 1997, was revision of the mark-up interpretation that was originally published in NTM 94-62.

The mark-up interpretation for transactions in debt securities set forth in Amendment No. 1 ("Debt Mark-Up Interpretation") reflects the additional efforts of NASD Regulation to address the application of the NASD's general rule concerning fair pricing, Rule 2440, to fixed income securities. Because of the lapse of time since the filing of SR-NASD-97-61, NASD Regulation is substituting new language of Rule IM-2440-2 in its entirety for that contained in the original filing and deleting the previously filed discussion under Part II., A., entitled "Purpose," and substituting this text, which sets forth again the purpose of the proposed Debt Mark-Up Interpretation, appropriately amended to reflect changes in the text of proposed Rule IM-2440-2.

The NASD's existing policy relating to appropriate mark-ups in transactions with customers in current Rule IM-2440, "Mark-Up Policy," was adopted by the NASD to provide guidance in applying Rule 2440, which generally requires members to conduct transactions with customers at fair prices. In particular, Rule IM-2440 (proposed to be renumbered as Rule IM-2440-1) provides guidance in

determining whether a mark-up or mark-down is reasonably related to the prevailing market price of a particular security. Rule IM-2440 states that, in the absence of other bona fide evidence of the prevailing market, a member's own contemporaneous cost is the best indication of the prevailing market price of a security. With regard to debt securities, Rule IM-2440 notes that a higher percentage mark-up customarily is appropriate for a common stock transaction compared with the transaction in a debt security of the same size.

Rule 2440 and Rule IM-2440 apply to all over-the-counter transactions, whether in listed or unlisted equity and debt securities. These rules apply to corporate debt transactions but do not apply to exempted securities, such as government securities. After approval of the proposed rule change, these rules will apply to all debt securities, except municipal securities. Fraudulent mark-ups, however, violate existing legal standards and NASD Rule 2110, which prohibits conduct that is inconsistent with just and equitable principles of trade.

Rule IM-2440 describes a number of factors to be considered in determining the fairness of a mark-up or mark-down, and generally limits permissible mark-ups to no more than five percent. This test is not a bright line standard, however, and the appropriateness of the amount of a mark-up in a given case is heavily affected by the facts and circumstances of each case.

Under the law derived from Commission and NASD decisions applying the Mark-Up Policy, as approved by court review, the prevailing market price of a particular security for pricing purposes may be demonstrated by reference to inter-dealer transaction prices or, in some cases, quotations, where those quotations are validated by actual transactions that are close in time to the trade in question. Where such prices or quotations do not exist, the mark-up must be determined by reference to the dealer's contemporaneous cost of acquiring the security, absent other *bona fide* evidence of the prevailing market price.

The importance placed by the NASD on fair pricing and current Rule IM-2440 reflect the critical role that fair pricing considerations play in assuring the integrity of security markets and the confidence that investors place in those markets. The Debt Mark-Up Interpretation attempts to adequately protect those interests in a way that gives due consideration to the differences between debt and equity

markets, and the differences among various debt instruments and their markets, but does not depart from the basic tenets of current Rule IM-2440.

In general, proposed Rule IM-2440-2 is based on the premise that the fundamental principles that are applied to mark-ups in equity markets apply also to the debt markets. Specifically, proposed Rule IM-2440-2 seeks to provide guidance as to how to determine the "prevailing market price" for debt securities. This determination forms the basis for calculating the amount of an appropriate mark-up or mark-down in a particular transaction.

Proposed Rule IM-2440-2 distinguishes transactions entered into by dealers who are market makers and states that market makers ordinarily are entitled to calculate mark-ups based on their contemporaneous sales prices to other dealers. The Debt Mark-Up Interpretation does not address the application of mark-up principles in cases involving a market maker that exercises domination and control of a market in a particular security but notes that in such cases, the dealer's contemporaneous cost is the best evidence of the prevailing market price.

Proposed Rule IM-2440-2 recognizes that debt and equity markets often differ in the extent and availability of inter-dealer transaction prices for a particular security. It makes clear that a dealer, other than a dealer acting as a market maker in a particular security, must be prepared to rely on its own contemporaneous cost in acquiring a security when pricing the security for mark-up purposes, unless the dealer made no contemporaneous trades or can show that in the particular circumstances the dealer's cost is not indicative of the prevailing market price.

The Debt Mark-Up Interpretation sets forth various factors other than contemporaneous cost that relate to the prevailing market price of debt securities. Some of these factors relate to yields derived from "similar securities." In addition, in determining whether one security is sufficiently "similar" to another for these purposes, the Debt Mark-Up Interpretations sets forth four factors to consider. In this respect, proposed Rule IM-2440-2 recognizes that securities of different types and issuers may be more highly fungible in debt than in equity markets, to the extent that debt markets are more often driven by yield than by other considerations that are unique to a particular issuer.

Difficult questions often are posed with respect to mark-ups of debt securities that are relatively illiquid or

¹⁴ At the same time the mark-up interpretation was published, the NASD also published a suitability interpretation ("Suitability Interpretation"). The many public comments received about the Suitability Interpretation raised significant issues. As a result, the Association deferred action on the proposed mark-up interpretation until the Commission approved the Suitability Interpretation and the NASD's general authority to subject persons engaging in transactions in previously exempted securities to specified rules in the Rule 2000 Series, the Rule 3000 Series, and related rules. See SR-NASD-95-39, Securities Exchange Act Release No. 37588 (Aug. 20, 1996), 61 FR 44100 (Aug. 27, 1997); and NTM 96-66 (Oct. 1996).

that are designed for a particular customer or type of customer. The Interpretation presumes that a comparison to "similar" securities may be helpful in establishing the prevailing market price in these cases, while adhering to the principle that contemporaneous cost remains the default standard in these cases unless the dealer can show that this measure is not indicative of the prevailing market price.

The Debt Mark-Up Interpretation provides guidance regarding how members, in their principal transactions, should determine the prevailing market price of a government or other debt security as the basis for establishing the amount of the mark-up or mark-down for the security. In providing such guidance, proposed Rule IM-2440-2 addresses consideration of factors relating to yields and related prices of similar securities.

Description of Proposed Rule

Standard for Determining the Prevailing Market Price

The Debt Mark-Up Interpretation is not intended to represent a departure from Rule IM-2440 (proposed to be renumbered as Rule IM-2440-1), but is being proposed to more accurately apply existing principles to government securities and other debt securities. It states that "the prevailing market price for a security against which to measure a mark-up or mark-down is based primarily on the dealer's contemporaneous cost or, in certain cases, contemporaneous inter-dealer transaction prices in that specific security."

The proposed Debt Mark-Up Interpretation notes that contemporaneous cost is not always the best indicator of prevailing market price in certain circumstances. As is the case in the equity markets, integrated dealers who sell both to retail customers and also act as wholesale market makers in active and competitive markets are permitted to calculate mark-ups from their contemporaneous sales prices to other dealers. This principle recognizes that contemporaneous transactions by market makers in active and competitive markets constitute highly reliable evidence of the prevailing market price and thus, in these circumstances, the presumption that contemporaneous cost provide the best measure does not apply. The Debt Mark-Up Interpretation states that, in the context of the debt markets, a market maker is a dealer who, with respect to a particular security, furnishes *bona fide* competitive bid and offer quotations on

request and is ready, willing, and able to effect transactions in reasonable quantities at his or her quoted prices with other brokers or dealers. This language recognizes that dealers in debt markets may act effectively as market makers in a group of securities without publishing continuous two-sided quotations for each security within the group. Consistent with these principles as recognized in the equity markets, this rationale does not apply where a market is dominated and controlled by one firm.

In addition, the Debt Mark-Up Interpretation notes that contemporaneous cost is not the appropriate measure where the dealer made no contemporaneous trades in the security in question. In this regard, the Debt Mark-Up Interpretation states that a transaction is "contemporaneous" if it occurs close enough in time to a later transaction that it would reasonably be expected to reflect the current market price for the security. Conversely, a transaction is not contemporaneous if it is followed by intervening changes in interest rates or other market events that reasonably would be expected to affect the market price.

In cases where a contemporaneous trade does exist, a dealer that is not a market maker may adduce countervailing evidence when it can show that in the particular circumstances cost is not indicative of the prevailing market price. The Debt Mark-Up Interpretation cites, for example, the circumstance in which a dealer can show that the securities were bought from knowledgeable customers at prices below the prevailing market price.

Evidence That Overcomes the Presumption Regarding Contemporaneous Cost

The Debt Mark-Up Interpretation states that when inter-dealer transactions are not available, a dealer that effects a transaction in government securities or other debt securities with a customer and determines the mark-up or mark-down on a basis other than its own contemporaneous cost, must be prepared to "provide evidence that is sufficient to overcome the presumption that contemporaneous cost provides the best measure of the prevailing market price."

A member should maintain sufficient information and documentation to overcome the presumption and to justify the price relied upon in such circumstances. The type of information that should be maintained will vary from member to member, based on the type of security in question. However,

the information being maintained should place the member in a position to provide a clear and concise explanation when questioned about its mark-ups and mark-downs. Examples of such factors supporting *bona fide* evidence of a better market price, however, could include information such as the pre-payment speeds (PSA) used when pricing the debt instrument being acquired or sold, and the yield curve for U.S. Treasury securities at the time the transaction is executed.

Reliance On Other Transaction Prices and Quotations

The Debt Mark-Up Interpretation states that, in the absence of inter-dealer transactions, other factors may be taken into consideration in determining the prevailing market price of debt securities. None of the factors listed is intended to be per se *bona fide* evidence of a better market price. This determination must always be made by the member on a case-by-case basis.

The first factor is prices of any dealer transactions in the security in question with institutional accounts with which any dealer regularly effects transactions in the same or a similar security. This statement recognizes that the regularity of dealing with other institutions in the same security may increase the validity of referencing such transactions from pricing purposes.

The second factor for consideration is contemporaneous inter-dealer quotations in the security made through an inter-dealer quotation mechanism through which transactions do in fact occur at prices that are reasonably related to the displayed quotations.

The other factors enumerated are related to yields that are calculated by reference to similar securities, including yields calculated by reference to inter-dealer transactions, transactions with institutional accounts and validated inter-dealer quotations. Collectively, these factors assume that reliable indications of the market price for one security may be helpful in determining the market price for another security that is similar in terms of characteristics and trading environment. The inclusion of these factors reflects the importance of yield as a measure of comparison in the debt markets. However, the Debt Mark-Up Interpretation also states that, in considering such factors, firms may not rely on a limited, unrepresentative number of transactions. This point is particularly relevant with respect to isolated transactions with institutional accounts, the prices for which may be heavily affected by factors unique to the transactions, including the nature, size, and sophistication of the customers who

are counterparties to the transactions. The inclusion of this factor is intended to recognize that in some cases, institutional customers that trade frequently in the debt markets may possess levels of sophistication and influence that are equivalent to dealers in the same markets.

Determining the "Similarity" of Securities for Pricing Purposes

The consideration of similar securities for pricing purposes requires a determination that other securities are, in fact, similar enough to be used as a pricing reference. The proposed rule change, therefore, provides examples of factors that a member should consider to determine whether another security is similar enough to be a useful pricing reference.

The first factor for consideration relates to credit quality issues, i.e., whether the security is issued by the same or similar entity, bears the same or similar credit rating, or is supported by the same or a similar guarantee or collateral. These factors may be significant with regard to certain corporate debt and other securities for which creditworthiness is important.

The second factor for consideration is the extent to which a security trades at a comparable spread over U.S. Treasury securities of similar duration.

The third set of factors relates to the general structural characteristics of the issue, including coupon, maturity, duration, complexity or uniqueness of the structure, callability (and likelihood of being called, tendered or exchanged), and other embedded options.

The fourth set of factors relate to other issues that may affect how the market determines prices for the security in certain circumstances, such as the size of the issue, the size of the transactions or quotations being compared, the float and recent turnover of the issue and legal restrictions on transferability.

The factors described relate both to the unique characteristics of the security and also to the characteristics affecting the trading market for the security in question. The latter set of factors, e.g., the extent to which a security trades at comparable spreads to U.S. Treasury securities, are intended to refer to the market that exists at the time of the transaction that is being analyzed for purposes of determining the mark-up

Applicability to Particular Debt Securities

The Debt Mark-up Interpretation states that it is not intended to apply to all debt securities. It clarifies that the use of similar securities of unrelated companies will generally not be relevant

for pricing purposes in the case of those debt securities that trade with significant equity-like characteristics (that is, where the value of the security is highly dependent on the particular circumstances of the issuer, rather than responding to changes in interest rates in a manner typical of most other debt securities).

2. Statutory Basis

NASD Regulation believes that the proposed rule change is consistent with Section 15A(b)(6) of the Act,¹⁵ which requires, among other things, that the Association's rules be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest. The NASD believes that the proposed Debt Mark-Up Interpretation will provide guidance regarding mark-ups and mark-downs in fixed income securities and will aid members in complying with their obligations under the Association's rules, including Rule 2440.

B. Self-Regulatory Organization's Statement on Burden on Competition

NASD Regulation 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, as amended.

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

The proposed rule change was published for comment in NASD Notice to Members ("NTM") 94-62 (Aug. 1994), and eight comment letters were received in response. Of the eight comment letters, one was in favor of the proposed rule change without change, six were in favor with recommendations, and one was opposed. Because a period of time has elapsed between the filing of SR-NASD-97-61 and the amendments, by Amendment No. 1, NASD Regulation is deleting the previously filed discussion under Part II, C., and substituting this text, which sets forth the concerns of the commenters and the Association's response, appropriately amended to reflect any changes in the text of the Debt Mark-Up Interpretation.

The Debt Mark-Up Interpretation reflects revisions from the proposal contained in NTM 94-62 and this proposed rule change (SR-NASD-97-61) as it was originally filed. These

changes should provide additional guidance to members.

With several revisions, the Association seeks to clarify that the Debt Mark-Up Interpretation is not a departure from the Association's existing Mark-Up Policy, but rather makes clearer the application of the Mark-Up Policy to markets for government and other debt securities. First, a statement to this effect has been added to the Debt Mark-Up Interpretation. In addition, for similar reasons, a sentence has been added in the first paragraph to reiterate the long-standing policy that the mark-up or mark-down from the prevailing market price for most types of government and other debt securities should usually be substantially less than 5 percent.

The fifth paragraph of the Debt Mark-Up Interpretation has been modified to clearly articulate that, absent countervailing evidence, the contemporaneous cost to the dealer of acquiring a security should be used as the basis for determining a mark-up, although the new Debt Mark-Up Interpretation also explicitly says this standard does not apply to market makers, who generally are able to price from their inter-dealer sales prices. The Debt Mark-Up Interpretation also contains language to clarify that where inter-dealer transactions are not available, a dealer determining a mark-up or mark-down on a basis other than its own contemporaneous cost must be prepared to provide evidence that is sufficient to overcome the presumption that contemporaneous cost provides the best measure of the prevailing market price of the security.

In addition, to provide more clarity in the Debt Mark-Up Interpretation relating to the pricing of a security when a dealer is a market maker or when the dealer is engaging in a riskless principal transaction, the Association has added the following. First, the Debt Mark-Up Interpretation defines market maker in the context of fixed income securities and also makes clear that a dealer who is a market maker in an active, competitive market is permitted to calculate its mark-up from contemporaneous sales prices to other dealers, rather than relying on the dealer's own contemporaneous cost in acquiring the security. Second, proposed Rule IM-2440-2 notes that the Commission has held that when a dealer that is not a market maker effects a riskless principal transaction, the dealer's cost must always be used as the basis for the mark-up.

The Debt Mark-Up Interpretation also addresses the increased complexity for compliance and enforcement purposes

¹⁵ 15 U.S.C. 78o-3(b)(6).

surrounding use of similar securities for pricing purposes. Central to this matter is the issue of which characteristics make two securities similar enough for pricing purposes. In the seventh paragraph, the Debt Mark-Up Interpretation states that, ideally, a security should be sufficiently similar to the security under review that it would serve as a reasonable alternative to an investor seeking the risk profile of an investment in the security under review. It also states that, at a minimum, a security or securities should be sufficiently similar that a market yield for the security under review can be fairly estimated by interpolation or extrapolation from the yields of a similar security or securities.

The Debt Mark-Up Interpretation also clarifies that the factors listed for consideration in determining the prevailing market price of a particular security should not be mechanically prioritized in the order listed. Rather, the relative importance of the factors listed depends on the facts and circumstances relating to the transaction, such as the order size, timeliness of the source of information, and relative spread of the quotations.

In note one, the Association has clarified that certain regulatory issues that are related to the pricing of a security are not intended to be addressed by the proposed rule change. Specifically, the Debt Mark-Up Interpretation does not apply to transactions involving the domination and control of the market for a particular security.

Specific Comments

Two commenters (Nos. 1 and 6) expressed concerns that the list of factors for consideration in determining the prevailing market price of a security are not correctly prioritized. One commenter (No. 1) suggested that the Debt Mark-Up Interpretation clarify that the factors used to determine the prevailing market price are not necessarily listed in preferential order, or if so, that the factors be reordered to reflect that factors such as inter-dealer transactions in similar securities and validated inter-dealer quotations in similar securities are more significant factors than their current order in the list indicated. Similarly, one commenter (No. 6) stated that the first two factors, *i.e.*, prices of dealer transactions with institutional customers and validated inter-dealer quotations in the same security, may be equally as rare as inter-dealer transaction prices for some debt securities, particularly for those securities specifically designed to meet the needs of a specific investor. In

response, the Debt Mark-Up Interpretation now contains a footnote stating that the relative importance of the factors listed depends on the facts and circumstances relating to the transaction, such as the order size, timeliness of the source of information, and relative spread of the quotations. In addition, because the ultimate evidentiary issue is the prevailing market price, isolated transactions or quotations generally will not have much, if any, weight or relevance. Finally, when those factors are applied to trades by dealers that are not market makers, the footnote states that the mark-up must be based on the bid side of the market, *e.g.*, the inter-dealer bid quotation, or in the case of a mark-down, on the offer side of the market, *e.g.*, the inter-dealer offer quotation.

One commenter (No. 1) questioned why some of the factors listed for determining the prevailing market price reference the term "price" and the other factors reference the term "yield." This commenter also was concerned that the proposal did not clarify that most bonds are traded on a "basis-point spread" against U.S. Treasury securities and that debt securities with similar characteristics will trade at similar "base-point spreads" against comparable U.S. Treasury securities. The commenter argued that this issue is important because it is the practice in the government security inter-dealer market to determine a particular bond's market price by comparing it with the basis-point spread of similar securities rather than a similar security's "execution price."

In response, NASD Regulation agrees with the commenter that the terms "price" and "yield" are interchangeable for referencing transactions in the "same security." However, the terms are not interchangeable when referencing "similar" securities. This distinction exists because similar securities may have different prices depending on their maturity, coupon, or other characteristics, while at the same time the yields of the two securities may be related (for example, both trade with a similar basis-point spread against U.S. Treasury securities). NASD Regulation has continued to frame the first two factors in terms of price because the Association preliminarily believes that these factors will be more readily understood in this way, although NASD Regulation would wish to consider any comments on whether the Debt Mark-Up Interpretation should provide more focus on yield.

One commenter (No. 1) raised concerns that the proposed rule change should reflect that the prevailing market

price of a government security will depend on whether the transaction involves an odd or whole lot and, further, that the wholesale price of government securities, in general, varies depending on the quantity of the securities in the transaction involved. In response, the Debt Mark-Up Interpretation provides that the degree to which a security is "similar" to another security may be determined by technical factors, such as the size of the transactions and quotations being compared.

One commenter (No. 1) questioned the merit of proposed language that would allow a member to aggregate the value of components of a security where such values can be derived from prices or yields of similar securities as reflected in transactions or quotations in the market between dealers or with sophisticated institutional customers. The commenter suggested that this was actually a subset of what could be taken into account when evaluating prices of similar securities, rather than a discrete approach for determining the prevailing market price of a particular security. NASD Regulation concurs with the comment and the language in question was deleted from the Interpretation.

One commenter (No. 2) suggested that the proposed rule change should contain a definition of the term "contemporaneous cost." In response, in the fifth paragraph NASD Regulation has stated that a transaction is "contemporaneous" if it occurs close enough in time to a later transaction that it would reasonably be expected to reflect the current market price for the security, and that a transaction is not "contemporaneous" if it is followed by intervening changes in interest rates or other market events that reasonably would be expected to affect the market price.

One commenter (No. 3) recommended that the proposed rule change use the "fair and reasonable" pricing approach employed by Rule G-30 of the Municipal Securities Rulemaking Board ("MSRB"). Similarly, one commenter (No. 4) suggested that the proposed rule change should address the size of spreads of different government securities, taking into account the complexity and familiarity of the industry with the type of security. In response, NASD Regulation notes that the Debt Mark-Up Interpretation is not intended to duplicate or replace either Rule 2440 or the Mark-Up Policy, which provide a regulatory purpose similar to MSRB Rule G-30, but to apply the principles of these NASD rules to the debt markets for purposes of determining the prevailing market price

of a particular security on which to base a mark-up or mark-down. The Mark-Up Policy also currently allows for differences in mark-ups and mark-downs based on considerations such as the complexity of the security.

One commenter (No. 8) supported the methodology contained in the proposed rule change, but noted that a degree of subjectivity will of necessity accompany the use of the factors. Similarly, one commenter (No. 6) stated that the process of evaluating the degree of similarity between and among securities is clearly more subjective and qualitative than reference to actual prices or quotations in the same security, and subsequently, much will depend on the analytical approach utilized by members, customers and regulatory officials to determine which securities are similar. This commenter, therefore, suggested that a continuing effort may be required to refine the NASD's regulatory approach to determining and quantifying degrees of similarity among debt securities. NASD Regulation acknowledges that the Debt Mark-Up Interpretation, in providing guidance, does not answer all questions that will arise but presently does not believe that more objective standards are feasible. NASD Regulation would wish to consider any comments relating to this issue.

One commenter (No. 1) noted that the proposal contained the two terms, "sophisticated institutional investors" and "institutional accounts," which appeared duplicative. In response, NASD Regulation replaced the term "sophisticated institutional investors" with the term "institutional accounts."

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 90 days of the date of publication of this notice in the **Federal Register** or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents,¹⁶ the Commission will:

(A) by order approve such proposed rule change, or

¹⁶ The NASD will file Amendment No. 3 consenting to a period of 90 days, beginning from the date of publication of notice of filing of the proposed rule change SR-NASD-97-61 in the **Federal Register**, for the Commission to act as provided in Section 19(b)(2). Telephone conversation between Sharon Zackula, Assistant General Counsel, NASD Regulation, and Karl Varner, Attorney, SEC (Sept. 30, 1998).

(B) institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, DC 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 in the Commission's Public Reference Room. Copies of the filing will also be available for inspection and copying at the principal office of the NASD. All submissions should refer to the File No. SR-NASD-97-61 and should be submitted by December 7, 1998.

For the Commission, by the Division of Market Regulation, pursuant to delegated authority.¹⁷

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 98-26998 Filed 10-7-98; 8:45 am]

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SECURITIES AND EXCHANGE COMMISSION

[Release No. 34-40496; File No. SR-PCX-98-42]

Self-Regulatory Organizations; Notice of Filing and Immediate Effectiveness of Proposed Rule Change by the Pacific Exchange, Inc. Relating to Equity Rate Reduction and Simplification

September 29, 1998.

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 September 8, 1998, the Pacific Exchange, Inc. ("PCX" or "Exchange") filed with the Securities and Exchange

Commission ("Commission" or "SEC") the proposed rule change as described in Items I, II, and III below, which Items have been prepared by PCX. 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

PCX proposes to change its Schedule of Fees and Charges for Exchange Services for equity trade-related transaction charges. The text of the proposed rule change is contained in Exhibit A.

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

In its filing with the Commission, PCX 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. PCX 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

1. Purpose

Currently, under the Schedule of Fees and Charges for Exchange Services, members are subject to equity trade-related charges based on cumulative billable trade value per month. The value charges are incremental and resulting charges are subject to discounts for automated trades. The Exchange proposes to reduce transaction charges and simplify the way volume based charges are calculated. Specifically, the Exchange proposes to eliminate listed comparison charges, reduce transaction fees and establish a share-based structure with four tiers (as opposed to the current value-based structure with seven tiers and twelve discount categories). The Exchange also proposes to cap block transactions at 20,000 shares, and to continue to waive transaction and off-board comparison charges in AMEX-listed issues.

¹⁷ 17 CFR 200.30-3(a)(12).

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.